ANZ Research

RBNZ Formulation and Implementation of Monetary Policy Review

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The RAFIMP

Introduction

- The RBNZ has released the Review and Assessment of the Formulation and Implementation of Monetary Policy (RAFIMP). The RBNZ has stated that this report "assesses monetary policy decisions of the past 5 years in the context of the best available information at the time, and with the benefit of hindsight". The RAFIMP is designed as a 'report card' on decisions made by the MPC and how effective those decisions were.
- Today's report is the first of its kind (after becoming a legal requirement in 2018) and is distinct to the other kind of reviews to which the RBNZ is subject, which focus on monetary policy frameworks, targets and guidelines.
- The RAFIMP documents the significant challenges and economic uncertainties COVID-19 brought into the policy-making fray. However, it is necessarily backward-looking and we don't see any implications for our central expectation of the monetary policy outlook.
- The RAFIMP highlights how the recent crisis has tested new unconventional policy tools, monetary policy strategy, and led to a broader set of tools being available to the RBNZ to respond to future events. Some tools (like QE) were used for the first time in modern history in New Zealand, while other capabilities (like preparedness for negative interest rates) were implemented but not used. The costs and benefits of deploying these new tools are now better understood, but there is still plenty of work to be done in this space.
- Overall, and with hindsight, the RBNZ's 'scorecard' appears be a 'pass', but with some room for improvement.

The scorecard

The RAFIMP evaluates monetary policy developments from 2017 to mid-2022, focusing on distinct economic phases within the period. The review then assesses whether the MPC met their obligations as set out in the MPC's Remit and Charter. Of most interest to us is the post-pandemic era, where extreme economic uncertainty has presented a significant challenge to policy makers the world over.

Overall, and with hindsight front of mind, the RBNZ's 'scorecard' appears be a 'pass', but with some room for improvement.

On meeting the Bank's objectives, the report notes "the formulation and implementation of monetary policy has been consistent with its objectives" and "the dramatic easing in monetary policy was largely warranted during the pandemic, and worst-case economic scenarios were avoided."

Regarding Additional Monetary Policy (AMP), the report notes "AMP tools were effective at restoring functionality to the financial system" and "provided further monetary policy stimulus, as well as successfully addressing market dysfunction in conjunction with other liquidity measures."

On recent changes to the RBNZ's Remit the report notes "the Committee's inflation and employment objectives have not been in conflict."

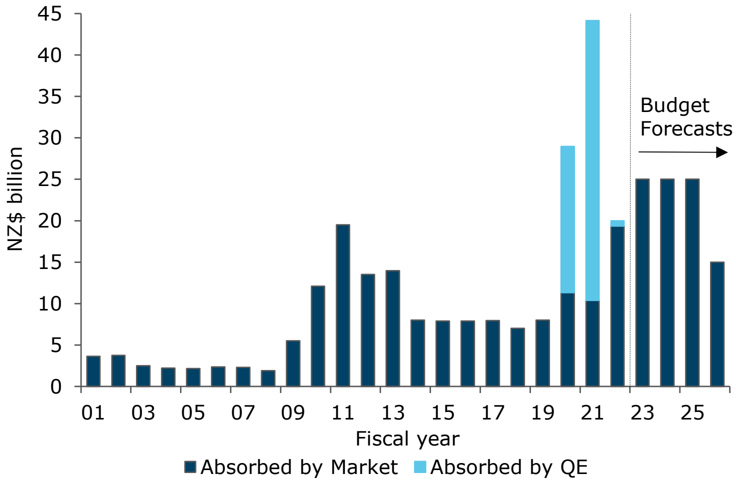
At the "useful learnings" end of the spectrum, the report notes: "the FLP could have been designed with more flexibility", "monetary policy should have been tightened earlier in 2021", and "the effectiveness of fiscal policy during the pandemic were likely underestimated."

New tools in the toolkit

The report discusses the use and efficacy of alternative monetary policy tools, such as the Large Scale Asset Purchase Programme (LSAP) and Funding for Lending (FLP) programmes.

As is always the way, it's very difficult to know the counter-factual. That is, we can argue 'til the cows come home what would have happened if the RBNZ didn't step up with unconventional policies in the wake of the pandemic. Take QE as an example. At its height, the Government was spending up large and taking a haircut on revenues to such an extent that the Treasury had to issue a record-breaking amount of government bonds, and do so very, very quickly. With the RBNZ 'in the market', taking down a very sizable share of these bonds (figure 1) both the cost of Government funding and market uncertainty were lower than otherwise. Although there is plenty of debate now about whether QE should not have been as aggressive and/or lasted for as long, at the time it was almost universally acknowledged that something needed to be done. And QE had been the go-to policy used by the Fed and BOE in the wake of the GFC.

Figure 1. RBNZ vs market absorption of New Zealand Government bonds



Source: Bloomberg, NZDM, RBNZ, ANZ Research

The RBNZ notes in the "Areas for Improvement" section of today's review that the "LSAP programme was highly effective in response to the liquidity crisis that emerged in early 2020, when financial markets were becoming dysfunctional", adding that "as such, LSAPs should be used to correct dysfunction in financial market in future". Although the report stops short of saying that LSAPs shouldn't be used as monetary policy tools, it does go on to say that "the OCR is the preferred tool for managing the level of monetary stimulus through economic cycles, provided the OCR is above the effective lower bound". The report notes that "while AMP tools influence interest rates, they carry reputational risk as the general public only directly observe the marked-to-market fiscal implications of the Reserve Bank holding government bonds, as well as operational risk in calibrating their effectiveness".

With the RBNZ now ready to implement a negative OCR in the future as needed (maintaining operational readiness for a negative OCR was part of one of the nine identified areas for improvement), that suggests that the hurdle to use LSAPs will be higher in the future, and that they are more likely to be used to improve market functioning in the event of a crisis.

With regard to the FLP, today's report notes that "the FLP could have been designed with more flexibility". With hindsight, the RBNZ probably would have preferred to have done so, even though as they note, "To be effective, the FLP required a long time-commitment to ensure banks were confident that a stable and secure funding source was available".

What is done is done, and unwinding the RBNZ's larger balance sheet will come at a cost to the taxpayer going forward. However, QE indisputably helped facilitate the Treasury fund rapidly evolving government policy at a very uncertain time, and as the RBNZ notes, the "LSAP was the preferred AMP tool to launch at this time because of the importance of the New Zealand government bond market to the overall New Zealand financial system. The interest rate on New Zealand government bonds is a benchmark interest rate that influences other interest rates in the economy. If the government bond market is not stable and the Crown is unable to issue debt, then private sector borrowers will also be unable to do so. LSAP was also operationally relatively easy to implement compared with other AMP tools, and there were examples over the prior decade of other central banks implementing LSAPs or similar programmes. Furthermore, other central banks were launching, or expanding existing, LSAP programmes at the same time."

Areas of improvement

As part of the RAFIMP, the RBNZ indicates nine areas of improvement across monetary policy formulation and implementation.

On the monetary policy formulation side, the RBNZ notes the need to:

1. Develop broader insight into the impacts of supply shocks on inflation
2. Develop new sources of data for economic monitoring
3. Develop better measures of 'neutral' interest rates
4. Understand the future role of fiscal policy instruments in managing economic shocks
5. Refine the measure of 'maximum sustainable employment'
6. Use LSAPs to mitigate financial market dysfunction
7. Be cautious in providing forward guidance in uncertain times

Broadly, these learnings reflect the largely unprecedented nature of the COVID shock. Monetary policy is used to dealing with demand-driven recessions, in which the textbook response is to slash interest rates to boost demand and drive up economic activity. However, supply shocks are very different, since they drive activity down and inflation up, and in that case, lower interest rates can worsen inflation. The RBNZ notes the impact of the Government's wage subsidy was "underestimated by the Reserve Bank and other forecasters over 2020", and that's very true. The ability of the Government to limit the damage to the labour market meant that the economy bounced back far more strongly and quickly than anyone really anticipated. And while that's a good thing, it's also a key reason why underlying inflation pressures have been so much stronger than was expected at the time.

On the implementation of monetary policy, the RBNZ notes they should:

8. Maintain the OCR as the preferred tool for setting monetary policy

9. Maintain operational readiness for AMP tools

This is consistent with previous comments from the RBNZ that amount to saying that the OCR is now the primary tool for monetary policy, with the unwind of the LSAP and residual drawdowns of the FLP largely happening in the background.

At this juncture it's important to note that the RAFIMP is separate to the Remit review which the RBNZ is also carrying out at the moment. As the RBNZ note "The Remit review is about the guidelines or framework for MPC decisions. RAFIMP is designed as a report card on what was done in the past 5 years and how effective those decisions were."

Implications

We don't see any implications in today's report for the monetary policy outlook. Clearly, with core and domestic inflation way too high, the labour market outside the bounds of sustainability, and inflation expectations creeping up, the RBNZ has a job to do to get on top of inflation and guide the economy to a sustainable growth path.

Beyond our central forecast, the work done to prepare the economy for future crises over the past couple of years (eg QE, the FLP, negative interest rates), may once again prove to be valuable. But the work required to fully understand the costs and benefits of such tools is just beginning.

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