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RODNEY'S RAVINGS

Has Governor Bollard learnt from his last big mistake?

EXECUTIVE SUMMARY

When Governor Bollard last faced the need to deliver a series of OCR hikes earlier this decade he only hiked when it became apparent his “go for growth” experiment with low interest rates had stirred up an inflation problem. By waiting until the inflation data confirmed that the OCR had been too low for too long the governor ensured that inflation gained a foothold. Consequently, 13 OCR hikes were needed between 2004 and 2007 to fix the inflation problem caused by his misguided experiment. In his defence, most economic forecasters were right behind the experiment.

The old saying, “a stitch in time saves nine”, is relevant here. If Governor Bollard had started hiking earlier last time around he would have reduced the need for excessive OCR hikes. The governor’s experiment resulted in boom-bust economic and housing/property cycles, with the latter playing a key part in causing the demise of many finance companies that hit many investors hard.

This Raving shows that the RBNZ has learnt some valuable lessons. This time around the RBNZ’s forecasts for economic growth, the unemployment rate, inflation and interest rates are more realistic. The RBNZ’s latest forecasts suggest that Governor Bollard will not wait until inflation gains a foothold before starting to hike the OCR. However, again encouraged by a number of bank economists, the RBNZ is still going to be slow out of the blocks. This means that monetary policy will continue to exacerbate economic cycles, albeit probably not to the extremes experienced in the past. However, why not try something novel, like operating monetary policy according to best practice, which would significantly reduce volatility in the economic environment faced by firms, employees and investors.



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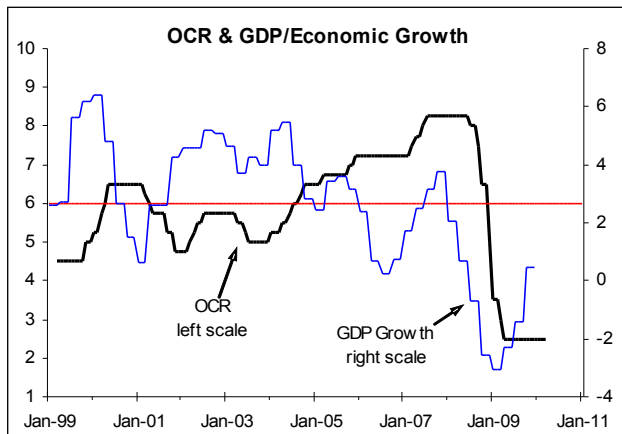
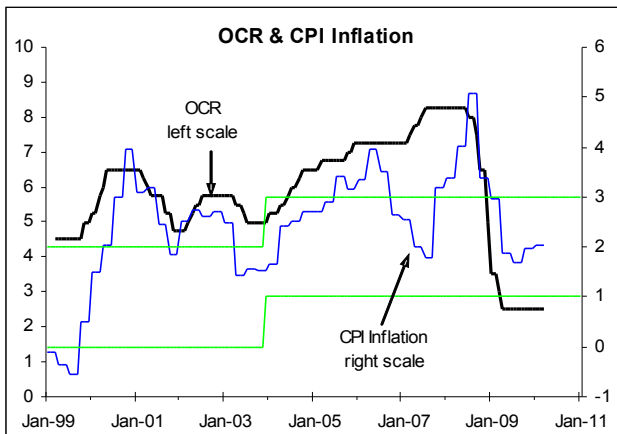
Waiting for the smoking gun before delivering OCR hikes

The primary objective of monetary policy is to keep annual inflation in the consumer price index (CPI) within 1-3% on average over the medium-term. The March quarter CPI was released yesterday and revealed that annual CPI inflation remained at 2%. It should therefore be no surprise that the media coverage of the CPI was along the following lines: “There is no smoking gun in inflation figures for the Reserve Bank to lift official interest rates in June, with the risks swinging towards a rise in July, according to some economists.” (Source: <http://www.nzx.com/news/economy/3603258/Retail-discounting-keeps-inflation-low>). However, comments like this confirm why “some economists” are dismal scientists.

Mainstream thinking in economics is that changes in the OCR/interest rates take around a year to filter through to economic growth, while changes in economic growth take around a year to filter through to inflation. The analysis contained in our monthly **Interesting Times** economic reports confirms the conventional wisdom. If you want to know more about the valuable insights in these reports please get in touch (rodney@sra.co.nz). The obvious implication of how the economy works is that if the RBNZ waits until the inflation numbers provide the smoking gun it will be two years behind the game.

Adjusting to OCR on an extremely reactive basis, like waiting until the inflation numbers confirm that it is too low or too high is a sure way of exacerbating economic cycles, which is more than just a bit undesirable. But this is exactly what the RBNZ did earlier this decade, encouraged by most bank economists, and if the RBNZ takes on board the advice of “some economists” it will repeat the mistake.

The left chart shows the OCR (left scale) and annual CPI inflation (right scale) since the OCR was born in April 1999. The green lines show the target range (right scale), which used to be 0-2% in the short-term but was increased to 1-3% and made a medium-term target in 2004. The relationship in this chart isn't perfect, but it is good enough to conclude that inflation is the “smoking gun” that the RBNZ has responded to the most since the OCR was adopted as the primary tool of monetary policy.



NZ's experience in the decade prior to the introduction of the OCR in 1999 suggested that the neutral or equilibrium level of the OCR was around 6.5% (i.e. the level it needed to be on average to keep inflation within the target range over the medium-term). For various reasons the RBNZ experimented with a below average OCR in 1999 and again between 2001 and 2005. Dr Bollard became governor in September 2002 and pursued a new approach to monetary policy: an experiment with low interest rates that I dubbed the “go for growth” approach at the time.

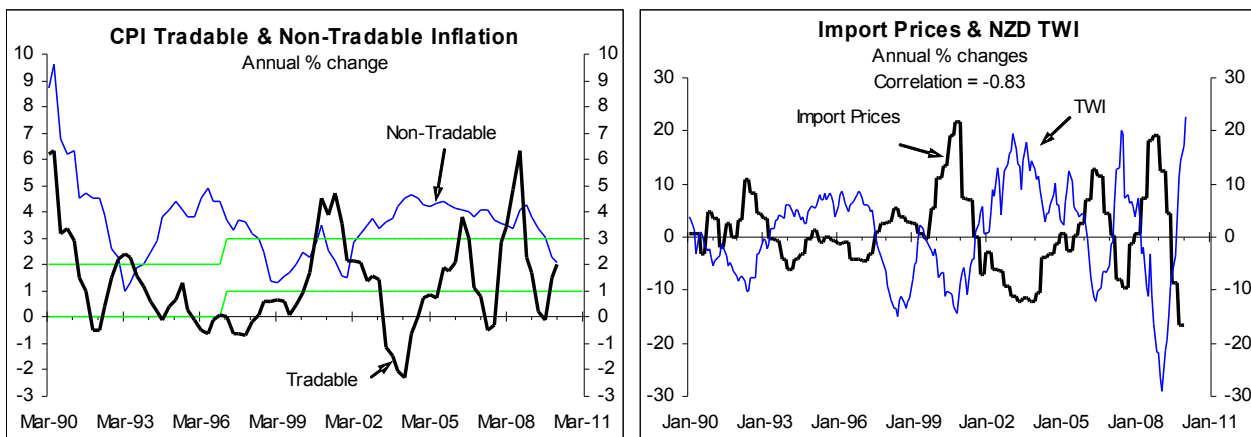
The right chart above shows the OCR (left scale) and annual GDP/economic growth (right scale). The red line is an estimate of the neutral level of the OCR, with 6% being used because it roughly equals the average level since 1999 and is in line with what the RBNZ is currently predicting the OCR will increase to over the next three years. The RBNZ actually forecasts the 90-day bank bill yield, the benchmark short-term wholesale interest rate, but implicitly these are OCR forecasts. The right chart shows that the RBNZ's experiment with a below average OCR in 1999 and again between 2001 and 2005 contributed to economic growth running at above average rates – the red line can also be used as an estimate of NZ's average or sustainable growth rate (right scale).

The sustained low interest rates and above average economic growth created an inflation problem that had several facets. It drove the unemployment rate to super low levels that fuelled labour cost inflation well



beyond the rate justified by productivity growth and made labour shortages a major problem for employers. It created a housing/property market bubble that eventually burst most painfully, taking finance companies and the life savings of many people with it. It also played a major part in driving the exchange rate to levels that were painfully high for exporters, but the high exchange rate also drove down import prices and disguised the underlying inflation problem the RBNZ had created.

The blue line in the right chart below shows the annual % change in the NZD on a trade-weighted or TWI basis (i.e. measures the behaviour of the NZD relative to the currencies of NZ's major trading partners). The above average economic growth between 2002 and 2005 was the major factor contributing to the NZD TWI appreciating 40% between January 2002 and December 2005. If you want access to the best available analysis of exchange rate prospects, ask about our **Forex Prospects** and **Forex Update** reports. The right chart shows how the rising NZD over this period resulted in annual import price inflation turning significantly negative (black line). Falling import prices played a major part in disguising the underlying inflation problem that developed because of the RBNZ's experiment with low interest rates.



The underlying inflation problem is best seen by what happened to the official measure of non-tradable or domestic inflation (blue line, left chart). This measure of annual inflation in domestically-produced and domestically-consumed goods and services headed above 3% in 2002 and remained above 3% until the inevitable recession in 2008 purged the economy of the inflation problem created by the RBNZ's experiment with low interest rates. The non-tradable component of the CPI includes roughly half the goods and services covered by the CPI. The other half are goods and services (mainly goods) that are traded internationally and for which movements in the exchange rate and international prices, including the oil price, have the major impact. Again, the experiment with low interest rates and the resulting strong economic growth drove the NZD higher, and this contributed to annual tradable inflation being well below 3% between 2002 and 2005 (black line, left chart).

The strong economic growth and the housing boom fuelled by the experiment with low interest rates between 2002 and 2005 was great while it lasted, but it allowed inflation to gain a foothold. This meant the RBNZ had to keep hiking the OCR until it eventually peaked at 8.25% in 2007. A recession was an inevitable consequence of the "go for growth" approach to monetary policy, with the NZ economy heading for recession even before the financial crisis broke in late-2007.

If the RBNZ experiments with a low OCR then waits until the CPI inflation numbers confirm that the OCR has been too low it will create an inflation problem that will take some reigning in. A sustained above average OCR needed to achieve this, as we last experienced between 2005 and 2008. Waiting for inflation to be the smoking gun is a recipe for excessive cycles in economic growth, with many industries and firms experiencing excessive volatility in sales along the way. Unfortunately, this is just what "some economists" are recommending the RBNZ does again.

We are already seeing some of the 2002 to 2005 misadventure repeated, with the rise in the NZD TWI last year again driving import prices down. "Television and computer equipment prices fell almost 6 per cent in the March quarter, to be 14 per cent lower than a year ago on average, Statistics NZ said. Big retailers such as Smiths City have recently advertised as much as \$400 off a large screen plasma TV, down to just under \$1000, with no repayments for 12 months. Chain store Noel Leeming has advertised \$200 off computer notebooks, down to about \$1100." (Source: <http://www.nzx.com/news/economy/3603258/Retail->



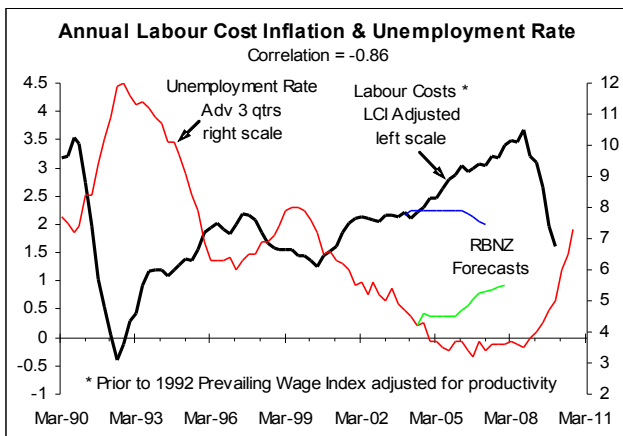
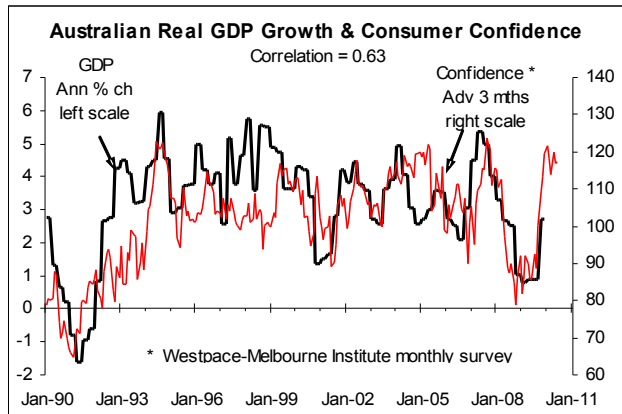
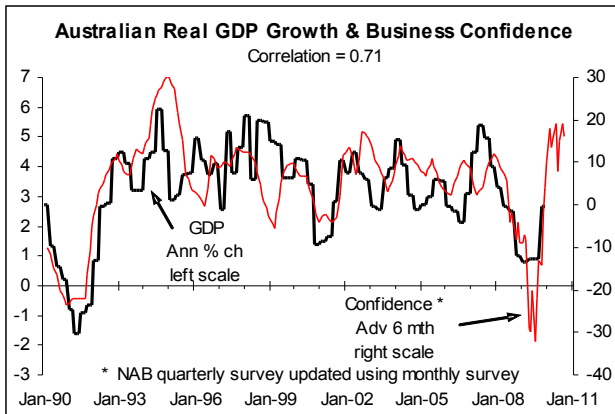
[discounting-keeps-inflation-low](#)). This article initially attributed the fall in television and computer prices to “discounting”, implying firms were cutting margins. Thankfully sanity eventually prevailed and at the end of the article the BNZ economists were quoted as saying the fall in the likes of appliance and electronic equipment prices was because they were “priced off the exchange rate”, which is very different to “discounting”. Some economists are great at making the facts fit their petty theory, but thankfully the BNZ economists set the record straight. However, many readers would have lost interest before they got to the end of the article and been left assuming the fall in prices was entirely due to discounting.

By attributing the price cuts to discounting the economists are reinforcing their preconceptions that the economic recovery will be “mixed”, “patchy” or “weak” this year. By contrast, as covered in our **Interesting Times** reports, the economic recovery is filtering around the economy roughly as normal and, even allowing for the negative impact of the drought and the vulnerability of the housing market, has the potential to deliver above average growth this year.

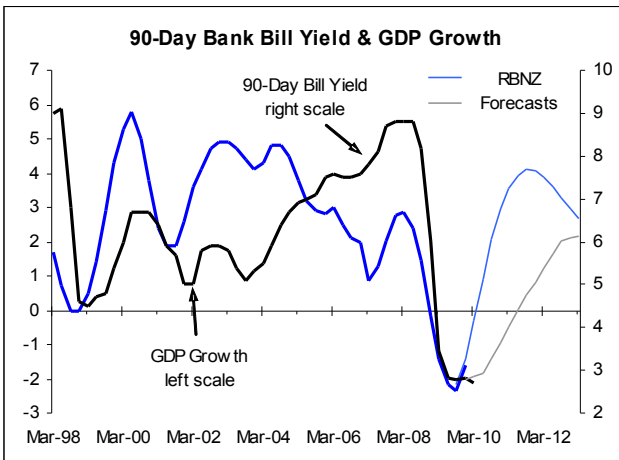
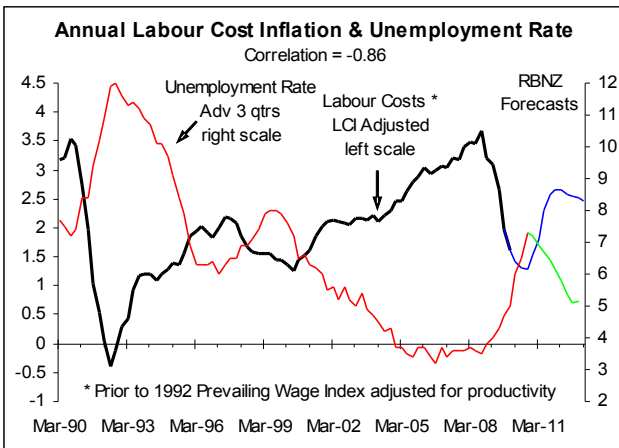
Has Governor Bollard learnt anything from his misguided “go for growth” experiment?

All central banks are reactive to some degree, which means they all exacerbate the volatility in economic cycles to some extent. However, the smarter (less dumb?) central banks, like the Reserve Bank of Australia (RBA), don’t wait until the inflation numbers confirm that the OCR is too low. They start hiking when the leading indicators of economic growth point to growth heading to above average or unsustainable rates. This is very much a case of a hike or five in time (five being the number the RBA has already delivered) saving thirteen (being the number Bollard delivered between 2004 and 2007).

The charts below show that the Aussie leading indicators of economic growth are pointing to growth rebounding to well above average levels this year. By leaning against excessive growth momentum reasonably early the RBA is greatly reducing the odds of an inflation problem gaining a foothold, which in turn reduces how much the cash rate will ultimately have to be increased. Interestingly, the NZ leading indicators of economic growth are not too different to the Aussie indicators (i.e. a bit weaker on average but still consistent with the economy heading to above average growth this year). Governor Bollard doesn’t appear to have learnt enough to be up with best practice, but there are reasons for believing that he has learnt something from his misguided experiment with low interest rates between 2002 and 2005.



The black line in the adjacent chart shows the measure of labour cost inflation the RBNZ focuses on most, with it representing the inflation component of labour cost inflation as distinct from increases associated with good things like productivity growth. The unemployment rate is a good leading indicator of this measure of labour cost inflation (the red line, which has been advanced by three quarters). In March 2004, after delivering only one OCR hike, the RBNZ predicted that the unemployment rate would increase (blue line) and that this would result in a mild fall in labour cost inflation (green line). History confirms that these forecasts were based on wishful thinking rather than sound analysis.



Almost all rather than just some bank economists shared the RBNZ’s misguided views in the mid-2000s, which made it easier for the RBNZ to continue with the experiment with low interest rates for much longer than was healthy or prudent. On a couple of occasions during this experiment I met with my old colleagues at the RBNZ and pointed out the folly of their forecasts, but my comments fell on deaf ears. But I am pleased to report that the RBNZ’s forecasters have certainly learnt, as reflected by the forecasts in the adjacent charts.

The RBNZ forecasters are predicting above average economic growth over the next two years (thin blue line, second chart). They expect the rebound in growth to push the unemployment rate down (green line, top chart), and that this will result in labour cost inflation rebounding (blue line, top chart). So this time around the RBNZ forecasters have a more realistic economic cycle built into their forecasts. But they are predicting that the RBNZ will not push the 90-day bank bill yield back up to the historical average rate until after higher labour cost inflation becomes entrenched. This may be justified by factors associated with the financial crisis, as discussed in the **Interesting Times** reports, although it has a hint of Dumb & Dumber to it. However, at least this time around the RBNZ is predicting that it will start OCR hikes well before labour cost inflation becomes a problem.

Again, the measure of labour cost inflation shown in the charts above reflect bad pay increases rather than the good increases associated with productivity growth (a bit like good versus bad cholesterol). Why the RBNZ would keep the OCR below average for long enough to fuel a problem with bad labour cost inflation strikes me as being bizarre, but if the RBNZ starts hiking this time around before bad labour cost inflation starts increasing it will reduce the risk that inflation becomes entrenched. This will in turn reduce the extent to which the OCR will ultimately have to be hiked to solve the problem caused by having the OCR too low in the first place. A hike in time may not save nine, but several hikes in time can certainly save us from much larger hikes down the track.

But will the OCR return to the historical average level as the RBNZ is implicitly predicting? Our insights on this are reserved for readers of the **Interesting Times** reports. Again, if you want to have the best available economic analysis, you know where to find me (rodney@sra.co.nz).