Monetary policy: would you like fries with that?

- **The Official Cash Rate has been very effective at slowing an overheated economy and keeping inflation low.**
- **There is no need for 'supplementary instruments'.**

The Reserve Bank has been concerned that monetary policy may be losing its punch, and that supplementary measures may be required to augment the work of the Official Cash Rate and exchange rate. We do not think that the monetary tools are broken. Any supplementary instruments[1] should stand on their own merits, not on the mistaken notion that the monetary tools have lost their efficacy. For clarity of message, we'd prefer that the monetary policy burger came without extras.

In the following, we highlight why we think the existing monetary policy tools are effective. We seek to dispel some of the misperceptions that are being promulgated to promote the potential introduction of supplementary monetary policy instruments.

It didn't slow by itself

Economic growth slowed to 1.5% at the end of 2006, from 4.5% two years prior. This dramatic slowdown occurred despite a robust world economy (with global growth in its strongest phase since the late 1960s / early 1970s), very strong NZ commodity prices, the ongoing housing boom, and fiscal policy turning from contractionary to expansionary. The prime cause of the slowdown was tighter monetary conditions (i.e., higher interest and exchange rates). To be able to slow the economy against such a strong backdrop, monetary policy clearly still packs a wallop.

[1] Possible measures include bank capital requirements (or linking to cyclical risk), tax treatment of LAQC's, tax on property intended for resale, mortgage interest levy, discretionary loan to value ratio limit.

The market has responded

Wholesale interest rates have fully responded to Reserve Bank increases in the OCR. Table 1 compares the increases in wholesale interest rates and retail mortgage rates since their low points in mid 2003. Wholesale interest rates have increased by more than the OCR all the way out to the three year part of the swap curve. Even 5 year swaps have now increased almost as much as the OCR (221 bps v 250bps). Any central bank in the world could not reasonably hope for greater wholesale interest rate responses to monetary policy moves.

Table 1: Interest rate changes, in basis points, since their mid 2003 lows

	As at February 2007	As at 4 April 2007
OCR	225	250
90 day bank bill rate	273	287
1 year swap rate	290	303
2 year swap rate	259	280
3 year swap rate	230	257
4 year swap rate	209	233
5 year swap rate	189	221
New customer floating mortgage rate	246	266
1 year fixed mortgage	244	272
2 year fixed mortgage	217	264
3 year fixed mortgage	190	245
4 year fixed mortgage	169	223
5 year fixed mortgage	144	199

Starting point

The RBNZ has faced a few headwinds in terms of getting full traction from their OCR moves. These include contraction of bank margins, customers moving from floating to fixed mortgages, and customers extending their fixed rate terms. But the starting point

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is all important. These factors will not prove to be such a headwind in the future, so any OCR moves from now will have even more impact.

Since 2003, bank margins on fixed rate mortgages dropped from around 120bps in 2003, to 60bps in early 2007. (In late March / early April 2007, those margins have been partially restored to around 90bps). But it is easier for margins to shift from 120bps to 60 than it would be for them to move from 60bps to zero!

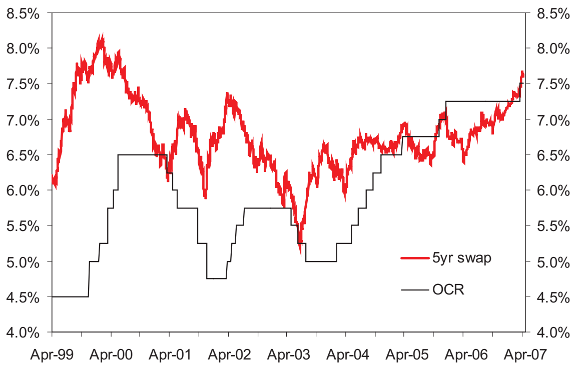
Fixed rate mortgages have increased from 60% of total mortgages in 2003 to 85% currently (partly due an inverted yield curve, and partly due to higher margins on floating rate mortgages). While the fixed rate share can move from 60 to 85%, it is impossible to move from 85 to 110%!

Borrowers have also been extending the duration of their fixed rate mortgages. The average fixed rate term has increased from 1.27 in 2003 to 1.82 years. With now only 20bps of difference between a one and four year fixed mortgage rate, the incentive to lengthen duration is less.

The popularity of fixed mortgage rates means many people are actually paying something lower than the current interest rates, at least until their mortgages roll over. But this does not make interest rates any less effective. It is the current interest rate that matters for new borrowing/saving decisions, not the average rate being paid by other people. A few people may live 'hand to mouth', but most are forward looking – if they expect to roll on to a higher mortgage rate in the future, they will tighten their belts now. We think that the RBNZ's focus on the 'effective mortgage rate' is misleading. In the US the majority of mortgages are at 30-year capped rates,[2] yet we have never heard anyone say that it takes a whole generation for US monetary policy to have its effect!

Regardless of all the above, Table 1 illustrates that mortgage rates out to 3 year fixed terms have either increased more than, or in line with, OCR increases.

Figure 1: 5 year swaps vs OCR



Even 5 year fixed rates have increased almost 200bps, despite convergence of long-term global interest rates.[3]

Stock of debt matters

The stock of household sector debt has increased from around 60% of household disposable income in 1990, to 180% currently. That means that any interest rate increase ultimately has a bigger impact on household debt servicing costs, because the quantum of debt has increased so markedly. In terms of impact on household debt servicing relative to income, a 32bps increase in the effective mortgage rate now is equivalent to a 50bps increase 5 years ago.[4]

Mixing it up

One complaint about the OCR is its effect on the exchange rate. There are certainly many hard-working exporters, especially in the manufacturing sector, who are struggling against the headwind of a high NZD. But it is not obvious that interest rates are entirely to blame. The New Zealand dollar appreciated 25% in 2003, a year in which the OCR was cut by 75 basis points. Last year the currency fell and then rose, but the OCR was steady all year. The New Zealand dollar is a commodity currency – when world commodity prices rise, the New Zealand dollar rises.

The rise in the New Zealand dollar has been a big factor in keeping inflation low, by making imports cheaper. Without the inflation-dampening exchange rate, interest rates would have risen much higher this cycle. That probably would have been even less popular than the high exchange rate! The Reserve Bank cannot control the mix of monetary conditions, but using the OCR, it can control inflation.

Two wrongs don't make a right

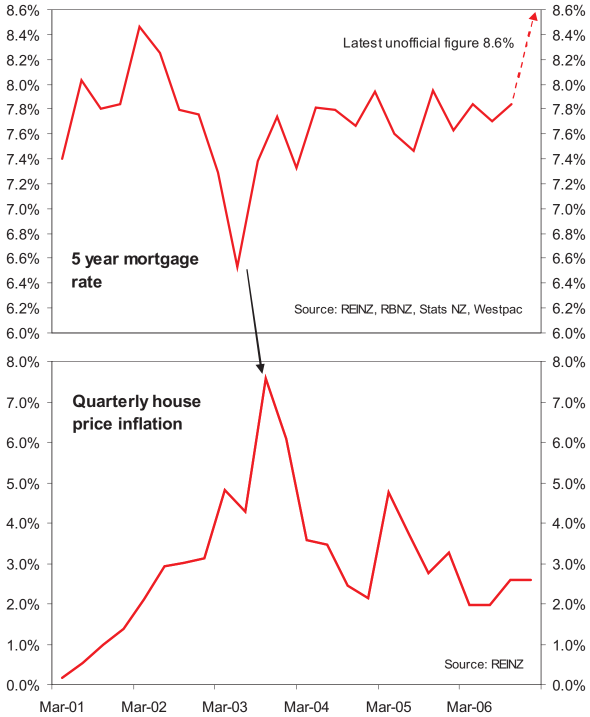
The inflation pressure that the RBNZ is currently facing is partly of its own making. With the benefit of hindsight, the RBNZ made a major policy mistake in 2003. The OCR was cut from 5.75% to 5.00% on fears of global deflation. However, these cuts occurred at a time of around 4% GDP, a positive output gap, net migration inflows in excess of 40,000, core inflation above 3.5% and rising, double digit house price growth, unemployment dropping, and high capacity utilisation at 0.91. The RBNZ tested the speed-limit of the NZ economy, and the economy was found wanting.

[2] In the US, the standard mortgage is a 30-year fixed rate. However, with no prepayment penalties when refinancing, it is effectively a 30-year capped rate. "Adjustable rate mortgages (ARMs)" have risen from 18% of the total in 2003, to 25% in 2005. The interest rate on ARMs resets after 3, 5, 7 or 10 years depending on the loan.

[3] Our latest issue of DownUnder Swap and FI Focus, 2 April 2007 has more on the OCR's effect on mortgage rates.

[4] See our Bulletin *A Dysfunctional Tool*, 7 March 2006.

Figure 2: Low mortgage rates fuelled house price boom in 2003



The cuts of 2003 are evidence that the OCR works very well indeed. Interest rates were cut, the housing market boomed, consumers borrowed to the hilt, and the economy expanded at an unsustainable pace. As there are long lags between monetary policy, economic growth, and inflation, the policy mistake of 2003 impacted on inflation outcomes right through to the first part of 2006. The long and protracted period of high interest rates ever since has been catch-up.

Safe as houses

If the effectiveness of monetary policy is being measured by what has happened to house prices, then this is the wrong yard-stick. Monetary policy should be solely measured on its ability to deliver a stable price level, not its ability to target a specific asset price. After all, the Reserve Bank Act states that the primary function of the Bank is "stability in the general level of prices". There have been strong fundamental factors behind the increase in NZ house prices, with the success of the RBNZ being partly responsible. Interest rates are lower and less variable than they were in the 1990s, and output variability has been reduced. Lower interest rates have lowered the cost of borrowing and allowed households to take on more debt. In turn this has pushed up the value of houses. The more stable macroeconomic environment has delivered the willingness to take on more risk. To boot, the increase in the top marginal tax rate increased the value of housing as a tax shelter. Our research suggests that, given fundamentals, most of the increase in house prices were justified. That adjustment to fundamentals in debt and house prices[5] has largely run its course, but the RBNZ trying to halt the correction was like King Canute trying to stop the tide from coming in.

Singing a different tune

The RBNZ could usefully change tack in its communications and start singing its own praises. The RBNZ has been successful in slowing the economy, it has kept the cash rate relatively stable, and inflation has quickly come back within the target band. This is despite true headwinds coming from the oil price shock in 2005/2006 and a marked drop in NZ's productivity performance reducing its potential growth rate.

We think that clarity of the RBNZ message would be enhanced if it sticks to the traditional monetary transmission mechanisms. Credibility is not enhanced if the central bank is intimating that its tools are not working well. To us, monetary policy is packing as much – if not more – punch than ever. For supplementary tools to be introduced, at the potential cost of unintended consequences and dilution of the central banks message, they must stand on their own merits. The current tools are not broken.

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[5] See our Bulletins *Household Debt: Why it has soared,* 16 Feb 2007 and *Bubble, Schmubble*, 16 March 2007.