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## **A superior framework for making OCR decisions**

In the previous two reports on monetary policy I highlighted some of the major mistakes the Reserve Bank (RBNZ) has made since 1989 and showed that the fine tuning of the OCR by the RBNZ is a major source of instability in economic activity (see <http://www.sra.co.nz/pdf/MonetaryPolicyMediaRelease1.pdf> and <http://www.sra.co.nz/pdf/MonetaryPolicyMediaRelease2.pdf>). Most importantly, the RBNZ could have achieved its inflation targets without playing the role of the grand old Duke of York and marching interest rates up the hill, only to march them back down again.

Since 1989 the RBNZ has tried a number of approaches to operating monetary policy, but it has not tried the obvious choice. It has not tried keeping the OCR close to the level that is consistent with achieving the medium term inflation target (i.e. the "neutral" level of the OCR). Rather than creating unnecessary instability in the economy by marching the OCR up the hill, only to march it back down again, the RBNZ should instead focus on assessing the realistic range within which the neutral level of the OCR lives and it should keep the OCR within that range. If a major structural shock like the global financial crisis comes along the neutral level of the OCR will change. It is relatively easy to assess how the neutral level of the OCR has fallen in the aftermath of the financial crisis. However, consideration also needs to be given to why the RBNZ was given independence over monetary policy in the first instance and what this implies about OCR decisions.

By focusing on the neutral level of the OCR rather than fine tuning the OCR on the false pretence this can be done effectively, the RBNZ can achieve its inflation target and contribute to more stability in output, interest rates and possibly also the exchange rate than has been the case since 1989 (i.e. it can better achieve what it is supposed to be doing). Neither the Reserve Bank Act 1989 nor the Policy Targets Agreement (PTA) signed between the Minister of Finance and the RBNZ Governor need to be changed.

My contention that a more stable interest rate environment is desirable is not new. In 2002, when I was head of research at ASB, I wrote an informal booklet that reviewed the undesirable consequences of the RBNZ's monetary policy experiments up until 2002. It provided a timely warning about the risk of experimenting with low interest rates and made a case for more stable interest rates. In 2008 I loaded a cut down version of the booklet to our website (see <http://sra.co.nz/pdf/MonetaryPolicyBooklet.pdf>), with the only significant update from the 2002 edition being the chart on page 14. The booklet was titled **Monetary Policy Madness – And Your Chance to Stop It**. It has something of a South Park style (i.e. it has a bit of fun as well as providing an insightful critique of monetary policy and a policy recommendation).

In the pay-to-view **Monetary Policy Briefing** reports we provide the best available assessment of what the RBNZ will do with the OCR in the context of the framework currently used by the RBNZ to make OCR decisions (visit <http://sra.co.nz/monetary.html> for information on these). As part of the campaign for more stable interest rates I will in the future release regular **Alternative Monetary Policy Statements** that will assess what the RBNZ should do with the OCR if it focused on keeping it close to my assessment of the neutral level. You can sign up for these free reports on our website (<http://sra.co.nz/lists/>) and you will also receive **Rodney's Ravings, Property Insights** reports and the occasional bit of marketing material.



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## The monetary policy challenge and what not to do

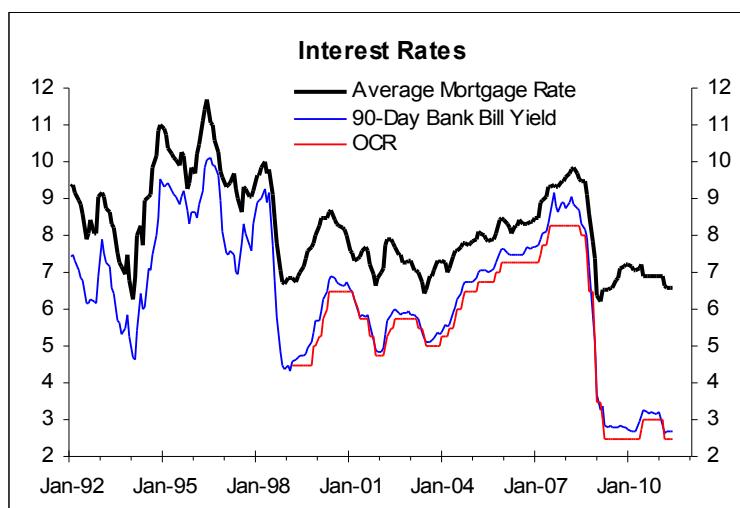
The challenge is to devise a framework for making OCR decisions in the context of the two most important clauses in the Policy Targets Agreement signed between the RBNZ Governor and the Minister of Finance:

- For the purpose of this agreement, the policy target shall be to keep future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term.
- In pursuing its price stability objective, the Bank shall implement monetary policy in a sustainable, consistent and transparent manner and shall seek to avoid unnecessary instability in output, interest rates and the exchange rate.

<http://rbnz.govt.nz/monpol/pta/3517828.html>

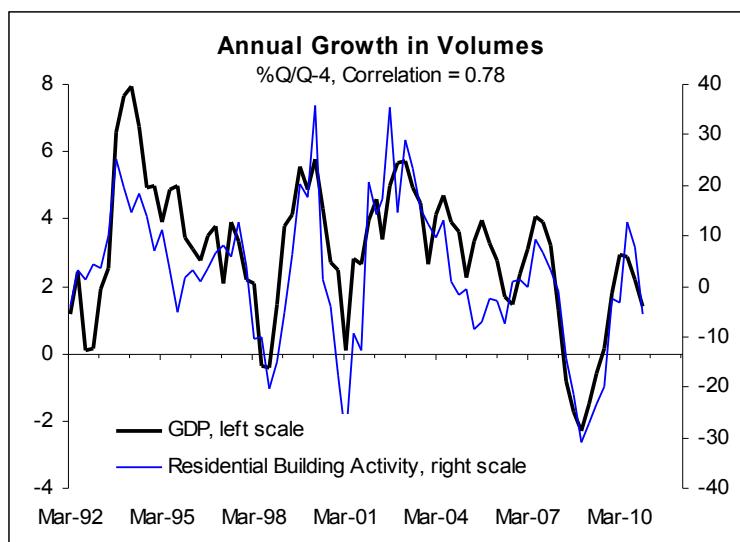
Set these objectives, I would not operate the forecasting-based approach currently used by the RBNZ because the forecasts are unreliable and it turns into a reactive decision making process that is prone to creating instability in output, interest rates and the exchange rate. This was discussed in the second report on monetary policy (see <http://www.sra.co.nz/pdf/MonetaryPolicyMediaRelease2.pdf>).

Equally, I would not bounce from one failed experiment to the next (e.g. from the failed experiment with the Monetary Conditions Index in the late-1990s to the disastrous “go for growth” experiment conducted in the early to mid 2000s), as discussed in the first report on monetary policy that reviewed the experience since 1989 (see <http://www.sra.co.nz/pdf/MonetaryPolicyMediaRelease1.pdf>).



The top chart shows the history of the OCR from when it was born in March 1999 and the histories of the 90-day bank bill yield, the benchmark short-term wholesale interest rate, and the average mortgage interest rate charged by the major banks since 1992. 1992 is a good starting point because that is roughly the start of the modern era of low inflation.

Much of the sharp fall in interest rates in 2008 was justified by the financial crisis. But the general marching of interest rates up the hill, only to march them back down again overseen by the RBNZ since 1992 has little bearing on achieving the medium term inflation target. To a large extent it is unnecessary instability in interest rates that creates lots of instability in output/economic activity.



Interest rates have a major impact on activity levels in the real estate and residential building industries, while these industries play a major part in driving cycles in economic growth. The result of the RBNZ's fine tuning of interest rates and its experiments has been massive instability in residential building activity (blue line, right scale), resulting in exaggerated cycles in GDP growth (black line, left scale).

The RBNZ has largely achieved its inflation targets but along the way it has caused lots in instability in interest rates,



output and probably also the exchange rate. The major and largely unnecessary cycles in interest rates and economic growth have been the primary drivers of the major cycles in the exchange rate, although recent experience with developments in the US reinforces why what happens in NZ is only half the story when it comes to the exchange rate.

There should be no doubt that the various approaches the RBNZ has tried for making OCR decisions (and decisions about monetary conditions prior to the birth of the OCR) have been a failure in terms of seeking to “avoid unnecessary instability in output, interest rates and the exchange rate”. The fine tuning of the OCR and monetary conditions undertaken by the RBNZ in the name of achieving low inflation and a stable economic environment is a scam because the central bank has been a major, if not the primary source of instability in the economic environment.

### **The answer is to try the obvious (i.e. more stable interest rates)**

All the RBNZ has to do is stop marching the OCR up the hill, only to march it down again. There will be exceptions, like if a global financial crisis comes along. But it is reasonably easy to assess how much the OCR should be adjusted in the aftermath of a structural shock like the financial crisis (see pages 6-8). Consideration also needs to be given to why the RBNZ was given independence over monetary policy in the first instance and what this implies for OCR decisions (see pages 9-10 for a discussion of this).

I am suggesting that the RBNZ keeps the OCR reasonably close to the level that is assessed to be consistent with achieving the medium term inflation target (i.e. the “neutral” level). Since 2002 the RBNZ has had the flexibility of a medium term target range, so why would it fine tune the OCR based on dubious economic growth forecasts or, even worse, hike and cut the OCR in response to historical outcomes for economic growth, which is what the RBNZ has largely done since 1989?

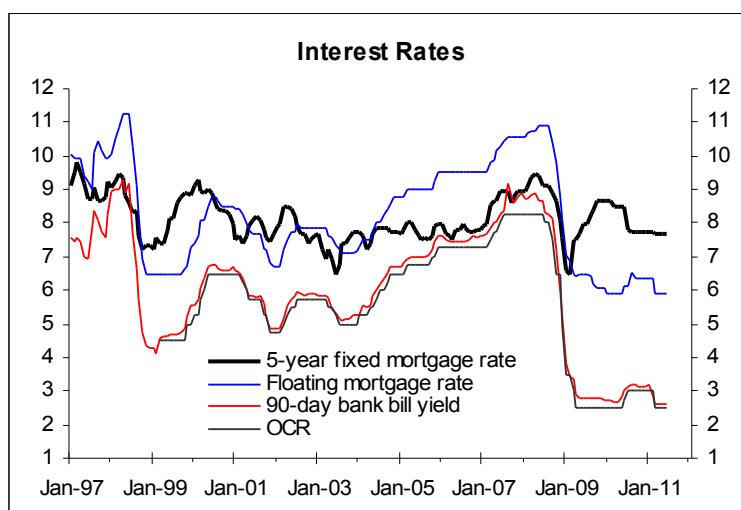
Central banks tend to shy away from trying to quantify the neutral levels of official interest rates. Some will argue that it is too hard to quantify and likely to change too much over time to warrant trying. My suspicion is that central banks don’t want to focus on the neutral level of the OCR because doing so would expose the silliness of the game of marching interest rates up the hill, only to march them back down again. Central banks are familiar with playing the role of the grand old Duke of York and they would rather keep playing this destructive game, which makes them the constant centre of attention, than play a more passive role, which would be the case if they focused on assessing the neutral level of the OCR.

But it does not take a rocket scientist to make a reasonably educated guess of the ballpark the neutral level of the OCR lives in. And it is reasonably easy to estimate the extent to which the neutral level of the OCR has fallen as a result of the financial crisis. Most importantly, any uncertainty over the neutral level of the OCR is minor when compared to the extreme highs and lows in interest rates experienced as a result of the grand old Duke of York approach to running monetary policy.

A more stable OCR means a more stable 90-day bank bill yield, with the latter moving in synchrony with the OCR, as shown in the chart. A more stable 90-day bank bill yield would result in more stable short-term borrowing costs. The chart shows the floating mortgage interest rate having a relatively stable margin over

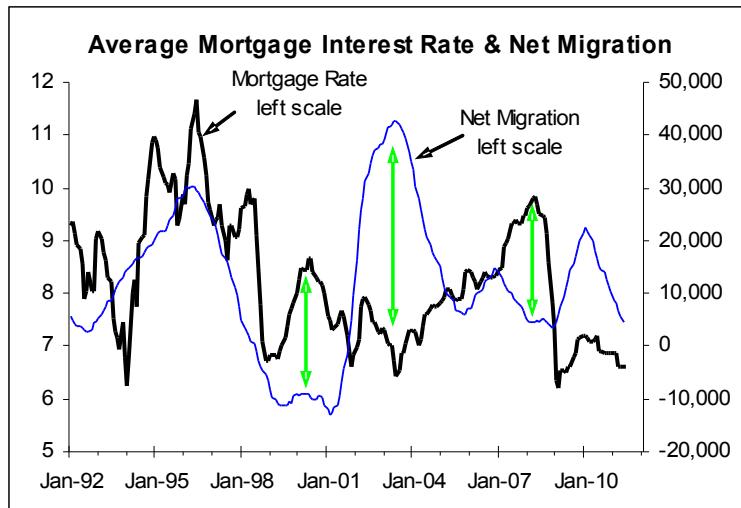
the 90-day bank bill yield prior to 2008. The margin has increased significantly because of the financial crisis (i.e. there is a structural reason why the OCR can be much lower now than was the case before the crisis – see pages 6-8). But since the second half of 2008 the floating mortgage interest rate and short-term fixed mortgage interest rates are again largely mirroring the behaviour of the OCR (i.e. the margin has become relatively stable again).

Longer-term borrowing costs, like the 5-year fixed mortgage interest rate shown in the chart, are impacted partly by what the RBNZ does with the OCR and partly



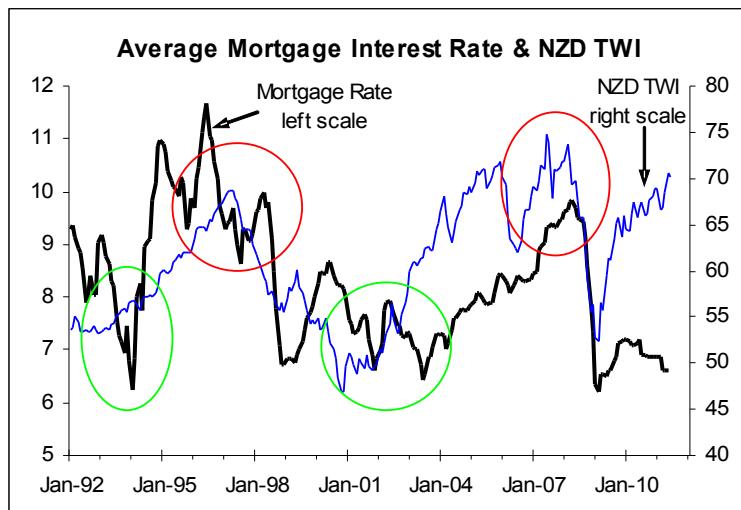


by overseas developments that the RBNZ can't control. But in the first instance the 5-year fixed mortgage interest rate has been much more stable than the floating mortgage interest rate that the RBNZ largely controls. Secondly, if the RBNZ had kept the OCR much more stable than it did, the 5-year fixed mortgage interest rate and other longer-term fixed borrowing costs would have been significantly more stable than was the case. There should be no doubt that a much more stable OCR would mean significantly more stable borrowing costs across the board.



Part of the reason why housing market cycles have been so extreme, with major implications for economic growth more generally and the exchange rate, is because the fine-tuning approach to monetary policy has at times resulted in periods when low interest rates have coincided with high net migration (e.g. 2002-04), while in other periods high interest rates have coincided with low net migration (e.g. 2000 and 2008). In these instances the RBNZ has significantly accentuated the housing market cycles that would have resulted from the cycles in net migration, with net migration being the primary variable in population growth cycles. A relatively stable OCR wouldn't

eliminate housing market cycles, but they should be significantly less extreme than has been the case in the last decade.



Keeping the OCR relatively stable would also avoid the coincidence of lower interest rates and a low exchange rate that supercharge economic growth (see the green areas in the chart). Equally, it would eliminate the coincidence of high interest rates and a high exchange rate that is a precursor to recessions (the red areas). This would be mainly because interest rates would be much more stable. It would be partly because more stable interest rates would mean more stable economic growth, which together should mean less dramatic cycles in the exchange rate. But there would still most likely be significant exchange rate cycles driven by overseas developments.

A more stable OCR is not the solution to many of the challenges faced by businesses, employees and households, but it offers a real hope that the RBNZ can achieve its inflation target at the same time as stopping monetary policy from being the primary source of instability in the economic environment. Running a business is hard enough without the RBNZ driving either short, sharp upturns and downturns as was the case in the Wild West days in the 1990s or the mega-cycle in the 2000s.

If monetary policy was focused on assessing the neutral level of the OCR and on keeping the OCR relatively stable, except when structural shocks occur, it has lots of things going for it:

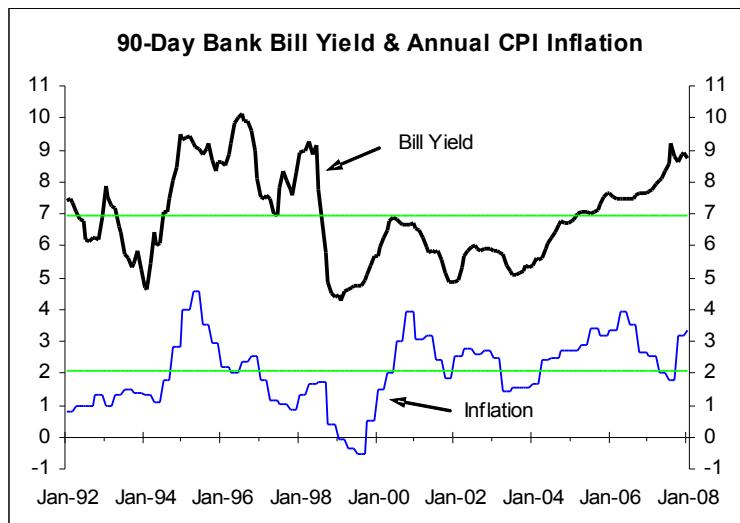
- It is in tune with the RBNZ's flexible inflation target (i.e. keeping annual CPI inflation in the 1-3% target range on average over the medium term).
- It will contribute to a more stable economic environment than has been the case since the RBNZ was given formal independence over the operation of monetary policy in 1989 because interest rates are the most powerful driver of short-term cycles in economic growth.



- It doesn't rely on dubious economic forecasts, although it doesn't mean the RBNZ needs to stop undertaking or supplying economic forecasts.
- It doesn't require any changes to the Reserve Bank Act or Policy Targets Agreement.
- It can quite easily take into account the impact of structural shocks, like the global financial crisis, as discussed on pages 6-8. And it will help the RBNZ make the important distinction between structural shocks, like the financial crisis, that warrant a significant change in the OCR, and transitory shocks, like SARS, that don't warrant any change in the OCR (see pages 6-8).
- It should have large support from the business community and the populace because it will mean much more stability in interest rates and housing market activity, at least a moderately more stable economic growth and possibly a more stable exchange rate. The RBNZ and the government need to take much more account of the damage caused by the volatility in interest rates experienced because of the RBNZ's grand old Duke of York approach to operating monetary policy.
- The idea of keeping the OCR relatively stable at around the assessed neutral level fits with the KISS principle (see <http://www.businessdictionary.com/definition/KISS-principle.html>). Some technocrats will argue that the neutral level of the OCR is too vague a concept to be useful in the real world, but this is only the case if you put pedantic nitpicking ahead of sound judgment and the lessons learnt from over 20 years of monetary policy independence and meddling.
- A focus on the neutral level of the OCR can take into account what the government does or plans to do with fiscal policy (see pages 9-10). This is important because the primary reason the RBNZ was given independence over monetary policy was to discourage the government of the day from the excessive use of taxpayers' money to buy votes in election years.
- It is a framework that Governor Bolland or any future governor could easily adopt. All that is needed is a change in the focus of the Monetary Policy Statements.

### The starting point for assessing the neutral level of the OCR

The financial crisis has had a major impact and will do for many years to come. The crisis has had a major structural impact on the neutral level of the OCR, as assessed below. But the most useful starting point is to assess what the neutral level of the OCR was before the financial crisis and then make an allowance for the impact of the financial crisis. Doing it this way means we can first learn from the almost two decades of experience with low inflation prior to the financial crisis.



Between January 1992 and January 2008 annual CPI inflation averaged 2.1% (bottom green line in the chart). This is an entirely acceptable outcome in the context of the RBNZ's inflation target range. In the second half of the period it averaged somewhat higher, at 2.6%, but that is still within the 1-3% target range. Over the same period the 90-day bank bill yield averaged 6.9% (the top green line), while it varied between 4.3% and 9.9%. Since its birth in March 1999 the OCR has averaged 0.2% below the 90-day bank bill yield. So the 6.9% average for the 90-day bank bill yield between January 1992 and January 2008 implies a neutral OCR of around 6.7%.

I contend that if the 90-day bank bill yield had been kept much more stable than was the case over this period of history, like close to 6.9% throughout the period, New Zealand would have had a similar average inflation rate but much of the large volatility in economic activity and especially the extreme volatility in housing market activity would have been avoided. Some technical considerations would need to be taken into account, like whether more stable interest rates would make people more inclined to take risk, but



these considerations are small compared to the undesirable implications of allowing the 90-day bank bill yield to vary between 4.3% and 9.9%. To put this instability in the 90-day bank bill yield in the proper context, if a borrower faces an increase in borrowing costs from 4.3% to 9.9% it represents a 130% increase in interest costs. How can people be reasonably expected to manage their personal finances when they face anything like this sort of volatility in interest costs? And how can start-up and expanding businesses that rely on debt be expected to survive let alone prosper when they face this sort of instability in interest costs?

When Dr Brash started as governor in 1988 he didn't have available to him the historical information we can now draw on to assess what the neutral level of the OCR was before the financial crisis changed things significantly. But when Dr Bolland took over as governor in 2002 there was enough information available to arrive at the same conclusion as the one I reached above about the neutral level of the OCR based on the experience between January 1992 and January 2008. Between January 1992 and September 2002 inflation averaged 1.8% and the 90-day bank bill yield averaged 6.9% (i.e. exactly the same as it did between January 1992 and January 2008). Rather than keep the 90-day bank bill yield reasonably close to 6.9%, Governor Bolland allowed it to range from 5.1% to 9.2% between September 2002 and January 2008. This is moderately less unstable than experienced during the Brash-era, but I believe it to be a much wider range than is consistent with clause 4c in the Policy Targets Agreement (i.e. seeking to "to avoid unnecessary instability in output, interest rates and the exchange rate.").

In his defense, I believe Dr Bolland was intent on keeping interest rates more stable when he became governor than eventuated. His mistake was to try and keep the OCR more stable at an unsustainably low level. His cause was not helped by the naïve forecasts produced by his own forecasters, as documented in the second report on monetary policy. Equally, most bank economists encouraged him to experiment with low interest rates and some even argued that he should have experimented with even lower interest rates than he did. But this just highlights the risk of letting an inexperienced governor have free reign over the OCR. Any reasonably competent analysis conducted in 2002 of the experience prior to 2002 should have concluded that keeping the OCR well below 6.7% for a sustained period, as Governor Bolland did, would result in an inflation problem. Unfortunately, history suggests that the economic forecasters too often don't undertake reasonably competent analysis. This adds to the reason why economists, including central bank economists, should not be allowed the freedom to march interest rates up the hill, only to march them back down again. Allowing them to play grand old Duke of York with the OCR is madness.

### Assessing the neutral level of the OCR in the face of shocks

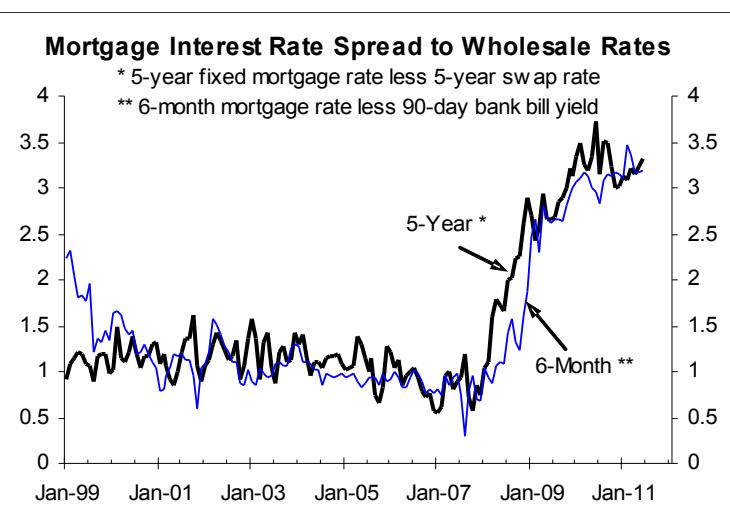
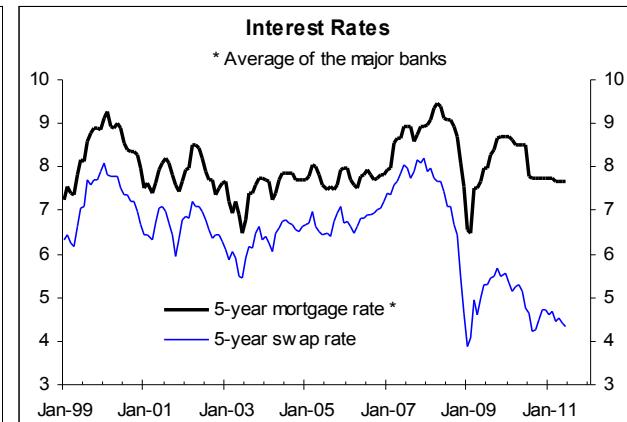
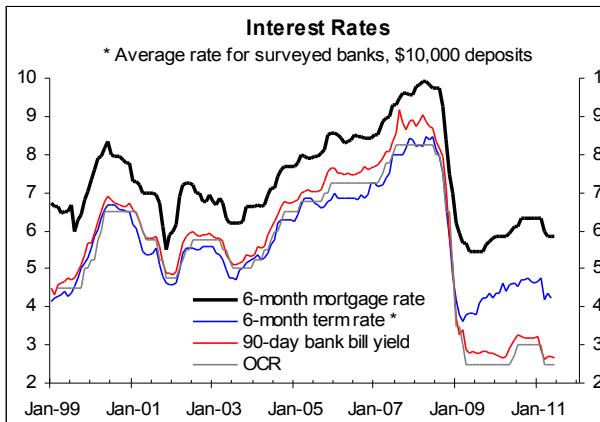
It is critical that a distinction is made between transitory shocks and structural shocks that have a major and lasting impact, although when a shock arrives it can be hard to be sure whether it is transitory or structural. In retrospect at least the outbreak of SARs in 2003 is a good example of a transitory shock. It had a significant but relatively short negative impact on some industries. Adjusting the OCR in response to these sorts of shock makes little sense. Why kick around the housing market and the domestic economy when this sort of shock will probably be transitory and have no bearing on the medium term inflation outcome?

International economic shocks, like the East Asian crisis in 1997-98, are other sorts of shocks that should have little or no bearing on the neutral level of the OCR. In the case of the East Asian crisis the RBNZ forced interest rates up, which was a bizarre response to say the least (see page 4 of the first report on monetary policy). But 2001 and 2003 are more conventional examples of the RBNZ cutting the OCR in response to negative international economic shocks. When these sorts of shocks arise overseas central banks (and sometimes governments) respond to stimulate economic growth, which solves the underlying problem without the RBNZ having to kick the housing market and domestic economy around. Cutting the OCR in response to these sorts of international economic shocks does nothing to fix the underlying problem, so why create unnecessary volatility in interest rates and output in the domestic economy?

But the global financial crisis is a shock of a lifetime and has had a quantifiable structural impact on the neutral level of the OCR. Not being in the finance sector at the time the financial crisis arrived I didn't initially realise how large a negative impact it was going to have, but the RBNZ was much better placed than me to make a judgment on this, especially because part of its role is supervising the banking sector. The financial crisis is a rare case where the appropriate response by the RBNZ was to cut the OCR dramatically in the first instance then worry later about quantifying how much lower the crisis meant the neutral level of the OCR would be. However, things have been relatively settled since 2009 on the financial crisis front in terms of assessing how much lower the neutral level of the OCR is.



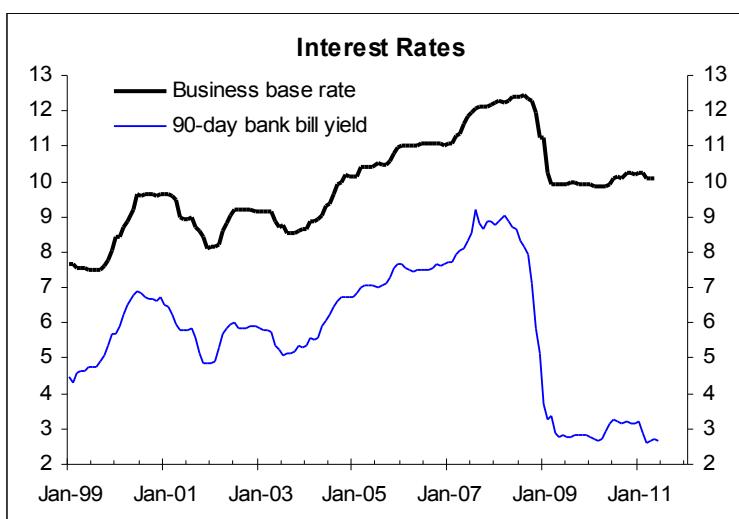
Between 1999 and 2007 the average 6-month fixed mortgage rate charged by the major banks averaged 1.1% (110 basis points) above the 90-day bank bill yield, while in the last year the gap has been 3.2% (320 basis points), as shown in the left chart. Part of the story is that the RBNZ has required banks to fund more through term deposits, which has resulted in term deposit rates, like the average 6-month term deposit rate shown in the left chart, increasing significantly relative to the 90-day bank bill yield and the OCR.



Between 1999 and 2007 the average 5-year mortgage rate charged by the major banks averaged 1.1% above the 5-year swap rate, which is the relevant wholesale interest rate, while in the last year the average gap has been 3.2% (right chart above). This reflects the increased cost of borrowing on overseas markets, which the banks still rely on significantly, with overseas funding costs being significantly higher than the 5-year swap rate. The adjacent chart shows the increases in these mortgage rate gaps.

The impact of the financial crisis has been even greater for many business borrowers. Between 1999 and 2007 the gap between the business base lending rate and the 90-day bank bill yield averaged 3.2% (bottom chart). In the last year this gap has averaged 7.2%. In addition to the financial crisis resulting in especially business borrowers paying much more relative to local wholesale interest rates than was the case before the crisis, access to credit has also become more difficult.

A full assessment of the impact of the financial crisis on the neutral level of the OCR would take some other factors into account. But when I consider what the charts on this page reveal, it points to the crisis meaning the neutral level of the OCR has fallen by significantly more than 2% and possibly by as much as 4%.



This implies that the neutral level of the OCR is well below 4.7% (i.e. 6.7% less 2%) and could be as low as 2.7% (i.e. 6.7% less 4%). My guess is that it is probably around 3-3.5%. But there are good reasons why

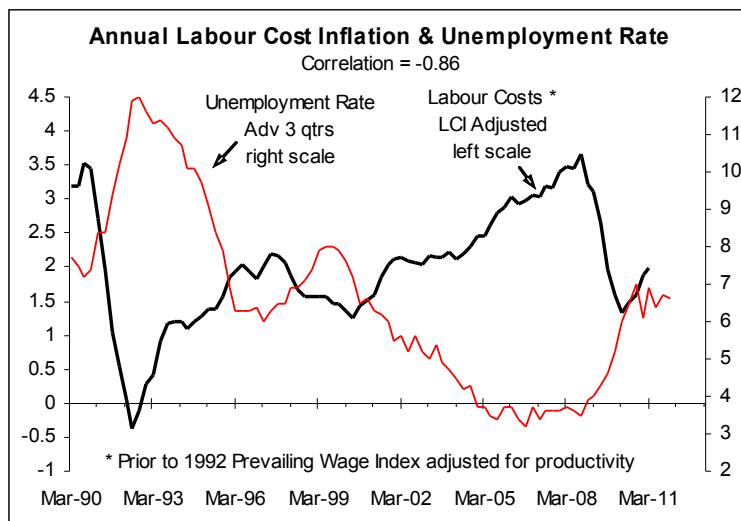


the RBNZ should currently have the OCR below this first-cut assessment the neutral level (see below). If the financial crisis heals and the margins shown on the charts above narrow, the neutral level of the OCR will increase, while if Greece defaults and this results in the financial system being blown back to the dark ages the neutral level will be lower. Most importantly, there is no quick fix to the financial crisis, so it is likely to mean the neutral level of the OCR will be much lower for a protracted period. What started as a private sector housing-banking crisis has evolved into a government debt crisis that by its magnitude will have a major bearing on international financial markets for a long time.

### Other considerations for setting the level of the OCR

Prior to shifting the OCR into the neutral range it is important to assess whether the economy is currently in a state of equilibrium or balance. If the economy is not in a state of equilibrium from a medium term inflation perspective, it should be encouraged to return to around an equilibrium state before moving the OCR into the neutral zone. This is not to say I am advocating the sort of fine tuning of the OCR the RBNZ has conducted. But rather that for an initial period the OCR can be outside the neutral zone to allow the economy to normalise or equilibriate.

One important consideration in this context is whether there is currently more or less spare capacity in the economy than is consistent with the RBNZ's medium term inflation target. Another consideration is whether the RBNZ's most recent experiment with monetary policy has left anything in a state of disequilibrium. The obvious candidate is the elevated level of debt associated with the 2002 to 2007 speculative bubble in the property market that the RBNZ played a significant part in fuelling.



In a modern economy, labour costs are the single largest cost for the average firm. This means the labour market is critical for assessing whether the current starting point is one of balance or imbalance. Specifically, we need to assess whether the unemployment rate is currently consistent with bargaining power in the labour market being balanced or consistent with the RBNZ's medium-term inflation target. In the second report on monetary policy I discussed the difference between good pay increases (i.e. those justified by productivity or personal advancements) and bad increases. Bad increases occur when the RBNZ excessively stimulates

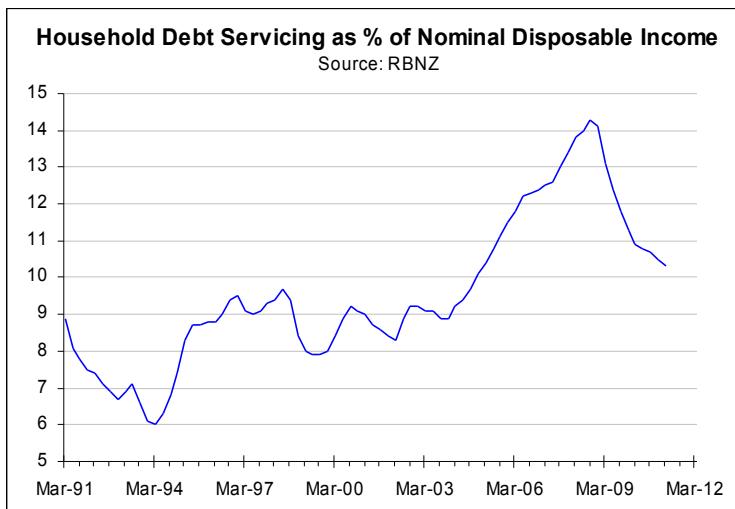
demand via unsustainably low interest rates, which sets in play a wage-price spiral and doesn't ultimately deliver an increase in real incomes or purchasing power for employees.

The black line in the chart above effectively measures the bad or purely inflationary component of labour cost inflation, as calculated by Stats NZ. It also shows a fantastic inverse relationship between the bad component of labour cost inflation and the unemployment rate. The best fit is with the unemployment rate advanced or shifted to the right by three quarters (i.e. around three quarters after a change in the unemployment rate alters the balance of bargaining power between employers and employees it results in this measure of labour cost inflation changing). When I interpret this chart I conclude that an unemployment rate of around 5.5-6% is consistent with the RBNZ achieving its medium term inflation target. This compares to an average rate of 6.5% since 1990. With the unemployment rate currently at 6.6% there is a case for the RBNZ allowing the OCR to be temporarily a bit below my assessment of the current neutral level/range (e.g. maybe 0.5% lower, which brings the current 2.5% rate into play).

In the 2011 June Monetary Policy Statement the RBNZ commented that, "Household debt remains very high and is expected to constrain retail spending and the housing market for some time." (Source: <http://www.rbnz.govt.nz/monpol/statements/4423322.html>). If the OCR is set within my first-cut estimate of the neutral zone (i.e. 3-3.5%) when people are still grappling with the debt accumulated during the speculative boom in the property market, it will probably mean lower housing market activity and consumer spending growth than is consistent with the medium-term inflation target.



The chart below is sourced from the RBNZ's website and shows household debt servicing costs as a % of nominal disposable income. In the decade before the speculative bubble in the property market debt servicing costs ranged between 8% and 9.5% of disposable income. At the peak of interest rates in 2008, which wasn't long after the peak in house prices, debt servicing reached 14.3% of disposable income. More in response to falling interest rates than as a result of falling debt, the debt servicing cost has fallen to 10.3% of disposable income. Debt servicing is still more of a burden than was the case before the speculative bubble in the property market, but it would become a significantly greater burden if the RBNZ was to increase the OCR in line with the increase it is currently predicting for the 90-day bank bill yield. In June the RBNZ predicted that the 90-day bank bill yield would increase from 2.6% currently to 4.9% by the 2013 December quarter. This would mean floating and short-term fixed mortgage rates would increase from an average of 5.9% currently to around 8.2%. People would find some refuge in longer-term fixed mortgage interest rates, but even they would increase at least moderately from current levels if the RBNZ forced the 90-day bank bill yield up as much as it is predicting. In my assessment the debt burden is a reason for the RBNZ to keep the OCR a bit below my assessment of the neutral zone for a while longer.



I conclude that both the labour market and household balance sheets are in states of disequilibrium that justify the OCR currently being a bit below my first-cut estimate of the neutral zone for the OCR (i.e. 3-3.5%). But when the unemployment rate falls and the debt burden heals the case for a sub-neutral OCR will disappear.

When the massive reconstruction job in Canterbury eventually gets a head of steam up it will probably boost economic activity and the demand for labour enough to impact on the medium term outlook for inflation (i.e. it is probably relevant to assessing the neutral level of the OCR). But when the reconstruction

starts to tail off it will have a significant negative impact on economic activity and demand for labour. I therefore struggle to justify neutral zone for the OCR being temporarily increased much if at all in the face of the reconstruction work in Canterbury given the two main factors the RBNZ is supposed to take into account (i.e. the medium term inflation outlook and stability in output, interest rates and the exchange rate). By contrast, by predicting that the 90-day bank bill yield will increase from 2.6% to 4.9% the RBNZ is currently implicitly predicting that the OCR will increase to around 4.7% by the 2013 December quarter.

Why should the vast majority of the country be subject to the instability in interest rates and output that would occur if the RBNZ followed its current plans because a natural disaster resulted in a major but still transitory boost in economic activity? However, a small, temporary increase in the neutral level of the OCR may be justified (e.g. from 3-3.5% to 3.5-4%)

My objective is not to be categorical about what the current neutral zone for the OCR is or about what important factors like the state of the labour market, the state of household balance sheets and the reconstruction job in Canterbury imply about the appropriate level of the OCR. My objective is to show what factors should be focused on in assessing the neutral zone for the OCR and how some important factors should be considered if monetary policy was focused on assessing the neutral level of the OCR rather than the pretence it can successfully fine tune the OCR in a desirable manner.

### **The original reason the RBNZ was given independence over monetary policy and why inflation is the primary target of monetary policy**

Before the Lange Labour Government introduced widespread reforms and undertook major restructuring of the economy after the 1984 election, the NZ economy was in a dreadful state: double-digit inflation, a massive fiscal deficit, a huge external deficit and towering government debt. A primary cause of these macro-imbalances was excessive government spending, with the government effectively able to write cheques on the RBNZ whenever it felt like spending more money. Giving the RBNZ independence over



monetary policy was designed to put a road block in the way of any future government that tried to make excessive use of taxpayers' money to buy votes. Inflation is a symptom of sustained abuse of power by the government of the day, which makes it the obvious symptom for an independent central bank to target.

Given the real reason why the RBNZ was given independence over monetary policy it is important that a part of the analysis done to assess the neutral level of the OCR is an assessment of whether the government is being responsible with fiscal policy. When Dr Don Brash was governor politicians were duly wary that he might tighten monetary policy if they tried to stimulate the economy excessively (i.e. cynically, motivated by political ends). In the Brash-era there was one instance of monetary policy being tightened because of concern about the government's fiscal plans. However, under Dr Alan Bolland's governorship the government was able to undertake major increases in government spending, which laid the groundwork for the current fiscal deficits. A case can even be made that Governor Bolland avoided hiking the OCR in the six months prior to the 2005 election when hikes were justified based on what was occurring in the economy at that stage, just for him to hike straight after the election.

Therefore part of the assessment of the neutral level of the OCR should be focused on whether the government is operating or planning to operate overly expansionary or contractionary fiscal policy. If this had been done over the last decade New Zealand's fiscal position would currently be much less weak than is the case right now.

### Why the OCR is the most appropriate tool of monetary policy

Over the years a number of people have proposed that tools other than or in addition to the OCR be used in monetary policy. Some want the RBNZ to focus on quantitative control of money and credit in the economy, while some want supplementary tools like variable superannuation contributions or a variable GST rate to be used. The objective of these suggestions is often the hope that the result will be a more stable exchange rate.

The RBNZ and others have done extensive work considering alternative approaches. I believe that none of the alternatives have gained traction because they are flawed. New Zealand is a perfect case study of the failure of quantitative controls. Why let the RBNZ or anyone else adjust superannuation contributions or the rate of GST when it has such a bad track record at fine tuning the OCR in a useful manner?

I believe that sticking with the OCR and keeping the primary focus of monetary policy on the medium term inflation outlook is well founded. It fits well with the primary reason the RBNZ was given independence over monetary policy, as discussed above. The OCR is the perfect tool to make sure that politicians don't abuse fiscal policy. There is nothing like the threat of higher mortgage interest rates to make a politician think twice about excessive use of taxpayers' money to buy votes.

What is not well-founded is the approach the RBNZ and central banks more generally use to make decisions about official interest rates. The grand old Duke of York approach central banks generally use means excessive tightening and easing is inevitable, with major negative consequences for the business sector and for everyday Kiwis.

### Should the RBNZ Governor have the final say over OCR decisions?

Decision by committee can be a stifling process, but it could reduce the risk of an inexperienced governor trying an ill-conceived and damaging experiment like Governor Bolland's "go for growth" experiment. If the objective is a much more stable OCR a committee approach to making OCR decisions could be better, provided the committee was comprised of the right people. But experience overseas shows that a committee approach to making decisions about official interest rates offers no real protection from monetary policy being a primary source of instability. We only have to look at the damage done in the US by the Federal Open Market Committee (FOMC) marching interest rates up the hill, only to march them back down again (see [http://en.wikipedia.org/wiki/Federal\\_Open\\_Market\\_Committee](http://en.wikipedia.org/wiki/Federal_Open_Market_Committee) for info on the FOMC).

More important than whether the governor or a committee have the final say over the OCR is the framework used to make OCR decisions and the quality of the analysis behind the decisions. The core reason monetary policy is a primary source of instability is because central banks wrongly believe they can successfully fine tune economic outturns by marching interest rates up the hill, only to march them back down again. If instead the RBNZ focused on assessing the level of the OCR that is consistent with it achieving its medium term inflation objective and kept the OCR close to the assessed neutral level it should greatly increase the chance of monetary policy being the cure rather than the disease.