

# Economic Bulletin.

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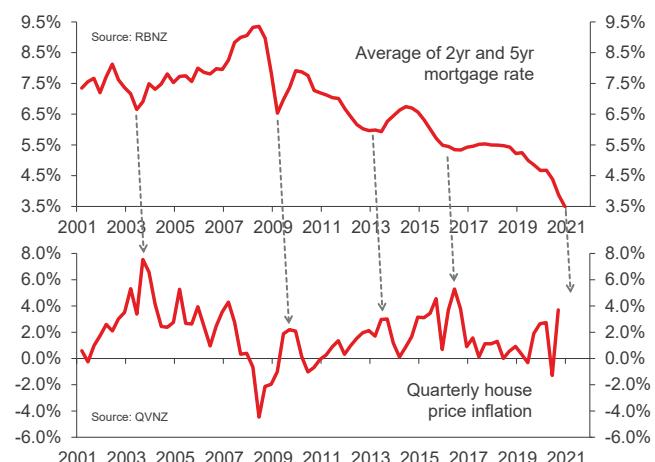
## Damned if they do, damned if they don't.

- The Minister of Finance proposes changing the RBNZ's Remit, as is his right.
- The RBNZ's main goals will still be inflation and employment.
- Watching out for house prices will make the RBNZ more gradualist.
- That makes near-term OCR cuts less likely. Our OCR forecast is under review.
- However, we still favour monetary easing at some point due to the closed border, low inflation, the rising exchange rate, the LSAP running out of fuel, et al.
- Central banks that pursue side goals usually end up missing their inflation targets and have to play catch-up later.
- The RBNZ could nix house price inflation in an instant by lifting interest rates...
- ... but that would boost the exchange rate, create unemployment, and cause deflation.
- It is great to see the government acknowledging the role of interest rates in pushing up house prices.
- However, changing the Remit won't make much difference to long-run interest rates or house prices.

The Minister of Finance's letter to the Governor of the Reserve Bank has thrown a spanner in the works for financial markets and economic forecasters. The Minister has expressed concern about low interest rates boosting house prices. He proposes a change to the monetary policy Remit that would add house prices to the list of things that RBNZ is supposed to avoid unnecessary instability in, alongside output, interest rates and the exchange rate.

I am pleased to see the highest level of government acknowledging the important role that interest rates play in the New Zealand housing market. Over many years the public sector has tended to over-emphasise the role of physical supply and demand in house prices. This has led to poor house price forecasting, ultimately affecting policy advice. We first predicted a big lift in house prices due to falling interest rates and the ruling out of capital gains tax in June 2019.<sup>1</sup> I'll publish more on the link between interest rates and house prices next week, as well as discussing what I think the best policy responses are.

### Interest rates and house prices



Adding house prices to the list of things in which the RBNZ is supposed to avoid unnecessary instability probably makes sense – a reference to asset prices was included in the RBNZ’s targets prior to 2018, and we questioned why it was removed. This will make the RBNZ more gradualist in the pursuit of its inflation and employment targets, but it is not going to make a great deal of difference to the long-run level of interest rates or house prices.

### Near-term OCR cuts less likely.

After this change to the Remit, the RBNZ will continue to pursue its medium-term inflation target, but it may take a more gradual approach to getting there. That might make the RBNZ less gung-ho about lowering interest rates in the near term. We were forecasting OCR cuts in April, May and August, but that timing now looks less likely. We are reviewing our OCR forecasts and will update them in due course.

During the Covid crisis the RBNZ’s approach has been “least regrets”. They have erred on the side of providing monetary stimulus more aggressively, because they judged the cost of overshooting the inflation and employment targets would be less than the cost of an undershoot.

That was appropriate during the darkest days of the Covid crisis, but the calculus is different now. If it does turn out that the RBNZ has over-egged the salad, then it will regret causing an unnecessary increase in house prices alongside its regret about inflation. This means that the RBNZ will require a higher burden of proof before easing monetary policy any further.

Another possibility is that the RBNZ could alter the Funding for Lending Programme (FLP) in order to skew it more towards business lending. For example, banks might be allowed access to more lending under the FLP if they increase their lending to businesses. This is the approach that the Reserve Bank of Australia has taken, and was what we thought would happen prior to the last Monetary Policy Statement. If the RBNZ does opt for more stimulus next year, this might be the way it goes.

### Central banks can’t cheat nature.

While the timing of OCR cuts is now in question, changing the Remit will make little difference to the level of interest rates over a longer timeframe. While we might have to alter the timing of our forecast OCR cuts, it is less likely that we will alter the longer-term outlook.

The thing is, no central bank can cheat nature. Falling interest rates are a global phenomenon caused by deep fundamentals like the global return on capital and global savings patterns. If the Reserve Bank of New Zealand tried to stand like King Canute in the face of that tide, it would soon be swept away by deflation.

If a central bank holds interest rates too high or too low in pursuit of some side goal, it tends to find that inflation drifts away from target. It then has to play catchup, moving interest rates even further in order to restore inflation to target. History is littered with examples of central banks failing to achieve side goals.

During the mid-2000s, then-Governor Alan Bolland was concerned about the high exchange rate and yawning current account deficit, and so became very reluctant to hike the OCR further. The eventual result was that inflation rose well above target, requiring bigger OCR hikes later to rein inflation back in. The exchange rate still rose.

In the mid-2010s then-Governor Graeme Wheeler was concerned that lower interest rates would exacerbate house price inflation, and so became reluctant to cut rates. During Wheeler’s tenure inflation remained consistently below target, and the RBNZ was eventually forced to cut the OCR well below their own lines in the sand. House prices still rose.

Also in the mid-2010s, Sweden tried keeping interest rates high in order to prevent a house price boom. The result was deflation, and Sweden was eventually forced to reduce policy rates below zero.

The reality is that central banks can only permanently alter one thing – inflation. They cannot permanently alter the level of real house prices, or the real exchange rate, or anything else. The key decision central bank governors make is how assiduously to pursue the inflation target. If they move interest rates slowly, inflation tends to vary more, but (arguably) there are less abrupt changes in things like the exchange rate and house prices. Focusing on rapidly meeting the inflation goal, as the RBNZ has done this year, tends to require rapid changes in interest rates, which can (arguably) cause volatility elsewhere in the economy.

The RBNZ’s many side goals, considerations, and requirements to avoid volatility all amount to roughly the same thing – more gradualism in pursuit of the inflation target. We think this gradualism is, broadly, a good idea. But it won’t make the inherent tensions of running monetary policy go away.

### Be careful what you wish for.

The RBNZ’s expanding list of side goals are going to come into conflict with one another, sooner rather than later. The Reserve Bank could nix rising house prices in an instant by lifting interest rates. But that would send the exchange rate through the roof, as well as causing more unemployment and deepening the recession – all in contravention of the RBNZ’s other side goals.

The trouble is that the RBNZ has many side goals but only one tool (the OCR, LSAP and FLP are all just variations on

<sup>1</sup> Our June 2019 bulletin predicting a sharp acceleration in house price inflation can be found [here](#). When Covid-19 broke out we predicted a 7% decline in house prices due to economic disruption, followed by a return to rapidly rising house prices due to low interest rates, as detailed [here](#). In reality the economic disruption was smaller than anticipated, and there was only a 2% drop in house prices. We recognised that and returned to forecasting rapid house price inflation due to low interest rates over August and September 2020, as detailed [here](#).

the theme of influencing private sector interest rates). The exchange rate is already rising as financial markets give up on the idea of the RBNZ cutting the OCR in the future. As the exchange rate rises further, this might become a ‘be careful what you wish for’ situation.

We still favour OCR cuts at some point. The damage Covid has done to the tourism sector has created a huge hole in economic demand. The non-tourism part of the economy may be doing well, but we are still not completely convinced that medium-term inflation is on track. To make matters worse, the recent rise in the exchange rate and wholesale interest rates amounts to a *de facto* tightening of monetary policy that will constrain the economy and inflation. And finally, the RBNZ’s Large Scale Asset Purchase Programme (LSAP) is going to run out of fuel and will have to be replaced with another form of monetary easing.

### **Playing by the rules.**

The Minister’s letter to the RBNZ was heavy-handed, but he is perfectly within his rights. Crucially, nothing the Minister said changes the Reserve Bank’s primary focus on inflation and employment, which is written in law. The Remit *defines* the inflation and employment goals – it sets out the rules by which the Monetary Policy Committee must play. The Minister decides the Remit, and he can change it whenever he pleases (although he must first consider advice – hence the letter). Before 2019 things were different. The RBNZ’s policy targets were decided jointly by the Governor and the Minister, so they tended to change only when there was a change in personnel in either position.

Changing the Remit is not an infringement on the Reserve Bank’s operational independence, although it does demonstrate the limits of that independence. However, I was less comfortable with the Minister of Finance’s reference to the alternative monetary tools the RBNZ is using to achieve its goals. That particular aspect of the letter did feel closer to telling the RBNZ how it should meet its goals, rather than leaving the RBNZ to its operational independence.

**Dominick Stephens**, Chief Economist

 +64 9 336 5671

# Contact the Westpac economics team.

## Dominick Stephens, Chief Economist

 +64 9 336 5671

## Michael Gordon, Senior Economist

 +64 9 336 5670

## Satish Ranchhod, Senior Economist

 +64 9 336 5668

## Nathan Penny, Senior Agri Economist

 +64 9 348 9114

## Paul Clark, Industry Economist

 +64 9 336 5656

## Any questions email:

 [economics@westpac.co.nz](mailto:economics@westpac.co.nz)

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