Adrian Orr: Opportunity or risk? Our choice

Speech by Mr Adrian Orr, Governor of the Reserve Bank of New Zealand, to the NZX Issuer Forum, Auckland, 26 September 2019.

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Tēnā koutou katoa,

Welcome everyone and thank you for inviting me to come and speak to you today at the NZX Issuer Forum.

I want to talk about some of the near-unprecedented challenges facing monetary policy, and how longer-term thinking can assist in our efforts to meet these challenges. The fact that we are celebrating the 150th anniversary of the NZX this year is a great prompt for longer-term thinking.

First, the here and now. Yesterday's Official Cash Rate announcement follows the Monetary Policy Committee's August decision to reduce the OCR by 50 basis points to 1.0 percent, the lowest rate since the OCR was introduced in March 1999.

When we made our August announcement we were rightly challenged by some commentators as to whether we knew something more than the conventional economic indicators have been showing? Our answer remains – no we don't. We operate in a transparent manner with primarily public data, but it is our job to be forward-looking.

In making our decision, we assessed that the impact on the New Zealand economy from slowing global economic growth and persistently low inflation necessitated further monetary stimulus – so as to maintain our inflation and employment objectives. We also judged that it would be better to move early and large, rather than risk doing too little too late. A more tentative easing of monetary policy risked inflation expectations remaining stubbornly below our inflation target, making our work that much more difficult in the future.

We are pleased with the outcome of our decision to date. Interest rates have declined across the board, as retail banks have passed lower lending rates to many businesses and consumers. The New Zealand dollar exchange rate also eased, and the cumulative impact of the easier monetary conditions is now working through the economy. Lower interest rates alter peoples' investment decisions, especially with the confidence that interests rates will stay low for a long time ahead.

In forming our policy position we spend significant effort monitoring domestic and international economic trends. Over recent weeks, for example, we have visited and listened to a wide group of New Zealand business people. What we heard is that demand for New Zealand's goods and services remains sound. However, there is a multitude of business concerns and challenges.

A common concern was that business capacity remains stretched, with some firms struggling to fill vacant roles or even find accommodation for their workers in the same region. Likewise there was a strong need to invest to expand capacity and productivity, but access to resources – land, capability, and equipment – was difficult. These are signs of an economy with ongoing momentum.

However, there was also discussion of rising economic headwinds from slowing global growth, and continued challenges to domestic business margins or profits. Many factors were sighted for the margin squeeze – global competition, low global inflation, and rising input costs as labour and capital resources become more scare. There were also plenty of stories of economic policy uncertainty, as global expectations rise with regard to environmental security, trade access, and climate change action. For a small trading nation, these issues impact confidence and investment.

Overall, we heard about an economy that is maintaining momentum, but demanding more policy certainty and business confidence, so that firms will invest for the long-term. These are quality business challenges.

We also spend a lot of effort assessing global economic developments. And this is where we are most challenged, but not alone. Global interest rates are now at a secular low level, in part for positive reasons and, in part, providing reason for concern.

The low level of interest rates globally over recent years primarily reflects low and stable inflation rates – a deliberate and desired outcome of monetary policy. This should be celebrated and not forgotten. We must not fall into the 'vaccination trap', where, for example, people observe that outbreaks of diseases are less frequent, and hence conclude there is less reason for continued vaccination.

Monetary policy has and remains effective when it comes to determining aggregate consumer price inflation.

Recently, in this restored low inflation environment, central banks across the world have faced a new challenge – inflation that is too low, and running consistently below inflation targets. This has prompted the need to reduce policy rates so as to stimulate spending and demand. However, given the low interest rate starting levels, some major central banks have had to implement negative interest rates and/or directly buy assets (increasing their balance sheets) so as to free up cash for the economy.

Understanding why inflationary pressures have eased so much is important as it helps us to calibrate our policy actions. As is often the case, there appear to be many reasons which we must balance.

The low inflation pressures are in part due to the slowdown in global economic growth, a regular cyclical event that central banks are well practiced in responding to. But there are also structural factors dampening inflation pressure and/or altering the impact of lower interest rates on investment and spending.

Some examples of structural changes include the changing nature of how we produce goods and services, with more reliance on global technology which is often delivered by a handful of global suppliers at single global prices. We are also producing more services, rather than physical goods as a proportion of total output, reducing our relative reliance on capital equipment and reducing our sensitivity to the cost of investment. Production locations are also mobile, and labour is highly mobile internationally, making wage bargaining harder even if there are domestic labour shortages. And, populations are ageing, as people live longer, leading to different preferences to save rather than consume.

By definition, these structural factors are slow moving, meaning they will anchor the historically low interest rates for some time to come. Meanwhile, central banks will continue to vary policy rates in response to cyclical factors, but rates will vary from a lower average, and possibly within a lower range than in the past.

In New Zealand, for example, we believe the neutral interest rate – the OCR that is neither contractionary nor expansionary for the economy – has drifted lower in recent decades. This is from a mid-point estimate of around 5 percent in the early 2000s, to around 3 percent today, with plenty of uncertainty around these mid-points.

The obvious challenge for many central banks, including us, is that the decline in the neutral rate means we have less room to manoeuvre our policy interest rates without concern for the zero per cent lower bound. What happens if we hit zero? Should the OCR go negative, and/or should we embark on direct asset purchase programme, and what other monetary policy strategies could be implemented?

We are currently thinking hard about these questions, because it makes sense to do so as a precaution – it's best to put the roof on when the sun is shining. Our current view is that we are unlikely to need 'unconventional' monetary policy tools. But we would be remiss not to be prepared.

We are in a good position to learn what to do, and not to do, from other central banks globally. Of course, one size does not fit all. New Zealand is a small, open, economy with a floating exchange rate, and a concentrated banking system. Hence, we need to tailor our own precautionary solutions, and understand intended and unintended consequences of different monetary policy tools.

We are certainly aware that the current low interest rates impact sectors of the economy differently. However, the dominant force to stimulate activity, employment and inflation across the economy as a whole is to bring forward spending and investment.

In terms of distributional impacts, low interest rates support employment opportunities and bolster asset prices and reduce the return on bank deposits. The opposite is true when interest rates are high and the net impact on household balance sheets will depend on the mix of assets they hold. Our role as a central bank is to contribute to overall economic prosperity by delivering an environment where inflation is low and stable.

Of course, there will be scenarios where monetary policy – whether conventional or unconventional – reaches its limits, and can no longer generate sufficient additional demand, or can only do so with undesirable or untenable side effects.

This is why many central bankers globally have said 'monetary policy needs friends'. The friends of central banks are government fiscal policy (taxes and public spending and investment) growth supportive structural policies, and the business confidence and capability to invest in productivity-enhancing infrastructure.

The good news for New Zealand, unlike many other OECD economies, is that our government's books are in good shape and there is already a strong fiscal impulse underway from public spending and investment. We have the trifecta of sound government finances, clear infrastructure demands, and low hurdle rates for investing.

The same can be said for corporate balance sheets in New Zealand, with relatively low levels of debt, and a strong demand for goods and services, our businesses are well placed to perform. So what is holding businesses and government back from further increasing investment and expenditure?

New Zealand's economic 'problem definition' appears well advanced, and the good news is the solutions sit largely with us as New Zealanders.

We have the macroeconomic stabilisers in place – well-established monetary policy practices and sound long-term fiscal parameters. However, there remains a loud call from all quarters of the country for leaders to better signal investment intent, and ensure we have the policy and goodwill to facilitate access to capital and resources to execute.

This call for investment-intent is to all collectively-owned (e.g., Iwi), Crown-owned (i.e., central and local government), and co-operatively owned (e.g., traditional primary sector) sectors. It is not just to traditional businesses, or any one party.

Easily said, harder to do without a clear desire to work together over an agreed horizon.

The Reserve Bank is working on a few long-term projects itself to ensure that our financial system is more resilient to economic slowdowns. Our Annual Report will be made public on Monday, outlining a wide range of investment activities.

Most importantly, we are acting to ensure New Zealand remains less susceptible to short-term, sometimes only fair-weather, funding that creates pockets of excess debt and exacerbates economic cycles.

We acknowledge that our actions at time may look confusing to the casual central bank observer.

On the one had we have set low interest rates to deliberately encourage investment and spending, which may be funded with higher debt. This is how monetary policy works.

On the other hand we are saying we are concerned about some pockets of debt – especially in some highly leveraged households (residential mortgages), and in some pockets of dairy farming (rural lending).

So how can we achieve more investment and more resilience at the same time? The good news is we have more than one tool at the central bank, and these tools work over different horizons and achieve different purposes.

For example, by now you should all be aware of the Reserve Bank's Capital Review proposal. Our proposals would see significant increases in shareholder capital in banks. With banks having more of their own 'skin in the game', the owners will sharpen their long-term customer focus, and it will reduce the chance of a bank failure and the cost on society as a whole should a bank fail. These outcomes are highly desirable for the long-term economic health of New Zealand, and should promote deeper and more liquid local equity and debt markets.

We finalise our decisions in early-December this year. Whatever our final decisions, we will be insisting on transition to higher capital at a sensible pace. But we will be talking more and better quality capital.

How have some lenders (banks) responded to date? Many of the large banks have spent the past 10 or so years lending aggressively to households and the dairy sector during the good times. They have also spent the last 12 months or so revisiting this wisdom, and have been raising their lending margins and/or making credit much harder to access for some customers – especially rural customers.

Such bank activity is pro-cyclical, fair weather, behaviour that leads to misallocated capital, industry booms and busts, and larger economic hardship on broad society – not the bank shareholders themselves. Over the last 12 months or so – as we have been working with all stakeholders on our capital proposals – we have reduced the OCR by more than the banks' estimated costs of the higher capital requirements. Yet, for some sectors of the economy, such as agriculture, their borrowing costs have risen. This can only happen if banks are significantly raising their margins.

This is not a sign of long-term thinking when it comes to bank borrowing and lending, and it is not a sign of a highly competitive banking services in core sectors of the New Zealand economy. We are monitoring this behaviour, to assess the degree of any 'front-loading' of our capital proposals, and I encourage all customers to question their banks on issues of competition.

I have covered a lot of ground. Why are interest rates so low? Why is this a global issue? What does it mean for New Zealand business and the Reserve Bank? What else can we do to take advantage of these low interest rates? And how can we better bolster the financial system to be more long-term in its capital allocation?

In summary, we are not alone in the low interest rate environment, this is a global phenomenon.

However, what we do have is more policy and business opportunities than most OECD economies and this is something that we need to take advantage of. We will need to be long-term in our planning and investing, and now is a good time to get ahead – given the trifecta of sound balance sheets in business and government, infrastructure gaps, and low hurdle rates to invest.

Meitaki, thank you