RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Monetary Policy: A Compass Point in Uncertain Times

Panel remarks delivered to Federal Reserve Bank of San Francisco

On 14 November 2019

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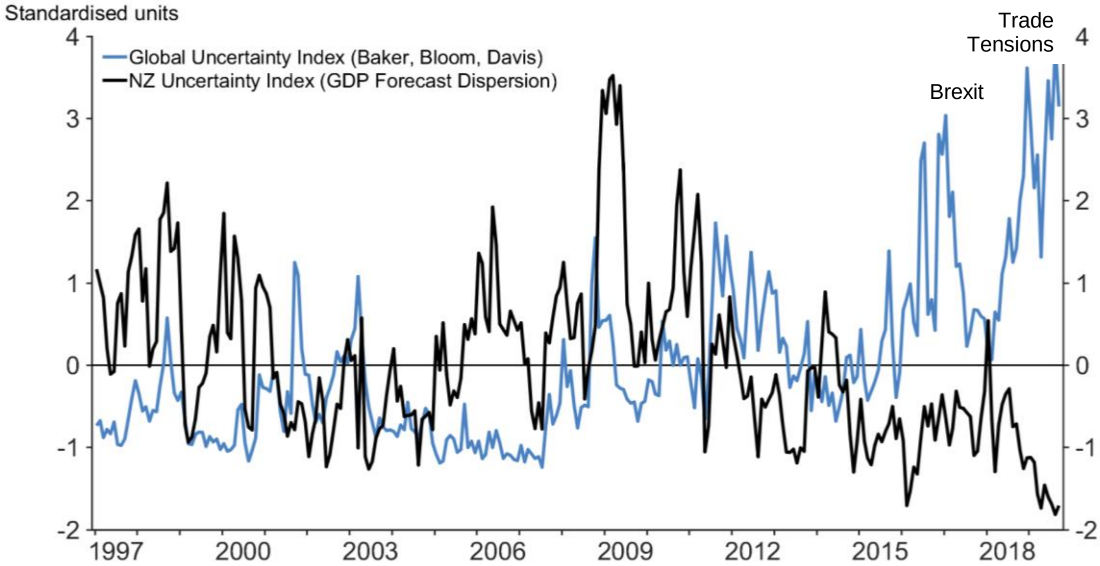
Introduction

Tēnā koutou katoa,

Thank you for inviting me to this panel discussion. It is a pleasure to speak on a topic that is so relevant to a small open economy like New Zealand—the effects of uncertainty and dampened global growth on monetary policy.

Heightened global uncertainty and slower international trade have contributed to a weakening in global growth since mid-2018. Much of the uncertainty is related to global developments, such as Brexit and the trade tensions between US and China (figure 1). In New Zealand, although some measures of uncertainty are relatively subdued, this may simply reflect a consensus that low growth is likely to stay in the near future.

Figure 1: Uncertainty indices for New Zealand and the world



Source: Bloomberg, RBNZ estimates (based on Rice, Vehbi, and Wong, 2018).

In light of this, it is vital that monetary policy acts as a compass point for decision making. We can do this by:

- Remaining focused on our core objectives;
- Adopting a risk-management approach for making monetary policy decisions; and
- Working in concert with all available policy levers—not as a lone force.

For New Zealand, this means setting policy to achieve our price stability target and support maximum sustainable employment. It means acting decisively to prevent an unnecessary worsening in economic conditions and the un-anchoring of long-term inflation expectations. And it means recognising the limits of monetary policy. Monetary policy has been relied on heavily over the past two decades given its success of anchoring inflation expectations and assisting the recovery from the Great Financial Crisis,[2] but it is not a long-term growth panacea.

[2] See Rogoff (2019).

Today I would like to discuss three topics:

- The impact of uncertainty on the New Zealand economy;
- How monetary policy in New Zealand is responding to these issues; and
- How clear communication and open-mindedness to new policy tools may help implementing our broadened mandate.

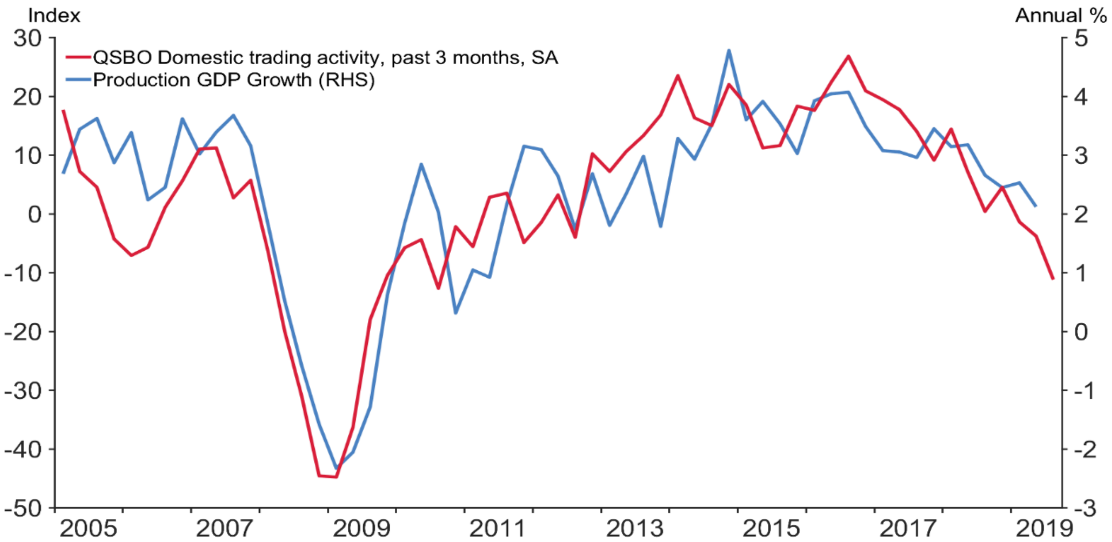
In discussing these topics, I will touch on how, since the Great Financial Crisis, central banks have been tasked with a widened set of objectives. On one hand, we appreciate the constraints faced by other institutes, and the peril that may have resulted from the crisis had central banks not stepped up to the task. On the other hand, central banks are sometimes expected to solve phenomena that are structural in nature, and that do not sit easily within the conventional realm of monetary policy. At the Reserve Bank, we are always exploring new policy options to meet our broadened mandate. In particular, we believe clear and honest communication injects not only certainty for decision makers, but also confidence to the public moving forward. I will elaborate on these points below.

Uncertainty and economic slowdown

Uncertainty and economic slowdown go hand in hand.[3] Uncertainty weighs on business confidence and makes firms hesitant to invest. This slows growth and holds down productive capacity. In our recent business visits, the biggest reported barriers to investment were:

- Policy uncertainty, particularly for infrastructure projects and environment policy;
- Regulatory requirements;
- Construction capacity constraints; and
- Access to finance.[4]

Figure 2: Falling business confidence is slowing business investment and GDP



Quarterly Survey of Business Confidence, and Stats NZ.

[3] See Rice, Vehbi, and Wong (2018) for analytical work on uncertainty.
[4] See the *November Monetary Policy Statement, Box 1* for the results of our recent business visits.

Business uncertainty highlights the importance of forward guidance and transparency when considering and setting economic policy. Even if the message isn't one that businesses want to hear, decision makers in business appreciate clarity and certainty.

In addition to the cyclical impact of uncertainty on business investment, there are also signs of a structural decline in business investment since the Great Financial Crisis.[5] If business investment remains low, this has a negative effect on our long-term prosperity. Our capital stock and productivity will struggle to develop, dragging down potential GDP growth. New Zealand's productivity growth has already been slow for some time.[6] Breaking out of this will require greater investment in technology, education, and infrastructure.

The Reserve Bank cannot directly make the investments the economy requires—this will have to come from the private sector and government. However, we can play a supportive role, which I will come to shortly. First, let's finish with the other impacts of uncertainty.

From a central bank perspective, uncertainty has one clear impact: it makes our job harder. Good monetary policy depends on reasonable forecasts. High uncertainty makes forecasting harder. There is more noise in the data and forecasts are more subject to revision. A consequence of this is that the Official Cash Rate (OCR) may be less predictable simply because the world in which we are making our decisions is less predictable.

Another challenge of uncertainty and low investment both globally and domestically is the downward pressure this creates on the global and domestic neutral interest rate. As a small open economy, our neutral interest rate is heavily driven by the global rate and we cannot escape this. A falling neutral interest rate will increasingly push the Reserve Bank to the limits of conventional monetary policy space, as we need to lower rates by a greater degree in order to achieve the same amount of stimulus as when the neutral rate was higher.

So, what can monetary policy do to offset the effects of global uncertainty and support our long-term prosperity?

Monetary policy response to uncertainty

The Reserve Bank can contribute to a stable economic environment by continuing to focus on fulfilling its dual-mandate.

Firstly, maintaining low and stable inflation enables organisations and individuals to carry out meaningful financial planning, by reducing overall uncertainty. This is something that is nearly impossible when prices are high and volatile or falling uncontrollably.

Secondly, when employment is near its maximum sustainable level, firms have a stronger incentive to make productivity-enhancing investments that raise their capacity.

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[5] This is hard to identify precisely, but is partly associated with the ongoing shift from manufacturing to services within the economy, with services contributing relatively lower measureable investment.
[6] See Nolan, Pomeroy, and Zheng (2019).

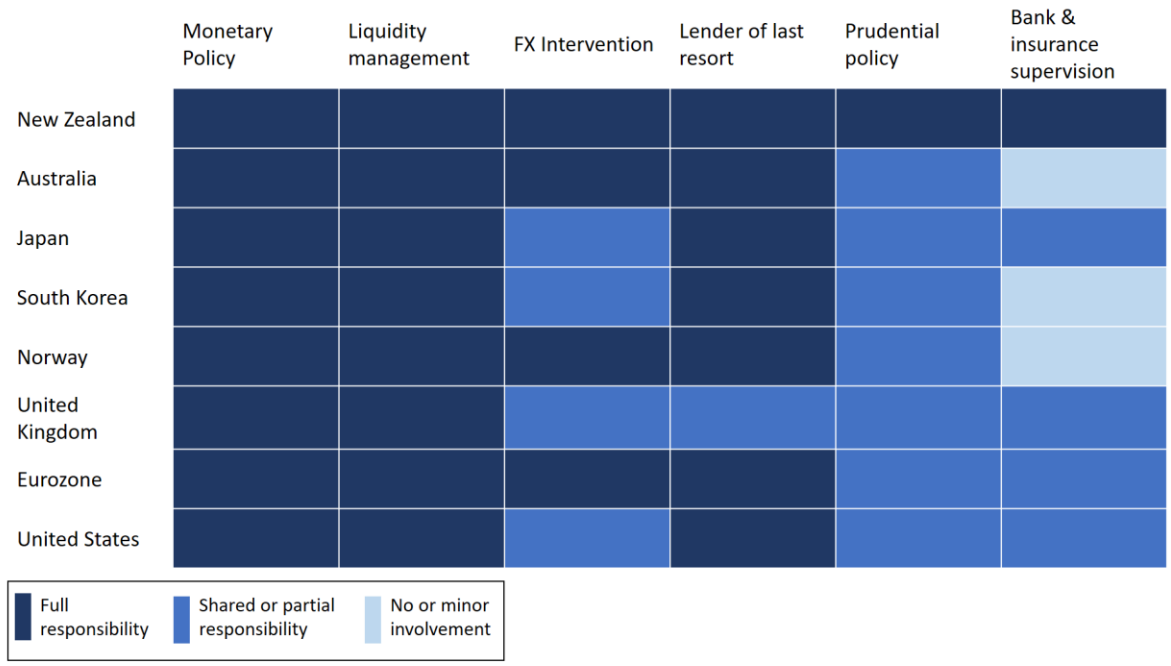
Uncertainty can affect the monetary policy response through the execution of this dual-mandate. In particular, it is now more suitable for us to take a risk-management approach. In short, this means we look to *minimise our regrets*. We would rather act quickly and decisively, with a risk that we are too effective, than do too little, too late, and see conditions worsen. This approach was visible in our August OCR decision when we cut the rate by 50 basis points. It was clear that providing more stimulus sooner held little risk of overshooting our objectives—whereas holding the OCR flat ran the risk of needing to provide significantly more stimulus later.

We can also address uncertainty through our communication and forward guidance, which are broad-ranging. We reveal our assessment of the economy—good or bad—to the public, so they can make decisions based on the best possible information amid the prevailing uncertainty. We voice the types of policies we believe may be needed to sustain long and prosperous growth—be they monetary, fiscal, or financial policies. We do not shy away from discussing our limitations in solving *all* economic problems. Ultimately, communication, and coordinated action from the full range of policy levers and policymakers will create the best pathway to a sustainable economy. We are promoting the foundation for this.

Ensuring consistency across the broad mandate of the Reserve Bank of New Zealand

The Reserve Bank of New Zealand is a full service central bank with a wide range of responsibilities (table 1). Each of these responsibilities comes with different policy levers designed to address specific issues. The OCR is primarily used for monetary policy and bank capital requirements and loan-to-value ratio restrictions (LVRs) are primarily for macroprudential policy. One of the benefits of managing these different policies under one roof is the ability to use the different levers in concert with each other to manage side-effects and spillovers. We will be reviewing our LVRs and bank capital requirements in the context of the low interest rate world we are going to be living in for some time.

Table 1: Central Bank functions



Source: Adapted from Aldridge and Wood (2014).

Beyond conventional monetary policy

It is possible that some of the uncertainty in the current economic cycle is due to a question of whether central banks have enough policy space to respond to a future recession; or even if we can continue to service our mandates if inflation remains low. Although this scenario is far from our central projection in New Zealand, it is much better for us to prepare for unconventional monetary policy while the sun is shining.

In the near future, we will publish the principles that guide our thinking on unconventional tools, and we are currently working our way through operational considerations of the different options. Having these tools ready, should we need them, will mean we can continue to contribute to a stable economic environment should the OCR reach zero. By getting this work done now and publishing our analysis, we can provide more certainty to the public over our ability to respond to any future downturns.

We have also come to appreciate the increasing importance of stepping up our coordination with New Zealand's fiscal authorities (the New Zealand Treasury) during unconventional times. Since 2018, an observer from Treasury has attended meetings of the Monetary Policy Committee as a non-voting member. The purpose of this initiative is to improve the flow of information between agencies. There are also ongoing conversations between the Reserve Bank and Treasury exploring the optimal arrangement for strengthening our coordinated response to future slowdowns.

Fiscal policy, like monetary policy, acts with significant lags. Many of the first-best options for long-term investment have the longest lead times. It is therefore best to set plans in place sooner rather than later, lest a second-best response be rushed out at a later date, with lesser impacts that arrive too late. Applying our risk management approach: there is little downside to investing now, and many downsides if the spending comes too late.

When we talk about unconventional monetary policy and fighting slowdowns, it is of course important to take a step back and look through the gloom: we are not in a recession, and we expect the economy to recover over 2020. It is possible that uncertainty could clear up in the coming year if there is closure on the topics of Brexit and trade tensions. We are readying ourselves if we need to act further.

Conclusion

Monetary policy is one tool. It needs to be seen in the context of all the Reserve Bank's tools as well as the wider economic levers which have seen less in recent times. In these uncertain times we must continue to communicate and offer forward guidance as to future path of policy. Yes, there is uncertainty. Yes, it is affecting us. No, monetary policy cannot directly resolve this issue. But we can offset its effects and empower others to fuel economic activity that will benefit us in both the short and long-term. There has never been a greater time to make use of accommodative monetary policy for investing in productive assets.

Meitaki, thank you.

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