The Treasury

Reserve Bank Act Review Phase 2 Submission Information Release

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Submission on Phase 2 of the Reserve Bank Act Review

The basic tenet behind the Reserve Bank (RB) review is to increase its intervention in the Trading Banks (TB's). The justification to quote the RB:

"Even with high capital requirements banks can still fail so regulation, supervision, resolution, and deposit protection all make up a financial safety net."

The RB propose increasing the prudential capital buffer from 2.5% to 10% so effectively raising the TB's capital ratio requirement from 10.5% to 18% of risk weighted assets. A research review by the RB indicates that the risk of bank failure is near zero at 25%. Modelling bank run risk is inherently difficult especially where a black swan event is possible. When sovereigns can issue negative yielding bonds now accounting for 25% of the bond market it implies real concern about capital preservation. The TB's long run average LVR is 67%, so their view of capital requirement is 33%. Those who have been involved in substantial risk taking especially where there is a timing mismatch would see 33% as a minimum, albeit increasing TB's capital to this level will need time. Any thought of too big to fail with the taxpayer on the hook should not be contemplated.

I submit that the capital ratio of the TB's be increased to 33% of risk weighted assets, and the proposed intervention be set aside, as sufficient regulation and supervision currently exists.

Further on interventionism:

1. It will stifle innovation, increase costs, decrease efficiency, and impose barriers to competition.
2. It will reduce access to funding which is the key to economic development.
3. Its results are not able to be conclusively assessed. Correlation versus causation of the LVR macro prudential policy review is a case in point.
4. Is effectively saying that that RB knows better on how to run a TB than the TB's.
5. There is no accountability for the RB actions.
6. Its unintended consequences are unknown.
7. It introduces a moral hazard.
8. It will lead to further intervention in the future on the grounds of either, it has or hasn't worked.
9. The view that because other countries do it is not sufficient reason for the RB to do it.
10. The monetary policy risks of the RB are a bigger factor in NZ's financial stability.

The quote by Fed Chairman Ben Bernanke in 2009 is particularly pertinent:

"The Federal Reserve devotes substantial resources to economic forecasting. You will know that many very smart people have applied the most sophisticated statistical and modelling tools available to try and better divine the economic future. The results unfortunately have more often than not been underwhelming."

As part of this review I would like to see the RB's monetary policies independently reviewed as the consequences of these have been significant in the call for further intervention in the TB's. Most importantly is the 2% inflation targeting which has driven lax monetary policy over the last 10 years and created the economic risk seen at present. Below is the letter sent to the MPC of the RB in May 2019 which asks the questions.

The Phase 2 Review Process is also in need of change because:

1. The review process lacks independence, as the Treasury and the RB itself are the principal reviewers.
2. The Independent Expert Advisory Panel input is not defined in the final decision making process. The Panel should be the principal reviewer, report to directly to the Minister of Finance, and its recommendations be made public.
3. There is not, but should be significant business representation on this Panel, who with skin in the game, create the wealth, pay the tax, provide the jobs and understand the risks.
4. The outcome of negative submissions has not been defined which makes one think the RB intends to proceed irrespective of these submissions.

In an effort to improve the decision making process I would recommend to all those involved they read "Thinking in Bets" by Annie Duke.

As part of a wider process fiscal policy risk should also be linked, and in this respect maximum levels of taxation and % debt to GDP should be agreed upon.

Summary:

1. Safeguarding the future of our financial system is best achieved by ensuring our Trading Banks are sufficiently capitalised by increasing their capital ratio to 33% of risk weighted assets.
2. No further intervention of the Trading Banks is required as sufficient regulation and supervision currently exists.
3. The review process needs to be completely independent of the Reserve Bank and Treasury along with having significant business representation on the Independent Expert Advisory Panel.
4. The Reserve Bank monetary policies need to be independently reviewed as they are a significant driver of the economic risk that now exists.

Alistair Coster

12 August 2019

27 May 2019

An Open Letter to the Monetary Policy Committee of the Reserve Bank of NZ

I have some questions

1. Why do we have a 2% inflation target defining a stable level of prices?

   Two percent inflation halves the value of your money every 36 years so $1 becomes worth 25c in your life time. How can this possibly be described as stable and why would anyone want this to happen to their money?

2. Why is the RB so concerned about deflation?

   The majority of people have to spend all they earn and the wealthy base their spending whenever they want to. Falling prices therefore are not an issue as seen in the rush to buy when the "Sales" are on. Lower prices increase real incomes and wealth. There is no evidence to suggest deflation will hold back economic growth as seen in the BIS March 2015 quarterly review "The Cost of Deflations."

3. Why does the RB use the CPI as a measure of inflation?

   Rentals and new home ownership account for 15% of the CPI yet the 2016 Household Economic Survey shows for an average family rent is around 30% of expenditure and for home ownership mortgage costs are around 35%. Rents have increased on average 6.25% per year since 2003 so effectively contributing 1.9% per year to inflation vastly different from the CPI figure of 0.25%. The CPI weighting is not operating in the real world and inflation is being grossly understated.

4. Why does the RB use core inflation?

   The concept of core inflation is irrelevant as any family looking at their Bank statements and seeing the cost increases can tell you. One off tax increases are not one off as far as the consumer is concerned.

5. Why is the RB trying to forecast inflation using capacity pressure as a driver?

   The constantly changing decisions by millions of consumers can't be distilled into anything of value as the data set is too large. Potential output and the output gap are not measurable so they need to be estimated. The RB is just guessing. It is simply not possible to forecast the future so why do it. Also in todays interconnected world the impact of policy change is almost immediate so negating the need to forecast.

6. Why is the RB trying to forecast inflation using inflation expectations as a driver?

   As said the majority of people have to spend what they earn and expectations as a result are meaningless. The only area where price expectation will be a driver is in the purchase of major assets such as property or shares. The signals given by the House price and Share market indexes however have been the exact opposite to the OCR movements. Inflation expectations don't work so shouldn't the asset indexes be used instead?

7. Why isn't monetary policy being primarily driven based on ensuring the financial stability of the Banking system?

   The biggest risk to the financial system is Bank failure. The NZ Bank lending to the residential property sector is around 57% of total lending. The loose monetary policy has resulted in lower interest rates which is a key driver in the purchase of assets especially residential property and shares. This has resulted since 2003

   - residential property up 300%,
   - the share market up 400%,
   - household debt to income up at 166%

   However GDP is only up 50% and supposedly inflation per the CPI up 35%.

   Monetary policy via inflation targeting has failed. It was a tool for a mind-set change when we had 17% inflation. Today however as a result of this policy a massive asset bubble has been created with a serious risk to the Banking system. Where did the Reserve Bank think the money was going to go? It's not the fault of the Banks and further macro prudential regulation of them is not the solution. The problem is the interest rate suppression by the RB has created the situation which will lead to a banking crisis. It is that the RB that is the problem and that it needs to get it right. The Australian banking system will be the trigger with already one million households under financial stress. An asset based monetary policy which is meaningful, easy and accurate to measure, doesn't require any prediction, will be far better at managing the risk by reducing the scale of the boom/busts.

8. Why is NZSIM the core monetary policy model used to produce the forecasts?

   This model is based on theoretical assumptions on the way firms and households interact, along with expert judgement and a range of other analysis to account for preferences and information not contained in the model, along with the 50 other RB statistical models. Fed Chairman Ben Bernanke in 2009 said "You know we have many very smart people who have applied the most sophisticated statistical and modelling tools but the results have more often than not been underwhelming" The fact that no Central Bank predicted any bubble says it all. The NZSIM is just guesswork.

9. Why is the RB using the Phillips Curve to model inflation and unemployment?

   A 2017 Fed study concludes that Phillips curve models are not relatively good at forecasting inflation on average. Charts suggest it works about half the time on a random basis meaning the theory doesn't work at all. Linear modelling simply doesn't work in the long run.

10. Why is the RB still thinking the Keynesian multiplier works and that by means of fiscal and monetary stimulus a recession can be prevented?

    Government spending is generated by firstly taking away from the wealth producers their savings via taxation which weakens the production of goods and services. Debt spending has the significant problem of declining productivity as the debt levels increase. On the monetary side interest rate suppression no longer causes inflation in the developed countries as the velocity of money slows. The Keynesian approach hasn't worked since the GFC which led Paul Krugman to state Governments and Central Banks simply hadn't done enough. Japan would be a good case study as to this flawed Keynesian approach. Surely we don't want Japanification to happen to NZ?

11. Why do we never hear about the growth in the money supply which is what inflation is about?

    The increase in the money supply in NZ from 2003 to 2019 was 300% and is in line with the property price increases. As a rule it is the increase in the money supply that sets in motion the increases in prices and causes a weakening of economic growth. The changes in price are the symptoms. Shouldn't money supply growth and its velocity be a key factor in monetary policy?

12. Why do savings not feature as a key component in the monetary policy?

    The chain of wealth creation is very simple. Supply has to occur before demand and without savings growth can't occur. Taxation takes away savings and depresses growth as there is less capital available to the wealth producers.

Profits – Taxation = Savings = Investment =Production = Employment= Growth

It's the supply of savings that provides the capital. When the RB drives the interest rate on deposits down with loose monetary policy (the last 10 years) then consumption rather than saving occurs and the wealth generation process diminishes. This is being seen around the world and to a greater extent in countries where lower real interest rates prevail. It is incorrect to view the substitution whereby increases in savings decrease employment. Savings are critical to growth and the Bank need to ensure real rates of return on them. If the norm of 2% above the rate of inflation to ensure savings is used then that would have the OCR at 3.50% instead of currently 1.50%.

13. Why has the RB agreed to maximum sustainable employment?

    To quote the RB, "MSE is largely determined by non monetary factors and is not directly measurable. It is the balance of supply and demand whereas monetary policy works by influencing demand." You are just guessing. Surely as MSE can't therefore be determined it should not be part of monetary policy?

14. Why is the RB running a loose monetary policy which is causing wealth inequality?

    The inequality in wealth is principally through booming asset prices is a result of the lax monetary policy of the RB suppressing the interest rates. While the public accept that we will not all have equal wealth, asset prices have become unhinged from the real main street economy. This will in the near future give rise to social unrest whereby the politicians will then seize the opportunity to gain power by promising taxation policies to fix the problem which in themselves will be hugely problematic. The inequality and the social unrest will fall back on the RB whose policies will be seen as a primary cause of the problem. Surely asset prices should be a key driver in monetary policy to prevent excessive wealth inequality?

15. Why does the RB continue to be a primary driver of the boom bust cycle?

    Reinhart & Rogoff in 2011 in a paper This Time is Different A Panoramic View Of Eight Centuries of Financial Crisis explain how history has repeated itself via easy money pumped into the system by Central Banks and Sovereigns, distorting financial decisions, so encouraging malinvestment of capital and causing prices to rise beyond their productively useful value, a debt crisis results, with the boom leading to bust. The more intervention the bigger the distortion and the bigger the bust. Interest rates impact on all financial pricing in the world and the Central Banks have distorted all these prices. Isn't it time to stop the monetary heroin?

16. By its actions why does the RB think that in this coming recession that driving interest rates down to zero and then probably followed by a bout of QE will be the solution?

Apart from Japanification what is at risk is that NZ not being a major economy capital flight to the majors will occur with a large fall in the NZD which along with being highly inflationary will force a rapid increase in interest rates in NZ. The RB needs to remember our dollars are only bits of paper and confidence can change incredibly quickly as seen in Venezuela. Large economic risks are being taken by the RB which will impact on the lives of most New Zealanders.

Hopefully these questions will lead to a change in approach to monetary policy by the RB in the near future.

Yours sincerely
Alistair Coster