Some Policy Lessons from a Year of COVID-19

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Introduction

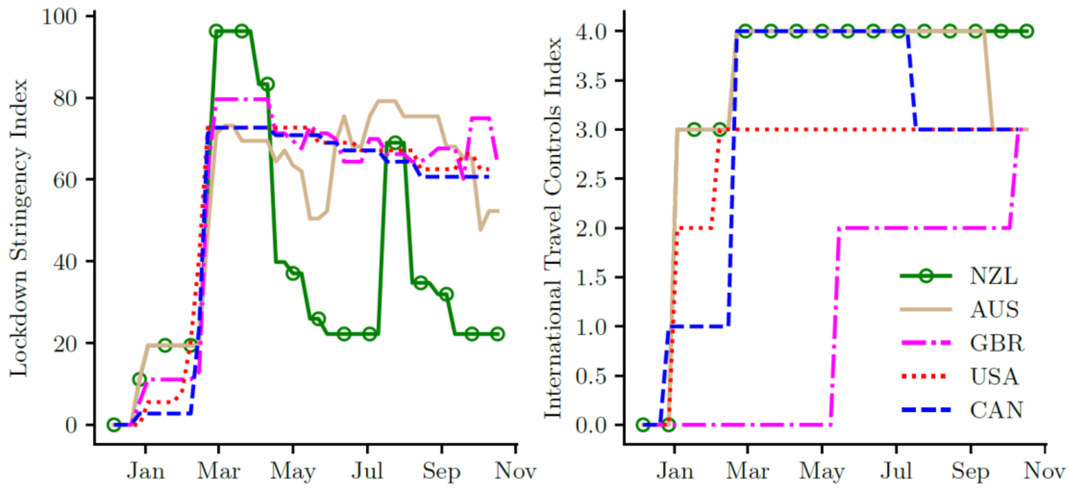
Tēnā koutou katoa, welcome everybody. Thank you for the opportunity to speak today on an important and live topic 'The policy lessons from a year of living with COVID-19'.

In the beginning…

From late-2019 citizens of the world have watched the COVID-19 virus evolve into a global pandemic. We observed global decision makers face what seemed an incalculable dilemma: whether to implement measures to contain the spread of the virus - potentially sacrificing lifestyles and livelihoods - or to endure the health consequences of allowing the virus to spread. This policy dilemma was quickly, and unfortunately, resolved by compounding hospitalisations, threatening the sustainability of health care systems. Policy inaction was not an option and social mobility has been dramatically curtailed as a result.

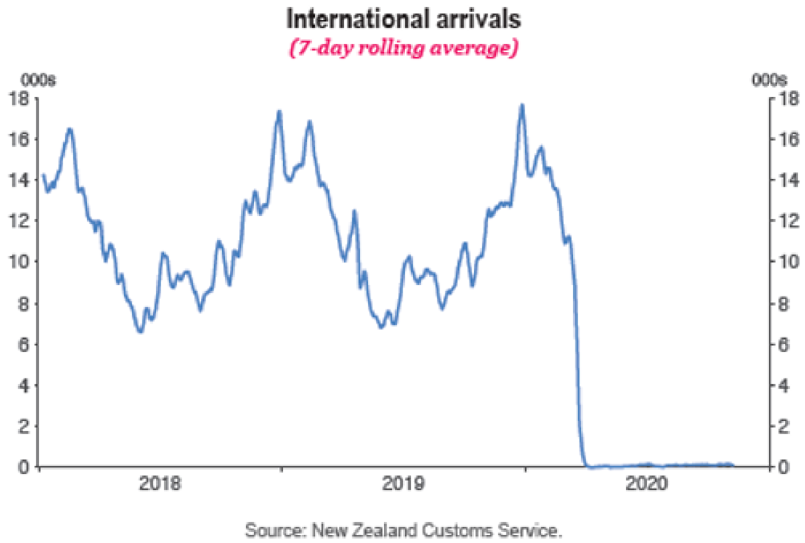
In Aotearoa, New Zealand, we have now been living in this constrained world for a year. The level of social restrictions has fluctuated with our COVID Alert Levels – as we have seen in the events of this week – between the extremes of being one of the most mobility-constrained societies on the planet to one of the most free (Figures 1 and 2). As citizens, our economic fortune has been closely linked to these actions.

Figure 1: Cross-Country Lockdown Comparisons



Source: Corona Virus Government Response Tracker from Oxford University (Hale et al., 2020)

Figure 2: International Arrivals



At the Reserve Bank of New Zealand, Te Pūtea Matua, we were also watching this global health crisis evolve and brew into a pending economic crunch. However, we were also in the midst of preparing a broader range of monetary policy and financial stability tools to bolster the resilience of New Zealand's financial system. This is our kaitiaki (guardian) role.[1]

Our work agenda followed largely from lessons learnt from the Global Financial Crisis a decade earlier. Our efforts included increasing banks' liquidity, capital buffers, and risk management awareness and ownership. We were also developing additional monetary policy tools to be used if the Official Cash Rate (OCR) reached a lower nominal bound. And, we were finalising the implementation of a superior payment and settlement system for New Zealand, while also formalising a more co-ordinated regulatory relationship between colleagues through the Council of Financial Regulators. [2] [3] [4]

An urgent, collaborative response

Our preparedness efforts proved timely given the arrival of COVID-19. Te Pūtea Matua was in a sound position to support cash-flow and confidence in the economy and continue to meet our core mandates in the face of the COVID-induced economic shock. These mandates are maintaining low and stable consumer price inflation while contributing to maximum sustainable employment, promoting and maintaining a sound and efficient financial system, meeting the

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1 The Journey of Te Pūtea Matua: Our Tāne Mahuta
2 Reserve Bank Statement of Intent 2019 – 2022
3 Reserve Bank Statement of Intent 2020 – 2023
4 Council of Financial Regulators

cash needs of the public, and providing robust payment and settlement services for New Zealand's financial institutions. [5]

Of course we were far from alone in the preparation for, and provision of, economic support in the face of shocks. At best we have played an important support role.

New Zealand's broader economic policy settings provided scope and optionality for economic policymakers. A low level of government debt, favourable terms of trade, and solid economic momentum at the commencement of the pandemic put Aotearoa in good stead to weather the initial economic brunt. Likewise, the rapid development and mobilisation of a suite of fiscal support measures significantly bolstered the balance sheets of households and businesses.

I am very proud that Te Pūtea Matua has been able to assist in the whole of government effort to develop, implement, and support this wide range of policy responses. We delivered a broad range of actions, including:

- Easing monetary conditions, including through the deployment of additional monetary policy tools to lower interest rates; [6]
- Introducing a range of liquidity facilities to support the smooth functioning of New Zealand's financial markets and to allow banks to swap their assets for cash in order to keep lending;
- Ensuring public access to cash was maintained during the social restrictions;
- Assisting the Government design and implement the mortgage payment deferral scheme and the business finance guarantee scheme; and
- Reprioritising our regulatory reform priorities – in coordination with COFR – to enable financial institutions to focus on the urgent tasks at hand.

And throughout this period, we worked very closely with industry, with two-way flows of information proving extremely important in shaping policy responses, understanding operational resilience, business dynamics, and credit and liquidity risks.

These initiatives continue to develop and advance as we speak. Working together – mahi tahi – (Figure 3)[7] proved to be a critical catchphrase and one that we will continuously foster. 'Mahi tahi' acknowledges that no one individual, enterprise, or policy institution can succeed alone.

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[5] Reserve Bank Annual Report 2020
[6] Tools to support the economy
[7] Mahi Tahi: Working together to ensure cash-flow and confidence

Figure 3: Working Together: Mahi-Tahi Diagram

Source: RBNZ. Released in March 2020

Being prepared beats guessing

The ability of New Zealand to sustain the current economic momentum remains in large part at the will of the COVID-19 virus in the short-term, and our confidence and adaptability in the longer-term.

Our recent *Monetary Policy Statement* (MPS)[8] outlines that New Zealand has been in the relatively fortunate position of having dealt swiftly with the initial COVID wave. This health outcome, combined with the economic policy response, has seen domestic activity pick up. However, we continue to emphasise that the current pick up is sector and event specific, and that we will not be 'resuming business as previous' in its entirety any time soon.

The initiation of global vaccination programmes is positive for both future health and economic activity. However, there remains a significant period before widespread immunity is achieved. In the meantime, economic uncertainty will remain heightened and international mobility restrictions will continue. Confidence and investment will be needed to sustain economic performance. For this reason we have retained a stimulatory monetary stance.

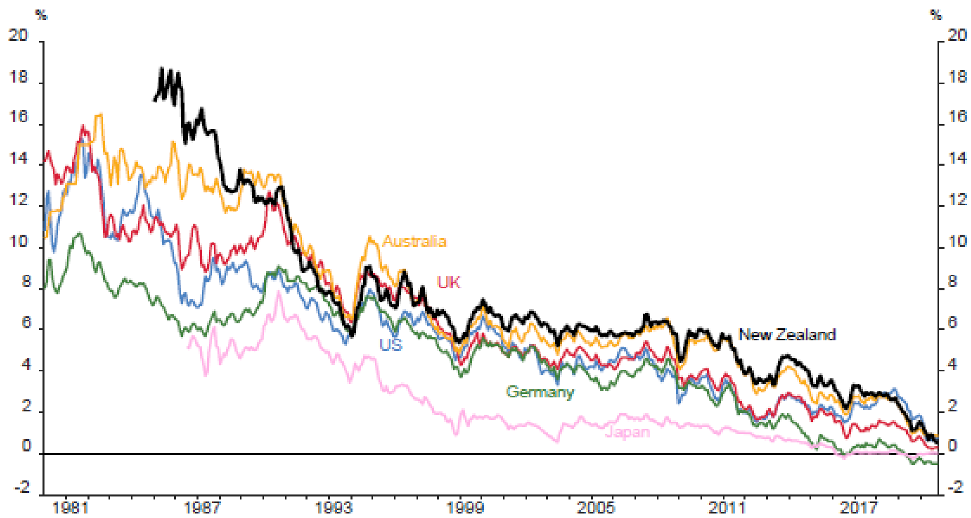
[8] Reserve Bank February 2021 Monetary Policy Statement

Given this elevated uncertainty, at the Bank we are still operating with scenarios in mind rather than predictions. Our recent *Briefing to the Incoming Minister* outlined some of the challenges confronting society globally and in Aotearoa, and their impact on Te Pūtea Matua policy considerations. We summarised the challenges under the long-term headings of Prosperity, Sustainability, Cohesion, and Inclusion. These headings reinforce a long-term horizon and the inter-related forces that will determine our success. [9]

For example, New Zealanders have all weathered the economic implications of the pandemic differently based on a wide range of drivers, e.g. demographics, location, sector of economy, connectedness to the labour force, and individual's reliance on wages or profits. Aggregate economic statistics mask a myriad of distributional implications for health and economic outcomes. This is a topic I will return to with regard to housing and house prices.

The pandemic also occurred during a secular decline in nominal and real (inflation-adjusted) interest rates (Figure 4). Lower real interest rates reflect lower expected future GDP growth rates and higher savings. Lower nominal interest rates reflect the addition of declining inflation expectations. The extremely low level of nominal interest rates has led central banks – including us – to develop additional monetary policy tools which remain effective but relatively untested.[10]

Figure 4: 10-year Government Bond yields in selected countries



Source: Haver Analytics

[9] Reserve Bank Briefing to the Incoming Minister 2020
[10] Monetary Policy: Same Objectives, Different Challenges, Speech by Adrian Orr, Governor RBNZ, September 2020

The pace and magnitude of the pandemic-induced economic shock also necessitated unprecedented coordination between policy agencies, and between Government and the private sector. 'Outsourcing' policy implementation – such as mortgage deferral or wage subsidies - has proved necessary.

Of significant interest to central banks globally was how timely and effective fiscal policy could prove to be in support of demand management? 'Quite timely and very effective' was the answer across many countries – with a 'very timely and effective' answer here in New Zealand. In recent months we have seen significant fiscal and monetary policy collaboration in both demand-side management and ensuring financial markets remain liquid and functioning.

Along with this collaboration, the Reserve Bank has been actively ensuring that people understand the similarities and differences between 'quantitative easing' (our Large Scale Asset Programme)[11] and direct financing of debt. While there appears to only be subtle operational differences between the two concepts, there are significant institutional differences.

The Government's debt issuance – or bond programme – is purely a fiscal policy decision, based on the Government's spending and investment intentions. Under the Bank's LSAP programme, the quantum and timing of our government bond purchases were decisions made by our operationally independent Monetary Policy Committee (MPC), with our purchase solely from the secondary market. The MPC's aims were to lower interest rates across the New Zealand dollar yield curve so as to meet their inflation and employment remit.

MPC's decision making processes and the Bank's LSAP operations ensure that monetary policy and the Government's debt management policy are independent. A Crown indemnity insulates the Bank's balance sheet from the financial risks associated with LSAPs in the absence of a significant increase in Bank capital. This provides the MPC sufficient capacity and optionality to discharge its duties consistent with the Reserve Bank Act and MPC remit. [12]

Another interesting twist to the pandemic is the role of our currency and payment systems. Technology transformation is permanent and we are in the midst of re-thinking the role of cash in society and how we deliver transactional capability to New Zealanders.

[11] See Large-Scale asset purchases
[12] Letter from the Reserve Bank to the Minister of Finance – 6 August 2020

Our recent work has highlighted the ongoing important role that cash plays with regard to financial inclusion and social cohesion. We are a 'less cash' not 'cashless' society.[13] Cash use continued to change with the arrival of COVID-19, so we are capturing the lessons and will need to adapt quickly. Expect to hear more from us on this topic shortly.

Monetary policy with relative benefits

As already mentioned, the Bank acted on a number of fronts to cushion the impact of the COVID-19 economic shock and promote cash-flow and confidence. Our main action was to significantly ease monetary conditions by lowering the OCR to a record 0.25 per cent and progressively implementing alternative monetary instruments - such as the Large-Scale Asset Purchase (LSAP) and Funding for Lending Programmes (FLP) still operating.

While the operational backgrounds differ for these tools, they all act to lower the interest rates faced by households and businesses so as to incentivise spending and investment and keep the NZ dollar exchange rate lower than otherwise. These actions aimed to head off unnecessarily low inflation or deflation and unnecessarily high and persistent unemployment resulting from the COVID-19 economic shock.

Monetary policy remains a blunt tool, however, with its relative impacts on individuals varying significantly. The impact of monetary policy decisions on wealth and income equality is an important topic for considering overall economic wellbeing. As Janet Yellen recently noted, despite the fact that the tools of monetary policy are generally not well-suited to achieve distributional objectives, it is nevertheless important that policymakers understand and monitor the effects of macroeconomic developments on different groups within society.[14]

Our current assessment of the international literature on the distributional impacts of monetary policy suggests it is unclear, on net, whether lower real interest rates increase or decrease income and wealth inequality.[15] The net results are an empirical rather than theoretical outcome and appear country and time specific. There are several channels through which lower interest rates can impact on the return on capital (profits) and the return on labour (wages). Our work is ongoing as to which channels are more important and under what circumstances.

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[13] The Future of Cash – Te Moni Anamata

[14] Macroeconomic Research After the Crisis, Remarks by Janet L. Yellen at the 60th annual economic conference sponsored by the Federal Reserve of Boston, October 14, 2016, https://www.federalreserve.gov/newsevents/speech/files/yellen20161014a.pdf

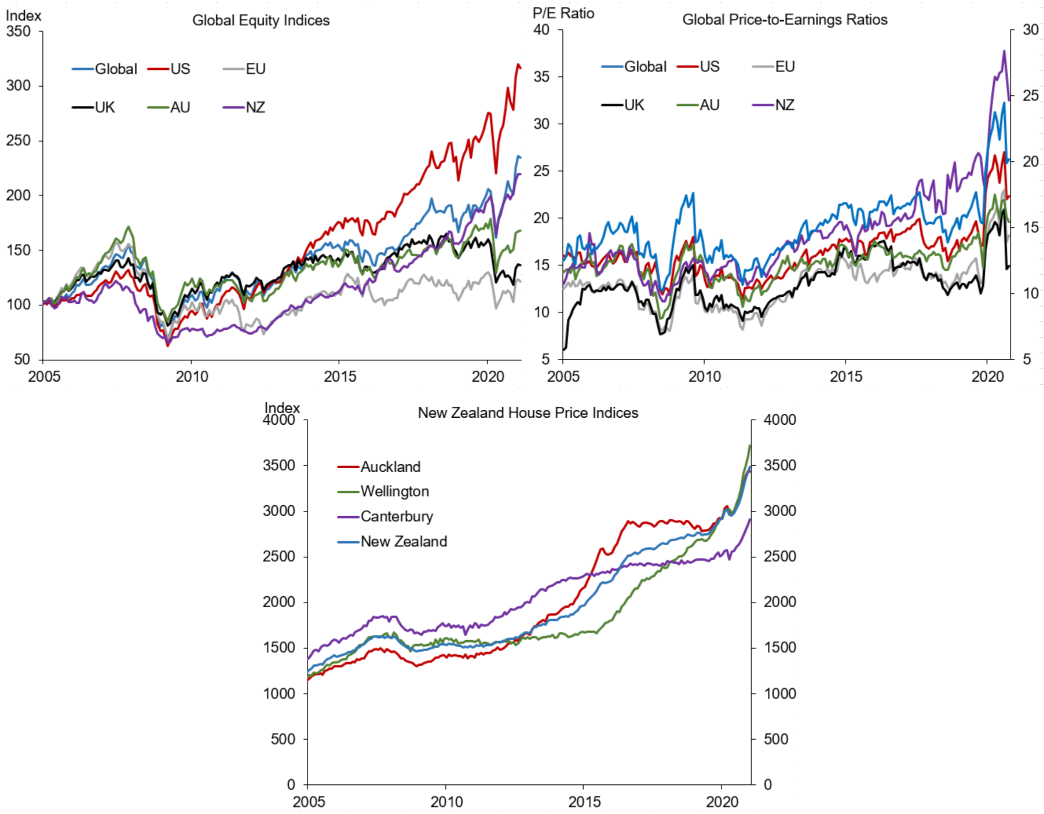
[15] *Distributional Impact of Monetary Policy*, Leong, J., RBNZ 2020 (Work in progress)

The house as a home and an asset

What is clear for one monetary policy transmission channel, however, is that lower interest rates assist in inflating asset prices, with the subsequent 'wealth effect' supporting spending by the owners of these assets. This 'wealth effect' directly benefits the owners of the assets, but it only indirectly impacts others in the economy through the subsequent increase in economic activity and jobs. The impact of low nominal interest rates and significant fiscal stimulus on asset prices is very evident over recent years. Global equity market prices have risen to historic highs both in market capitalisation terms and relative to companies' underlying earnings (Figure 5).

House prices have also risen in general across many of our trading partners and here in New Zealand, especially relative to household incomes. Given that adequate housing is a basic economic need, affordable housing and sustainable house prices will always be in the front line of economic policy importance. The Reserve Bank must have a clear understanding of the impacts its policy decisions have on the housing market both directly and indirectly – that is both our monetary and financial stability policies.

Figure 5: Asset prices in New Zealand and around the world



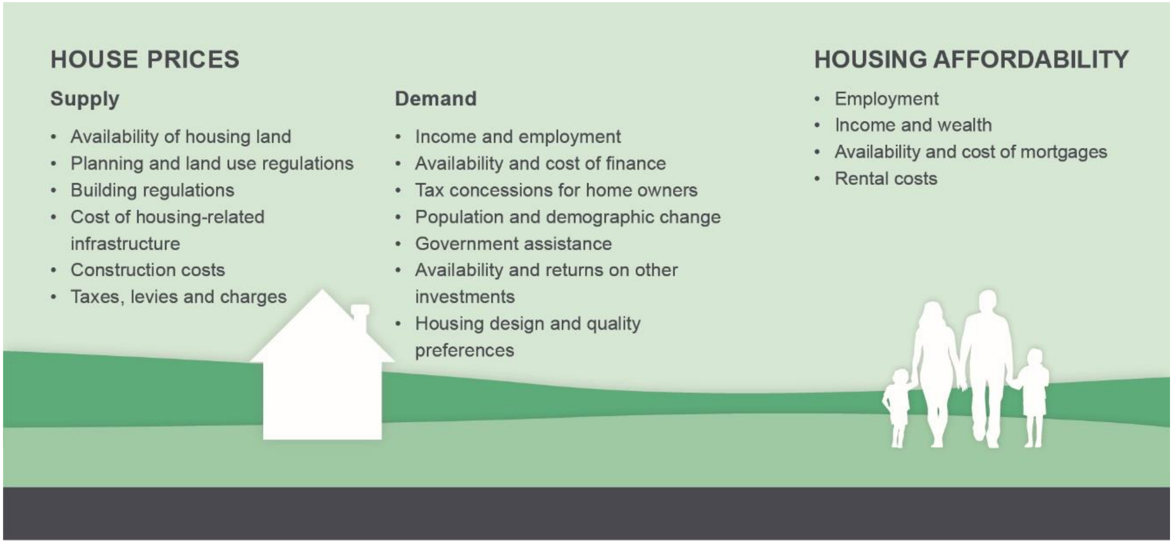
Source: Bloomberg, REINZ

Before talking directly to the impact of the Bank's policies, I briefly allude to the many factors – including the level of interest rates – that impact on both housing affordability and house prices (Figure 6).

Recent studies have identified housing supply as the most significant determinant of house prices in New Zealand, with responsive housing supply essential for ensuring positive and sustainable housing outcomes.[16] Likewise, housing demand factors can influence house prices, but increasing or suppressing housing demand generally only has a temporary impact on house prices and affordability.[17]

Ensuring house prices are sustainable, thus requires coordination and consistency across many government policies and agencies and non-government participants. Table 1 provides a simple snapshot of the many policy levers that can influence the demand, supply, and ultimately price of houses and housing affordability.

Figure 6: Factors affecting house prices and housing costs (or affordability)



Source: Adapted from the Productivity Commission's Inquiry into Housing Affordability (2012).

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[16] See, for example, the Productivity Commission's 2012 Inquiry into housing affordability in New Zealand, and Eaqub, Howden-Chapman and Johnson (2018), *A Stocktake of New Zealand's Housing*.
[17] Ministry of Business, Innovation & Employment. *Briefing for the Incoming Minister of Housing and Urban Development* (2017).

Table 1: Existing housing policy levers

Supply	Demand
Tax policy	Tax policy
Fiscal transfers	Fiscal transfers
Social housing	Overseas investment restrictions
Land availability / housing plans	Rental standards
Building standards (including materials)	Immigration
Infrastructure building	Capital market development
	Kiwisaver policy
Immigration (for example, hiring foreign builders)	Monetary policy
Education (for example, training programmes)	Financial policy

Monetary policy and housing

The Bank's Monetary Policy Committee (MPC) takes into account the impact of house prices on its inflation and employment remit targets in a number of ways. Housing demand affects the demand for housing-related goods and services, such as property construction, rents, and property maintenance. These components account for around one quarter of the Consumer Price Index weight – the target index for the Committee's Remit.

The level of interest rates also influences asset values, including house prices, and the decision to own or rent a house. In particular, house price variations influence households' spending decisions, and eventually economic growth, inflation, and employment. This 'wealth effect' is especially strong in New Zealand given that equity ownership in housing represents more than two-thirds of New Zealand households' total wealth.[18] And, higher house prices relative to the costs of house building will also encourage increased building activity.

These factors add up to a complex relationship between monetary policy, housing affordability, and house prices. For example, the current low interest rates are simultaneously contributing to both a rise in house prices while also improving housing affordability. The latter occurs through the lift in employment and household incomes and the lower debt-servicing costs of mortgage borrowers.

Financial stability policy and housing

Asset (including house) price volatility poses risks to New Zealand's financial system soundness. This is why, for example, retail banks actively manage their lending. They need to

[18] RBNZ estimate: *Household balance sheet ($m) – C22*. Estimate includes housing, land, and rental properties.

ensure their balance sheets (and economic returns) are not unnecessarily vulnerable to variations in both house prices and households' ability to service their mortgages.

These risks to financial system stability become particularly acute when many mortgage borrowers are highly indebted - relative to either their incomes and/or home values. The risk of borrowers defaulting on their loans is further exacerbated when banks provide a large amount of credit to higher-risk borrowers, in particular housing investors. It is easier to enter and exit ownership of an investment property as you are not the occupant.

Bank balance sheets overly exposed to higher-risk investment property loans is a recipe to amplify house price volatility. The recent rapid rise in higher-risk house lending – in particular high-LVR investor lending – is largely why the Reserve Bank recently reinstated more stringent Loan-to-Value Restrictions (LVR).[19]

The Reserve Bank also has a number of other financial (prudential) tools which we are continuously reviewing to assist us to maintain financial stability. These include shining a light on financial risks (mostly via the twice-yearly *Financial Stability Report*); imposing capital and liquidity requirements on banks; stress testing banks' balance sheets; and supervising banks as to how they manage their financial exposures.

Even then, when it comes to economic equality, our financial stability (macro-prudential) tools have significantly different relative impacts over time. For example, higher prudential requirements generally imply higher deposit requirements, lower credit ceilings, and/or higher interest costs for the mortgage borrower. While these factors can suppress house prices over the short to medium term, they can disadvantage lower income and lower wealth households more immediately. The relative benefits and costs of our financial stability actions vary over time horizons.

[19] Media Release, February 2021: Financial stability strengthened by firmer LVR restrictions

New policy goals and consideration

In line with its recently announced housing policy objectives, the Government issued a direction to require the Reserve Bank's financial stability policy to have regard to *"support[ing] more sustainable house prices, including by dampening investor demand for existing housing stock which would improve affordability for first-home buyers"*.[20]

We welcomed the direction as it makes specific how our financial stability policies and actions can assist the Government's housing policy objectives, while operating consistently with our financial stability mandate. We are mandated to promote a sound and efficient financial system, under section 68 of the Reserve Bank Act.[21] The Government's direction is also in line with our recent advice to them in which we detailed the many influences on house prices, including the actions of the Reserve Bank.[22]

We will be considering our financial stability policy settings via our prudential tools – like loan-to-value ratios, bank stress testing, and capital requirements – against particular types of mortgage lending. This is done with a view to moderating housing demand, particularly from investors, to best ensure house price sustainability. We also welcome the Minister's request for more information and analysis on debt-to-income ratios and interest-only mortgages, and will respond in due course.

Importantly, the Monetary Policy Committee's remit targets remain unchanged. We remain focussed on maintaining low and stable consumer price inflation and contributing to maximum sustainable employment, as recently outlined in our *Monetary Policy Statement*.

The Bank will be required to outline, amongst other things, the impact of its decisions on the Government's housing objectives. This MPC Remit adjustment sits well with our long-standing commitment to transparency about our policy actions and approaches.

[20] The Government's policy objectives for the housing market includes:

- Ensure every New Zealander has a safe, warm, and dry and affordable home to call their own – whether they are renters or owners.
- In the short to medium-term, support more sustainable house prices by dampening investor demand for existing housing stock, which will allow additional opportunities for first-home buyers.
- Create a housing and urban land market that credibly responds to population growth and changing housing preferences, that is competitive and affordable for renters and homeowners, and is well-planned and well-regulated.

[21] Media Release, February 2021: RBNZ supports focus on housing

[22] Media Release, December 2020: Reserve Bank's response to Minister of Finance

The Government's direction creates important work for the Bank, both on our own and in collaboration with other government and non-government organisation. The multifaceted nature of the housing market necessitates a multipronged response.

For starters, the Bank (and our colleagues and stakeholders) will need to develop a collective understanding of what 'sustainable house prices' means, and how 'having regard to' fits within our broader financial stability mandate (section 68 of our legislation).

We will also discuss the effectiveness and efficiency of our current financial stability tools at influencing actual house prices toward 'sustainable' levels, and of course managing the public's expectations of our time horizons. This work and understanding necessitates us viewing the housing market from both an *'occupiers'* and an *'investors'* perspective.

The *occupier's* decision largely comes down to whether to rent or buy a house. To assess a sustainable house price, we need to understand how buying a house (and hence servicing a mortgage) stacks up against paying rent over the long-term. Buying implies you will own the house at the end of the mortgage period, hence it is a form of compulsory savings in a single asset. In a purely financial sense, this decision would depend on expected rental costs versus mortgage costs, plus expected capital gains in the house versus other forms of investing/saving. Of course there are also a broad range of additional considerations, including the availability of housing in the location of choice or need, and factors associated with the sense of long-term belonging to a community.

From an *'investors'* perspective, we need to understand how decisions to build new homes or buying existing ones fit into an efficient investment portfolio. There is a wide universe of asset classes readily available to savers/investors, with a range of expected risk and return characteristics. And, there are limits to 'how much is too much' of any one asset class, including residential property. This means we should be able to financially-explain what an 'optimal' allocation of savings/investment to residential investment property would be. The drivers of residential property investment can then be explained by factors influencing expected risk and return such as, for example, the ability to leverage (a 20% deposit on a house implies 5:1 leverage), tax (dis)advantages of competing investments, and/or myopic investment behaviours leading to under- over-investment.

I view the recent section 68b - financial policy - directive from the Government as a significant display of confidence in the Bank's capabilities and operational independence and transparency. It places a high level of trust in the Reserve Bank to apply our analysis and tools to support a specific objective – sustainable house prices - while remaining within our legislated mandate. The directive is also provided with a clear understanding that we are only one of the many stakeholders that influence the demand for, supply and price of houses.

Conclusion

I have covered a lot of ground today with a necessary light touch. The economic environment, the roles of monetary and fiscal policy, the challenges of building and operating new monetary tools, the perennial concerns related to excessive financial risk taking, and issues of income and wealth inequality.

We have been reminded that with low global inflation, and hence low neutral interest rates, our new monetary policy tools will become increasingly mainstream. We have also been reminded that fiscal and monetary policy coordination remains critical to economic wellbeing. In New Zealand our institutional relationships are strong, providing complementarity of fiscal and monetary actions. This collaboration has been supported – not deterred – by clarity around the Reserve Bank's purpose and operational independence.

Our ability to engage and communicate in a manner which all New Zealanders can understand remains key to our ongoing success. And, we have much to learn and communicate ahead. I encourage your interest and participation in our work. I hope you can at least feel my desire to lead a modern Central Bank that has the vision of operating as a 'Great Team at the Best Central Bank'.[23] As I said at the beginning, 'mahi tahi' means working collectively and collaboratively, so ensure we remain effective, relevant, and a cornerstone of New Zealand's economy and society.

Thank you for your attention today.

Meitaki ma'ata.

[23] Reserve Bank Vision and Values