Adrian Orr: We are not alone with monetary policy

Comment by Mr Adrian Orr, Governor of the Reserve Bank of New Zealand, 28 August 2019.

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It was clear that even in the remote mountain region of the US state of Wyoming we were among the crowd.

The annual August Kansas Federal Reserve's summit of many of the world's central bankers vividly highlighted our commonality. Inflation has been low and stable, and many labour markets are near their peak loading. New Zealand included. Independent central banks have successfully achieved their inflation goals, promoting economic wellbeing.

Yet, there was no vigorous back patting. There were mostly furrowed brows.

A slowing global economic outlook, increasingly prompted by pockets of volatile politics, is keeping the world's central bankers busy. In response to the economic chill, central banks around the world have lowered interest rates – often to record lows – to promote investment and spending. They continue to pursue their mandated low inflation goals.

That's our job. We aim to keep inflation low and stable and contribute to maximum sustainable employment. This is the best we can do as a central bank to promote economic wellbeing. We have the one main instrument – the interest rate lever or price of money – and we use this tool with our best view of what's on the horizon. We provide forward guidance on our expected activity, but remain flexible to incoming data.

Monetary policy remains as effective as ever, and for small open economies like New Zealand, the exchange rate plays a significant additional role in competitiveness. Our research gives us confidence that even at these low levels of interest rates, monetary policy remains as effective as ever at providing timely economic stimulus.

As the Governor of the Swedish central bank noted – those who think that monetary policy is losing its vigour should think of the alternative. Higher interest rates over recent times would have meant we undershot our inflation and employment goals, have significant weaker activity, and a rising domestic exchange rate – until it was unsustainable.

But there are natural limitations to what central banks can achieve with their tools, and if operating alone.

Global integration, productivity and technology, governments' fiscal and regulatory policies, changing demographics, consumer preferences and climate, and unanticipated events – including political volatility – play the dominant role in long-term prosperity.

Central banks operate within this context and need all policy levers working. My colleagues at the summit were very humble as to our influence over long-term economic growth prospects beyond our stable inflation contributions. Undoubtedly we are in new low inflation and interest rate territory collectively. Colleagues were interested to hear about each others' experiences and our recent decision to cut the Official Cash Rate by 50 basis points – as were most New Zealanders.

First, the interest rate lever is blunt. It is not personalised.

Savers (investors) and consumers are treated equally, and are often the same person doing various activities. We make our interest rate decision to best bring about prosperity and wellbeing of all New Zealanders in the long-term. This decision is repeated frequently – aimed at the same inflation and employment goal – as circumstances change.

Our recent OCR cut reflected an expected decline in trading partner growth, lower NZ inflation expectations, and a global swing to lower interest rates. It also reflected the ongoing funk global and domestic business confidence is in. Geopolitical uncertainty is paralysing decision making in major business centres – trade tensions, Brexit, Hong Kong, North Korea and so on – have all meant investment is lower than normal.

The NZ waka is tied off to the global 'risk free' interest rate wharf. When the global rate declines, we need more rope – or face a rising exchange rate and tighter financial conditions than needed.

Second, how you respond to lower interest rates is personal.

Lower interest rates stimulate investment (funding costs are lower as are expected hurdle rates of return). Income derived from passive savings in the bank is lower – prompting more active investment decisions. Asset prices rise as the present value of their future earnings rises. And spending – both government and the public – becomes more affordable, at least until consumer prices start to rise again. And a lower than otherwise NZ dollar will promote export earnings.

So how you feel about low nominal interest rates personally comes down to which of the activities you may be involved in. The central bank can only focus on the long-term wellbeing of all. There are different outcomes for different people. Home owners may feel wealthier, those outside of this asset market would be facing a higher price to buy but at more affordable servicing costs. Savers in low risk deposits will need to invest more actively – and so on.

Finally, a key concern amongst my international colleagues is that central banks are being tasked with more and more challenges – and public expectations continue to rise also.

The discussion was clear. Monetary policy (the domain of central banks) has its limitations and needs to be partnered with broader fiscal and structural economic policy (the domain of the government of the day). Likewise, business people need to consider a much longer-term horizon when investing, looking through the omnipresent political uncertainties de jour.

We are not alone in the Aotearoa waka. Other economic levers need to be utilised effectively to enhance social cohesion and wellbeing. The Bank's regulatory activity includes promoting financial stability. We have our prudential tools set to ensure our financial institutions are robust financially and culturally. This is our best lever into financial soundness and inclusion.

Providing certainty in uncertain times is a great skill to have, and central bankers world-wide are working hard to do just that. They are being challenged on communication – what they can and can't influence and how they are doing this.

We understand that lower interest rates do not remove the global political uncertainty. But they do offer greater certainty on the financial and investment front. Businesses and governments should be re-assessing their hurdle rates on their investment projects. Low and stable global interest rates mean that what was once costly may now be a sound investment for the future.

The Reserve Bank is among the global central banking crowd – we are not alone. But we need other actors to assist and understand.

Kia kaha.