

STIR

Campaigning for stable interest rates

MONETARY POLICY MADNESS And Your Chance To Stop It

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*** This booklet represents my private views. While every effort has been made to ensure the contents of this booklet are accurate, I accept no responsibility for inaccuracies, errors or omissions.**

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Introduction

This is a story about a modern plague and how you can help overcome it. It is a story about how the Reserve Bank of New Zealand marches interest rates up the hill just to march them back down again. While well intentioned, this is a pointless exercise at best. At worst, it is a plague on the entrepreneurial efforts of everyday New Zealanders.

Far from being part of the solution to achieving higher sustainable economic growth, the Reserve Bank has become part of the problem. Every time interest rates are marched down to unsustainably low levels it encourages people to undertake endeavours, too many of which are then destroyed when interest rates are subsequently marched up, at times to insanely high levels.

If enough people see this insanity for what it is and make their views known to politicians, we could be reprieved from it. We could enter a new era in which entrepreneurial effort survives, or not, on its own merits, rather than winning or losing at the whim of well intentioned but misguided central bankers.

My objective is to try and start a groundswell of support for a new way of operating monetary policy. A way that achieves what I believe to be the original key objective of creating an independent central bank – stopping politicians from using monetary policy in a cynical, politically-motivated manner that results in high inflation – but also a way that doesn't unnecessarily undermine New Zealanders' entrepreneurial efforts.

If you can see the truth in my story and want to play a part in campaigning for more stable interest rates, please forward this booklet to like-minded people and please make your views known to the Minister of Finance and/or the politician(s) of your choice.

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1996 – My god they killed Kenny, the exporter

Most memories of 1996 have become vague. I can remember it was the year of the first MMP election; after which Winston Peters denied Helen Clark the opportunity of becoming New Zealand's first woman Prime Minister. Clearest of my memories is that the Reserve Bank was engaged in a battle against the demon inflation, with the key short-term wholesale interest rate – the 90-day bank bill yield - peaking at over 10% in mid-1996 and the floating mortgage interest rate peaking at 11.5%. It was during this period the Reserve Bank's Governor Brash gained a reputation for having a grudge against New Zealanders' favourite past time – making a killing from investing in houses.

In its June 1996 Monetary Policy Statement the Reserve Bank produced an interest rate “track” that looked as dubious now as it did then. This interest rate “track” had short-term interest rates remaining at 10% over the “medium-term” (i.e. for the foreseeable future and a bit more for good measure).

This outlook for short-term interest rates implied that the floating mortgage interest rate would have to remain at 11.5% or higher for the foreseeable future. One could imagine members of the real estate industry considering buying Governor Brash a pair of concrete slippers for Christmas.

This was at a time when the average short-term interest rate in New Zealand's major trading partners was 4.7%, or less than half New Zealand's 10%.

Consequently, Belgian dentists and international investors more generally flocked to buy “Euro-Kiwi” bonds - NZ dollar denominated fixed interest securities issued in the Eurobond market, based out of London. To invest in Euro-Kiwis the Belgian dentists and the other international investors who were scrambling for a bit of the action had to buy NZ dollars.

In response to this scramble for NZ dollars the “Kiwi” went from being only ludicrously high at US 67 cents at the start of 1996 to insanely high when it peaked at over US 70 cents in April 1997.

These were exciting times in the financial markets, as times of extreme lunacy normally are. But in the factories in Penrose, Hornby and Te Rapa, Kenny the exporter gasped his last gasp before being put into voluntary liquidation. My god they killed Kenny!

The Reserve Bank was tempting international investors with the prospect of a protracted period of high interest rates, so it should have been no surprise to find that the sharks were circling our exporters and local firms competing against imports.

When the sharks had gorged themselves on the carcasses of our exporters, they deserted New Zealand waters as quickly as they came and the NZ dollar began its journey back from the stratosphere. But by then too many exporters and local firms competing against imports had been starved of oxygen for too long.

Most firms fought their way back to their feet after 1996, but too many still today bear the psychological scars of the over valued exchange rate. Put bluntly, some of their entrepreneurial spirit, key to achieving a higher sustainable growth rate for the New Zealand economy, had been kicked out of them.

To me the real story of Rogernomics and the deregulation of the New Zealand economy in the 1980s was about turning a nation of home handy people into a nation of entrepreneurs. But if our entrepreneurs get kicked in the guts too often, even if by a well intentioned central bank, we are condemning ourselves to a slow growth economy, short on funding for roads, police, health and education, not to mention the frivolous pursuit of retail therapy.

The Reserve Bank defends itself against claims it contributed to the overvalued NZ dollar in the mid 1990s on the basis that the NZ dollar has not been any more volatile than other currencies. But to me this episode reeks of poor judgment.

As a footnote, having produced an interest rate “track” in June 1996 that had short-term interest rates remaining at 10% over the “medium-term”, by April 1997 the Reserve Bank had allowed them to fall to 7%. The June 1996 interest rate “track” was at best a waste of time; at worst – and more accurately – a handful of nails in the coffin of Kenny, the exporter.

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1998 – Blame it on Rio

In many respects 1998 is best forgotten; that year I wrote off a few things, including my car, while it was also not a vintage year for the Reserve Bank and its Governor.

The Asian crisis officially started in October 1997 – the 26th, I think – when Asian equity markets got dashed on the rocks of despair. The normal sort of behaviour for equity markets following a period of speculative excesses, corporate mismanagement, a dash of dubious banking practices and government meddling.

Initially I underestimated the negative impact of the Asian crisis on global and NZ economic growth, although by December 1997 the penny was dropping for me at least, as the key leading indicators of economic growth started to tumble.

The magnitude of the problem seemed obvious to the, often maligned, foreign exchange market. The NZ dollar took a pummeling, falling 14% against the US dollar in the second half of 1997, reflecting the market's expectation New Zealand would be hit hard by the fallout from the crisis.

If the Asian crisis wasn't enough to celebrate, the 1997-98 summer was a cracker. The sun burnt the grass brown from Cape Reinga to the Bluff, with parts of rural New Zealand facing critical drought conditions. Starving sheep do not a good export season make, which added to the pummeling the currency was taking.

The Reserve Bank's response to the Asian crisis and the drought was novel. Based on concern about the potential inflationary impact of the falling currency, it enforced higher interest rates. The key short-term wholesale interest rate – the 90-day bank bill yield – was shunted up from 8% in September 1997 to a peak of 9.7% in March 1998, resulting in the floating mortgage interest rate rising to just over 11%.

This was the era of the Monetary Conditions Index (MCI). The MCI was a conceptually appealing beast that tried to quantify the relative importance of interest rates and the exchange rate, but it was wrapped in dubious maths and, in my opinion, applied with meticulous misjudgment.

Battered by the Asian crisis, the drought and by 11% floating mortgage interest rates, the New Zealand economy was driven into a full-blown recession in the first half of 1998 (i.e. people lost their jobs or saw their businesses crumble in around them, while investors in the share market took a beating).

For a long time after the event the Reserve Bank blamed the 1998 recession on "Rio" (i.e. the Asian crisis and the drought). I didn't blame it on Rio. Even at the time my analysis pinned much, if not a majority of the blame for the recession on the inappropriate response by the Reserve Bank (i.e. forcing interest rates up in response to two negative shocks).

The Reserve Bank didn't just force interest rates up in the latter part of 1997, it also ensured they remained high until the penny finally dropped in around late June 1998 – but not until after the New Zealand economy had been doused with punitively high mortgage interest rates for eight months. This is a special sort of madness only central banks seem able to understand.

I think the Reserve Bank's misjudgment in 1997-98 relates to a misunderstanding of how large an impact changes in interest rates can have on economic growth – a misunderstanding that I believe is still alive today at the Reserve Bank and amongst macro-economists more generally (the breed of economists that try and tell the economy's fortune).

The importance of interest rates may be hard to find in the bowels of mathematical models – the sort of models the Reserve Bank uses. However, business people and individuals who experience the real world impact of interest rates understand how powerful they are all too well.

1998-99 – From madness to insanity

Based on the interest rate "track" in the Reserve Bank's May 1998 Monetary Policy Statement, the 90-day bank bill yield was assumed to fall from 8.5% at the time to 8% a year later. However, by November the central bank had allowed this key wholesale interest rate to fall to 4.1%. Consequently the floating mortgage interest rate fell from 11.2% in May to 6.4% in November.

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How can an 11.2% floating mortgage interest rate be justified one moment and a 6.4% rate five months later? Am I missing something? The 11.2% rate was madness, but letting it drop to 6.4% in only five months was insane.

Having crushed interest rate sensitive sectors with floating mortgage interest rates that averaged 11% in the first half of 1998, by late that year the Reserve Bank was about to kill these sectors with kindness. The interest rate “track” in the November 1998 Monetary Policy Statement implied that the floating mortgage interest rate would remain below 7% for the next several years.

Just as the prospect of continued high interest rates made Belgian dentists act like bees around the honey pot in 1996, the prospect of a long period of low interest rates brought out a swarm of “developer” bees in 1999 – the Auckland apartment boom comes to mind, although it ran deeper than just apartments.

Interest rates were allowed to remain low long enough for many businesses to expand their existing operations or to undertake new ventures. However, these new ventures were just getting started in time for the Reserve Bank to realise that 7% mortgage interest rates were not such a good idea.

The Reserve Bank put the Official Cash Rate (OCR) up from 4.5% in March 1999 to 6.5% by May 2000 (a 44% increase), while the floating mortgage interest rate increased from 6.4% to 8.7% (a massive 36% increase in the “price” of debt).

Just as the exporters and local firms competing against imports had their businesses raped and pillaged by the high value of the NZ dollar in 1996-97, many developers and small businesses had their plans bludgeoned as a result of these interest rate hikes.

To some, property developers may be fair game, but forget the stereotypes, if property developers get hurt so do workers in the building industry, manufacturers supplying building materials and investors. Then there were the myriad of other businesses that got whip-lashed by the Reserve Bank’s misjudgments.

2001 – Playing to the last big mistake

I am an avid and at times also good golfer. Golf is addictive because you never know when you will next hit that near-perfect shot. While in pursuit of the perfect shot golfers regularly try to adjust for the mistake they made with their last shot. Unfortunately, when trying to adjust for the last mistake golfers often end up making a different mistake on the next shot. Golf and monetary policy have much in common.

The Reserve Bank’s recently ex-Governor has had plenty of practice admitting to big mistakes, although often not until well after the event (i.e. not until the mistake has become clear for all to see). Too often it seems that admitting to big mistakes is the primary source of credibility for central bankers.

I find that a useful way to understand what the Reserve Bank will do in the future is to consider its last big mistake. Other than the big mistake the Reserve Bank made cutting interest rates too much last year (the consequences of which are yet to be fully appreciated), the most recent big mistake the Reserve Bank made was in 1997-98 when it hiked interest rates in the face of the fallout from the Asian crisis.

It should therefore be no surprise that now ex-Governor Brash spent most of last year citing potential negative global risks as justification for cutting interest rates, even though it was questionable whether local conditions warranted such cuts. He was playing to his last big mistake in an attempt not to repeat it again, but in so doing he was running the risk of making a new mistake. Although in this case not a completely new mistake, really just the same mistake he last made in 1993.

In 1993 interest rates were cut too much at a time that other factors – a very competitive exchange rate, strong net migration and interest rate cuts overseas - were about to contribute to extremely strong economic growth. It was a bit like pouring petrol on a barbeque. We all ended up paying for this misjudgment in the form of high interest rates. The same high interest rates that helped drive the NZ dollar into the stratosphere in 1996 that resulted in the untimely death of Kenny, the exporter.

It is my assessment that the Reserve Bank made the same mistake last year it made in 1993 and the risk is that we will again pay for it with a period of excessively high interest rates in the future. When a central bank Governor starts recycling old mistakes then it is probably a good time for him to resign.

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The OCR era - The ultimate insanity

In March 1999 the Official Cash Rate (OCR) was born. I think the OCR is the appropriate lever for monetary policy. My concern is that the existence of the OCR does not solve the basic problem I see behind the poor operation of monetary policy, that being poor judgment.

Since the inception of the OCR in March 1999, movements in the OCR are best explained by changes in economists' forecasts for global economic growth. If I were trying to think of a really insane way of operating monetary policy, it would be to run it on the basis of what economists were forecasting. But that is just what the Reserve Bank appears to be doing now!

Remember the Reserve Bank is playing to its last big mistake and the last big mistake was misjudging the impact of deteriorating global growth on New Zealand. So what has the Reserve Bank got to rely on when it tries to assess the risks to New Zealand from the global economy?

My answer is to use a range of leading indicators that have a good track record at picking changes in global growth well ahead of when economists pick them. Unfortunately, the Reserve Bank's approach is to rely on economists' forecasts.

There are firms that survey what economists are forecasting for economic growth, among other things, in all the major economies and many of the smaller economies including New Zealand. For example, The Economist magazine undertakes such a survey and publishes the results once a month. When the individual country forecasts are combined, forecasts for global growth or growth in New Zealand's key trading partners can be arrived at, with such forecasts being labeled "consensus" forecasts.

Based on comments by the Reserve Bank Governor, and the central bank's actions since 1999, these consensus forecasts appear to be the most important factor driving changes in the OCR. Unfortunately, these forecasts are worse than useless.

In January 1999, after the fallout from the 1997 Asian crisis and an associated sharp deterioration in global growth, the consensus of economists was that the global economy would grow around 1.4% in 1999. During 1999 the global economy grew a little over 3%, only double what economist were predicting.

Robust growth in the global economy continued in the first half of 2000 and therefore it should be no surprise that in September 2000 the consensus of economists was that growth over the next year would be a healthy 3.6%. However, over the subsequent year the global economy grew by less than 2%.

In January this year [2002], still in the shadow of the 11 September terrorist attacks, the combined wisdom of economists was that the global economy would grow little more than 1% this year. The leading indicators of global growth that I monitor pointed to growth this year of 3-4%; much like 1999, global growth is likely to be over double what economists had been forecasting.

Macro-economists, the variety of economists that focus particularly on forecasting economic growth, at best tell you what happened last quarter. Their track record at forecasting growth in the year ahead, crucial to deciding the appropriate level of interest rates today, is poor to say the least. That these economists are paid six digit salaries to produce such forecasts seems silly enough to me, but to find that their forecasts appear to be a key factor driving what the Reserve Bank does with the Official Cash Rate is bizarre.

Like the Reserve Bank, private sector economists seem to have little faith that even major changes in interest rates will work, which is a key reason why their forecasting track-record is worse than tossing a coin. They always have some reason why interest rates will not work this time around (e.g. either the corporate sector or individuals have too much debt, or firms are operating too much below full capacity, or a higher than normal incidence of sun spots will inhibit consumer behaviour, etc.).

My experience is that economists generally have poor judgment in assessing the power of changes in interest rates, while the Reserve Bank currently exhibits double poor judgment; it not only appears to underestimate the power of interest rates, but also takes notice of what private sector economists forecast for economic growth.

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So why all the interest rate marching?

If marching interest rates up the hill just to march them back down again is so silly, why does the Reserve Bank persist in doing it? My conclusion is that the Reserve Bank does not appreciate how powerful interest rates are and lacks patience or “faith”.

On the question of the power of interest rates, allowing the short-term wholesale interest rate to fall from 8.5% in June 1998 to just over 4% by November 1998 meant firms borrowing from the money market experienced around a 52% drop in funding costs. Put another way, they could fund approximately double the amount of debt at the same interest cost. Equally, the increase in the 90-day bank bill yield from 4.1% in January 1999 to 6.8% in May 2000 represented a 66% increase in interest costs for firms funding from the money market.

Based on their behaviour – marching interest rates up just to march them back down again – and based on discussions I have had with many Reserve Bank officials, I am convinced they are not even close to appreciating how powerful and damaging such cycles in interest rates are.

When the Reserve Bank cuts interest rates to unsustainably low levels, like the 4-5% levels we saw in 1993 and again last year [2001], it encourages firms and individuals to take on more debt. It encourages people to start up new ventures, retailers to build more shops, manufacturers to build more factories and developers to build more apartments. And when the Reserve Bank produces interest rate “tracks” that point to interest rates remaining low for prolonged periods, as they have on several occasions, it is understandable that people take on more debt than might be advisable. Then when the Reserve Bank hikes interest rates by two or three percentage points – representing 40-60% increases in debt servicing costs for firms funding from the money market – it is no wonder that many of these new ventures get torched. Small businesses, particularly in their formative years, can be particularly vulnerable to cycles in interest rates. These small businesses are the future of New Zealand. To subject them to the sorts of interest rate cycles they have been subjected to in the last decade is, at best, ill advised.

Key to New Zealand achieving a higher sustainable rate of economic growth is that our scarce capital spending and labour resources get directed towards high returning projects. To me it is plain to see that the magnitude of the interest rate cycles administered by the Reserve Bank – and by central banks all over the world – seriously hinder quality investment of these scarce resources.

On the issue of patience, changes in interest rates take up to 15 months to impact fully on economic growth, and up to another year to impact fully on inflation, while the Reserve Bank, and central banks more generally, seem to be seeking instant gratification.

Instead of cutting or raising interest rates a bit and waiting patiently for the change to work – having faith that even modest changes in interest rates can ultimately have a significant impact on economic growth – they generally keep cutting or raising rates until they get confirmation the changes are working.

This desire for instant gratification and lack of faith in the power of interest rates is why I believe the Reserve Bank cuts or hikes interest rates too much and consequently is causing economic cycles and, at times, disastrous boom-bust cycles. To me such behaviour is plain to see in New Zealand's experience of the last decade, while it is equally visible when I analyse the behaviour of the US Fed, the Reserve Bank of Australia, the European Central Bank and the Bank of England.

Economic cycles are inevitable, but why are we, the taxpayers, paying central bankers to cause economic cycles? Unnecessary cycles in interest rates weigh heavily on certain sectors. More particularly, they burn out our scarce entrepreneurs; the very people we need to create new ventures, more exports, more jobs, higher pay rates and increased tax revenue.

If you can't forecast, don't meddle with the OCR

My analysis shows it takes around 15 months for a change in interest rates to impact fully on economic growth and around another year to impact on inflation. Consequently, for interest rate changes to be successful or justified, the Reserve Bank must be able to assess what economic growth will be 15 months in the future and what inflation will be up to 27 months in the future.

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Interest rate cuts should only be contemplated if the Reserve Bank has good grounds for believing economic growth will be undesirably weak 15 months hence if interest rates are not cut today. Equally, interest rate hikes should only be contemplated if the Reserve Bank is confident that economic growth will be too strong 15 months hence without rate hikes today.

To form such judgments the Reserve Bank relies mainly on the forecasts produced by its “econometric” model. At university my best subject in economics was “econometrics”, or maths for economists. When I was a young economist, “modeling” the economy with sophisticated mathematics was as exciting as watching models on the Fashion channel is today. It seemed the answers to the great questions of the day could be found in the bowels of mathematical equations, like how important wealth effects are to consumer spending and what are the costs of inflation? However, the more I had to do with the use of mathematical models of the economy, and in particular those used by the Reserve Bank and others to forecast economic growth, inflation and sun spots, the more I distrusted them.

While working at the Reserve Bank I had one particular experience that more than any made me wary of the ability of econometric forecasting models to foretell the future. The experience happened in the office of the Manager in charge of the bank’s Forecasting Section.

His team of forecasters had spent months refining the forecasting model, updating data and then running the model to produce the forecasts. The forecasts arrived on his desk in the form of an inch thick pile of computer paper with detailed quarterly projections for consumer spending, house building, commercial construction, exports, imports, etc. and mathematical equations with estimated “coefficients”, “goodness of fit” statistics and “residual plots”. An impressive show for the uninitiated.

The Manager then run his fingers diligently down each page, stopping regularly to say, “that doesn’t look right, use a z-factor” or “that is not plausible, exogenise that equation”. The months of hard work and sophisticated maths had come down to one person’s judgment as to what the forecasts should look like.

Forecasts that do not fit with the preconceptions of the forecaster(s) end up being mathematically tortured into the desired shape. So the forecasts end up only as good as the assumptions they are stacked with. Based on the forecasts the Reserve Bank releases every three months with its Monetary Policy Statements my conclusion is that the assumptions feed into the bank’s forecasting model are a combination of diligence, conservatism and wishful thinking.

Put bluntly, the use of sophisticated mathematical models to produce economic forecasts is, in my professional opinion, a farce. If the person(s) running the forecasting model doesn’t have good judgment, the forecasts are useless; if the person has good judgment then the model is largely superfluous.

Do these models have any use? Dr Rod Deane, who was the Chief Economist at the Reserve Bank when I joined and the father of econometric modeling at the bank, contended that the primary use of such models was to ensure forecasts were at least “internally consistent” (i.e. to ensure you don’t forecast strong growth in consumer and capital spending at the same time as predicting falling imports – these being mutually exclusive outcomes in the real world). There is considerable validity in what Rod said. However, a skillful forecaster can torture his/her model until it produces internally inconsistent forecasts; a skill the Reserve Bank forecasters seem to have mastered over the years.

I had another major “run-in” with economic forecasting models in January 1995, when I initiated a meeting with Governor Brash to warn him that he faced a protracted battle with inflation ahead – that is what the relevant leading indicators were pointing to. The polite answer I got from the Governor was that the bank’s forecasting model didn’t point to any such risk.

We had an amicable meeting and I appreciated the Governor taking the time to listen to my views. However, faced with persistent inflation pressures over the next two years the Reserve Bank ran a high interest rate policy with the floating mortgage interest rate averaging 10.8%. Leading indicators 1, forecasting models 0.

The evidence is that central banks (and private sector economists) have very little chance of forecasting economic growth 15 months hence and inflation 27 months hence with any degree of reliability. One of the cardinal rules of monetary policy should be that if the Reserve Bank can’t forecast economic growth with any reliability, it should not undertake excessive changes in the Official Cash Rate (OCR).

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In practice, the Reserve Bank, and other central banks, march interest rates up and down in response to historical economic data, not in response to well-founded expectations of the future. The Reserve Bank can dress up its interest rate decisions in 30 page Monetary Policy Statements pontificating about the future, but that it has actually been reacting to historical data is easy to show.

Prior to the introduction of the OCR in March 1999, the Reserve Bank manipulated short-term interest rates up and down predominantly in response to historical data on the housing market. After seeing several months of strong data on residential building the Reserve Bank used to push interest rates up which in time produced a fall in the building consents. After building consents had fallen for several months it kick-started the Reserve Bank back into action, and interest rates were cut, which with a lag of 5-6 months underwrote the next upturn in house building. Since the introduction of the OCR in early 1999 [and up until around 2004] the Reserve Bank has been playing a somewhat different game, but the end result is the same (see **The OCR era – the ultimate insanity**).

This behaviour is much like a dog chasing its tail (i.e. pointless unless you have the “utility function” of a dog). It might be entertaining if it were not for the fact that the dreams and aspirations of everyday New Zealanders were being whip-lashed by what I believe is irresponsible behaviour on the part of the Reserve Bank. So why does the Reserve Bank, and macro-economists more generally, persevere producing forecasts using econometric models when most sane people have long since given up on fortune-tellers? This is likely to remain one of life’s unanswered questions.

International best practice “sucks”

When I am not watching golf on Sky TV or plotting how to become a scratch golfer I often ponder the damage caused by the Reserve Bank’s big mistakes. When in lighter moods, I joke that the answer to the problem of poor monetary policy management is to tender the operation of monetary policy out. Other industries have been subjected to the fierce winds of international competition, so why not sub-contract the running of monetary policy to the Reserve Bank of Australia who have a much better track record?

However, it seems that all central banks have the “Grand Ole Duke of York” syndrome to some degree. While central bankers march interest rates not soldiers, marching interest rates up and down can and has resulted in plenty of casualties in the commercial battlefield.

In the March 2002 **Chartered Accountants Journal of New Zealand** I wrote an article titled, “***Does the Reserve Bank Stack Up?***”. I will not repeat the content of that article here. The conclusion of my analysis was that the Reserve Bank of New Zealand now operates monetary policy at something close to international best practice, but unfortunately international best practice “sucks”.

The Reserve Bank, like its international counterparts, adjusts interest rates in response to historical data, although the exact data each central bank responds to differs. The Reserve Bank of Australia has at times been a labour market junkie, responding to employment data, while the US Fed has at times been a capacity utilization junkie. In common is the fact that both employment and capacity utilization data are lagging indicators of economic growth, and by responding to them these central banks are ensuring they are always reacting after the horse has bolted. By responding to historical data central banks are all playing a part in causing economic cycles to be larger than they need to be, which exposes everyone to unnecessary whip-lashing.

My motto is, “let’s not try and replicate the best, let’s be the best”. Global best practice in central banking may be to march interest rates up the hill, just to march them back down again, but why should New Zealand subject itself to the same insanity? If enough people see this madness for what it is and make their views known to politicians, there could be a reprieve from destructive interest rate marching. We could enter a new era in which entrepreneurial effort survives, or not, on its own merits, rather than winning or losing at the whim of well intentioned but misguided central bankers.

One advantage of a small country like New Zealand is that it seems easier to convince people (and sometimes politicians) to try out something that seems non-conventional to the rest of the world. “Nuclear Free Wellington”, a sign I used to read on the way to the city from the Wellington airport, is one such example, although I always wondered whether nuclear fallout could read.

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The case for low interest rates, NOT

The catch-cry amongst many business people is that economic growth is good, a bit of inflation is harmless (potentially even needed to lubricate the wheels of business) and therefore interest rates should be kept low to promote growth. While marching interest rates up the hill just to march them back down again, as central banks do, is destructive, keeping interest rates permanently low is not the solution to increasing New Zealand sustainable growth rate.

If interest rates were kept too low we would ultimately end up with excessive spending, particularly in interest rate sensitive sectors, which would lead to growing external deficits and overseas debt and ultimately to damaging levels of inflation. We would end up back where we were prior to 1984 when politicians used to try and cheat the fundamental laws of economics (i.e. creating more demand in the economy without doing anything to increase supply, and then wondering why the excess demand spilt over into external deficits and inflation).

In my assessment, the holy grail of monetary policy will not be found through wishful thinking because we do not, unfortunately, live in a fairy tale. Experimenting with low interest rates is a sure road to disaster.

Low inflation – the Reserve Bank’s claim to fame

Inflation has generally been within the Reserve Bank’s target range over the last decade or so. Hip, hip, hooray. Hip, hip, hooray. The Reserve Bank and its recently departed Governor have done an outstanding job. Or so they would like the history books to read. But have they?

In the period the Reserve Bank has been targeting inflation, fiscal policy and global inflation have contributed significantly to New Zealand’s respectable inflation performance. I would even go so far as to say that the Reserve Bank played little part in keeping inflation down over the last decade, but the central bank can be attributed responsibility for “enhancing” cycles in economic growth and whip-lashing many businesses.

What caused New Zealand’s inflation rate to average 13% per annum in the 10 years to 1985? The main cause was irresponsible fiscal policy. Massive fiscal deficits created too much demand in the economy, which was a direct cause of the high inflation, especially as the deficits were too often funded by the Reserve Bank being “instructed” to print money to fund them. In addition, the excess spending fueled an insatiable demand for imports, resulting in yawning external deficits and a mountain of overseas debt. These, in turn, drove the NZ dollar down from US\$1.33 in January 1975 to US\$0.45 by mid 1984, with the falling currency pushing up import and export prices in NZ dollar terms, which further boosted inflation.

The responsible management of fiscal policy since the late 1980s [up until 2002 anyway] has meant the economy has not been awash with excess demand and hence the fundamental cause of inflation has been absent.

In my assessment, the low level of inflation over the last decade [up to 2002] is primarily because politicians have not shown the same inclination to abuse fiscal policy that was rife prior to 1984, aided by low global inflation. The Reserve Bank and, more particularly, now ex-Governor Brash can take some of the credit. The existence of an independent central bank and a fiercely independent Governor has helped keep politicians honest.

The Reserve Bank’s most important campaign, in my opinion, was when they put interest rates up in the lead-up to the 1990 election. This made it clear that Governor Brash intended to run monetary policy as he saw his mandate dictated, with no allowance for political niceties. The Reserve Bank’s actions in 1990, despite being misguided from an economic perspective and contributing to New Zealand’s worst recession in decades, put politicians on notice – and they have taken notice.

Any funny business with fiscal policy, like the trick the Minister of Finance tried in 1990 when \$1b or so of income from forestry asset sales was recorded as current income rather than capital income (i.e. earmarked for spending when it should have been used to reduce the then mountain of government debt), and the government would be punished with higher interest rates.

Keeping politicians' hands out of the till

Why did politicians make the Reserve Bank "independent" (i.e. give up the right to control interest rates)? It was because they had been naughty boys and girls!

In the bad old days prior to 1984, a politician who we will call Rob (later known as Sir Robert Muldoon) had a bad habit of abusing economic policy – and it seemed pretty much any policy he could get his hands on. While the abuse of economic policy in one form or another predated our Rob, he was the most skilled politician when it came to such abuse.

Then along came a "white-knight" politician – a most rare breed - who we will call Roger (later known as Sir Roger Douglas). Roger and his band of merry politicians (most noteworthy being Lange, Palmer and the "bulldog" Prebble) then unraveled the tangle of legislation that had brought the New Zealand economy to its knees during the Muldoon era and put in place checks and balances aimed at keeping politicians on the straight and narrow in the future (e.g. the Reserve Bank Act 1989). A few years later Rogernomics disciple Ruth Richardson reinforced the checks and balances by instigating the Fiscal Responsibility Act 1994.

The abuse of economic policy prior to 1984 resulted in several major problems. Huge fiscal and external sector deficits, both of which peaked at 8-9% of GDP (in current dollar terms around \$10 bn), towering external debt, economic growth that averaged only 1.5% or so per annum and inflation that averaged around 13% per annum for more than a decade.

Inflation was not a problem in itself, but rather a symptom of the political abuse of economic policy. In particular, prior to 1984 it was common for the government to fund its fiscal deficits by writing cheques on its bank account at the Reserve Bank, even though the cupboard was bare.

Now if you or I tried to do this, our bank would bounce the cheques. However, when the government did this in the bad old days, the Reserve Bank was expected to validate the cheques and it effectively did so by printing more money. In effect the government had an opened-ended overdraft at the Reserve Bank.

By using this overdraft regularly to buy goods and services, like a petrochemical plant, an urea plant, electric railway lines and exorbitantly expensive dams - just the sort of toys that politicians like to build in marginal electorates - the government created excessive demand in the economy that spilled into high price and wage inflation.

Again, the real problem was cynical politics, with inflation being just one of the symptoms of the abuse of economic policy by politicians. Forget all the pedantic debate about whether the Reserve Bank should be targeting 0-2%, 0-3% or some other rate(s) of annual inflation. Trillions of words have been wasted on this debate over the last decade or more. Thankfully not too many by me, that was except for one notable exception in 1996 when Governor Brash and I exchanged views on the matter.

The debate about the appropriate inflation target has distracted attention from why I believe the Reserve Bank was granted independence to run monetary policy in the first place. The debate may have been focused on the inflation target by some groups, including politicians and the Reserve Bank itself, because they were not willing to say - other than behind closed doors - that the primary purpose of giving the Reserve Bank independence was to keep politicians honest.

It is probably not the done thing in political circles to say that politicians should not be trusted to run monetary policy, while it is more palatable to say that monetary policy should be run by an independent central bank so it can fight the demon inflation. Thence started the debate about what inflation rate the independent central bank should target. The success of the Reserve Bank's operation of monetary policy is if, over the long haul, it continues to discourage politicians from putting their "hands in the till".

However, if the Reserve Bank continues to run monetary policy as poorly as I believe it has over the last decade, then one day it will give politicians an excuse to do away with the independent operation of monetary policy. Based on the Reserve Bank's track record, the voting public couldn't be blamed if at some stage in the future it gives politicians another chance to abuse economic policy.

Did you notice something funny in this section of my story? The bad guy got knighted and so did the good guy. There is clearly something(s) that I don't understand about politics.

Dare we try the obvious, more stable interest rates?

By running a “sloppy” monetary policy in 1993, including unsustainably low interest rates, the Reserve Bank fuelled a boom which then “necessitated” insanely high interest rates in 1994-98; to eventually be followed by a massive fall in interest rates to unsustainably low levels in 1998-99. When is enough, enough? In my assessment New Zealand could have achieved a low inflation outcome over the last decade without much of the marching up and down of interest rates.

Without all the unnecessary marching of interest rates, firms would have a more stable home economic environment in which to build their businesses, providing a strong foundation for fighting in the international battlefield for market share. Equally, new firms are more likely to survive the treacherous early years in a more stable interest rate environment. In a less volatile interest rate environment I would expect firms to be focused more on increasing productivity – key to improving New Zealand’s sustainable growth rate - rather than on making a quick killing from the property market.

By contrast, when interest rates are marched up and down people are encouraged to start new ventures founded on the “sands” of unsustainably low interest rates, just to have their plans and life-savings too often obliterated by the subsequent hike in interest rates. Equally, the interest rate marching favoured by the Reserve Bank plays a key part in creating cycles in the property market and encouraging entrepreneurs to focus too much on this market as a route to riches.

In my ideal world the key role of monetary policy is to lean against cynical, politically motivated fiscal policy and, in the unlikely event that central bankers can foretell a shock in advance, to adjust interest rates within relatively narrow bands to try and offset the impact of the future shock. In this world interest rates only need adjusting if the government runs an irresponsible fiscal policy, which should not be too often if the Reserve Bank operates monetary policy sensibly and consequently has strong public support.

Other than the primary focus on keeping politicians honest, the search for the holy grail of monetary policy should be the search for the level of interest rates that is consistent with there being only modest inflation in the long-term. That we should try a “stable” interest rate approach to monetary policy is compelling to me and I think to the majority of New Zealanders, but what rate and how much latitude should the Reserve Bank have to alter the rate?

On the question of what rate, many economists, financial market operatives and central bank economists seem to believe that the average interest rates in the post OCR era starting in early 1999 – around 6% for short-term interest rates – is reflective of the average sustainable rate going forward. However, this OCR era is unusual in that it featured two periods of weak global growth.

Since 1992 we have experienced a wide range of events of the sort the New Zealand economy could reasonably be expected to experience in the future (e.g. a global recession, mini-wars, a boom etc), although not a full blown war, foot and mouth, nor a major oil find. So, precluding extreme outcomes – outcomes that would warrant a rethink of the appropriate level of interest rates – the average short-term interest rate experienced since 1992 - 7% - is my prime contender for the starting OCR level in the brave new world of stable interest rates. But whether the starting rate is 7.5% or 6.5% is not a big issue. Even if the rate was held at 7% for a year and this proved too high or low, the damage would be small compared to that caused by the extreme interest rate levels the Reserve Bank has too often imposed on the economy.

On the question of how much latitude the Reserve Bank should be allowed to alter interest rates, the starting point is to recognise how powerful interest rates are and how long it takes the full impact of changes in interest rates to be reflected in the data. The Reserve Bank now adjusts the OCR in relatively small increments (e.g. 0.25% and at the most 0.5%), but after a maximum of 2-3 adjustments in any year it should have to wait, if necessary for a year or more, to see the outcome rather than continue to ratchet rates up or down and, in so doing, cause unnecessary and at times destructive economic cycles.

“Patience has its own reward” is one of the many sayings still ringing in my ears from my childhood. Being of compulsive nature, my parents probably came close to wearing this saying out on me. In the case of monetary policy, the reward for patience would be that less of New Zealand’s scarce entrepreneurial talent gets chewed up and spat out by excessive cycles in interest rates.

STIR

Campaigning for stable interest rates

The NZ dollar – The answer is blowing in the wind

Would more stable interest rates mean a less volatile exchange rate? I would hope so, but I cannot be sure. The answer may be “blowing in the wind”.

The extreme interest rate levels the Reserve Bank has mandated in the past, that in turn contribute to major cycles in economic growth, have clearly played a part in causing some of the extremes in the value of the NZ dollar (e.g. 1996). However, even with more stable interest rates, New Zealand will remain subject to global shocks, both positive and negative, and to the whimsical behaviour of the foreign exchange market – once a reef fish, always a reef fish!

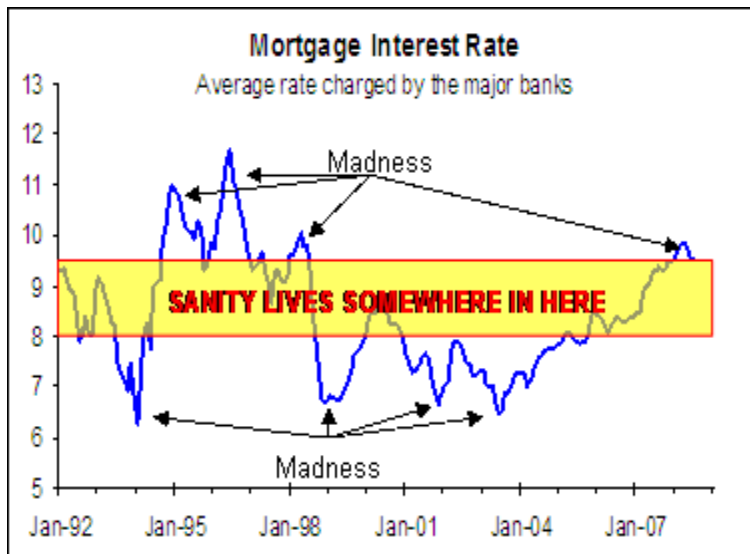
A more stable interest rate regime would not guarantee a more stable exchange rate, but I doubt it would mean a more volatile exchange rate. Provided the exchange rate was no more volatile than in the past, New Zealand would at least benefit from much more stable interest rates. Noting that interest rates are probably the most important “price” in the economy.

The exchange rate also plays an important part in buffering New Zealand from external shocks. In the face of a negative external shock, like the 1997 Asian crisis or the terrorist attacks in the US, the value of the NZ dollar normally falls, which improves the competitiveness of NZ exporters and local firms competing against imports. Equally, when global economic growth is on the upswing, as is happening this year [2002], the value of the NZ dollar often rises.

Irrespective of whether more stable interest rates would mean less volatility in the value of the NZ dollar, they would contribute significantly to a more stable domestic economic environment, providing individuals and firms with a better platform from which to deal with the important issues of improving productivity, developing new products and finding new export markets.

Just as people work better if they have a stable home environment, a more stable domestic economic environment would provide a better foundation from which firms could do battle in the international market place and cope with the vagaries of the exchange rate.

A picture tells 8,673 words



When I embarked on writing this booklet I set myself the challenge of not using a single chart, but once a chart junkie, always a chart junkie. The adjacent chart shows the boundaries within which I believe a sane floating mortgage interest rate should live.

Anyone who has read one of my reports or been subjected to one of my presentations will be familiar with my precious leading indicator charts, with the indicators preventing me from making the silly mistakes so often made by the Reserve Bank and economists more generally. The adjacent chart should be an integral part of monetary policy thinking.

Building a groundswell of support

If a player drops the ball too often on the sports field he/she cannot look forward to a long career in professional sport. When central bankers march interest rates up just to march them back down again, they seem to get their contracts renewed so they can do it all over again.

STIR

Campaigning for stable interest rates

My objective in writing this booklet is to try and start a groundswell of support for a new way of operating monetary policy. A way that achieves what I believe to be the original key objective of creating an independent central bank – stopping politicians from using economic policy in a cynical, politically-motivated manner that results in high inflation – but also a way that does not subject New Zealand to destructive cycles in interest rates.

If you can see the truth in my story and want to join the campaign please forward this booklet to like-minded people and please make your views known to the Minister of Finance and/or the politician(s) of your choice.