UNCONVENTIONAL
MONETARY POLICY

Principles
AND TOOLS

RESERVE
BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Principles for Using Unconventional Monetary Policy in New Zealand

Context

Like most central banks, the Reserve Bank of New Zealand typically implements monetary policy by controlling the short-term policy rate, the Official Cash Rate (OCR).

However, conventional monetary policy in New Zealand could be pushed to its limit in the future. In recent years, many foreign central banks have had to turn to unconventional monetary policies as their ability to lower short-term policy rates became constrained. Unconventional monetary policy represents the use of tools other than the OCR to affect the economy through multiple transmission channels (see Annex). This paper describes the principles that would guide the Reserve Bank Monetary Policy Committee's use of these tools, if they were required to achieve the Committee's *Remit* objectives. This paper also outlines the tools the Committee would consider, and the channels through which they affect the economy.

You can read more about the context for the Reserve Bank's work on unconventional monetary policy tools in Adrian Orr's speech on Navigating at Low Altitude: Monetary Policy with Very Low Interest Rates.

Principles for Using Unconventional Monetary Policy

We have developed the following set of principles, based on the Committee's objectives as set out in the *Remit*, to evaluate how different unconventional monetary policy tools contribute to effective monetary policy. Publishing these principles provides greater transparency about how the Committee would use these tools. Our aim in setting principles is to provide a clear framework for using monetary policy should the OCR reach zero.

Principles

MPC *Remit Principles*

Effectiveness	Tools would be designed to provide a strong influence over inflation and employment, to ensure that the monetary policy objectives are achieved.
Efficiency	The Committee would take into account the distortionary impact of the tools on the efficient allocation of resources within the economy, including between various groups and sectors of the economy.
Financial system soundness	The Committee would take into account the impact of the tools on financial system risks, to avoid the costs of financial crises.

In addition to these principles are two operational considerations related to the practical implementation of effective monetary policy.

Operational Principles

Public balance sheet risk	The Committee would take into account the financial risks that the tools would create for the Reserve Bank and Crown balance sheets, to protect public funds and central bank independence.
Operational readiness	Use of the tools would take into account the operational readiness of each tool, to ensure the transmission channels function as expected. This includes the readiness of the Reserve Bank to implement each tool and the readiness of financial markets and the New Zealand public to respond appropriately to the tools.

In many cases, the principles would be complementary. For example, monetary policy is more effective if it does not weaken the efficiency of the economy or cause financial instability. However, there could be conflict between some principles some of the time. For example, some tools could be highly effective but would create risks to the public balance sheet. In these circumstances, the Monetary Policy Committee would seek to balance the principles when making decisions on the use of tools.

It is desirable to provide some flexibility in how the Reserve Bank uses these tools because some are untested in New Zealand. Over time we will learn more about the tools and their impact on the principles. In addition, the importance of the principles could vary depending on the circumstances at the time. For example, the impact of monetary policy on financial system soundness could be of lower concern if the Reserve Bank were confident that other policies, e.g. prudential policies, would mitigate any build-up of financial system risks.

The principles recognise that the tools may operate differently from the OCR and, therefore, can have different side effects. Ultimately, the principles are designed to ensure that these tools would only be used to meet the Committee’s remit, as doing so is beneficial for New Zealand overall.

Summary of Unconventional Monetary Policy tools

We have been working to develop our understanding and capability to use a range of tools, building on the initial assessment in the 2018 RBNZ Bulletin, *Aspects of Implementing Unconventional Monetary Policy in New Zealand*. The tools we have been working on are described below.

Tools

Forward guidance	This would differ from our current approach of publishing our OCR forecast. It may involve publishing a forecast of the *shadow short rate*, which shows the combined stimulus from the OCR and other monetary policy tools through interest rates. It could also involve the MPC announcing a commitment to keep monetary policy expansionary, in order to hit our monetary policy targets in the medium term, even if the MPC expect this to eventually push inflation above 2% or employment above its sustainable level.
Negative OCR	Reduction of the OCR to the *effective lower bound* (the point at which further OCR cuts become ineffective), which may be below zero. The Reserve Bank could consider changes to the cash system to mitigate cash hoarding if lower deposit rates led to significant hoarding.
Interest rate swaps	An interest rate swap is a contract where one stream of future interest payments is exchanged for another. The Reserve Bank could enter into interest rate swaps to reinforce forward guidance. We would receive fixed rates and pay floating rates to financial market participants. This would reduce market interest rates.
Large Scale Asset Purchases (LSAPs)	The Reserve Bank could purchase domestic government bonds to lower interest rates and contribute to a flattening of the yield curve through the main channels of policy signalling and portfolio balancing. Unlike the OCR, LSAPs would have more of an effect on longer-term interest rates (2+ years), which are important for mortgage and business lending.
Foreign asset purchases	The purchase of foreign currency or assets to reduce the NZD exchange rate and, if desired, to increase NZD liquidity. This could include the systematic purchase of foreign assets or buying fixed quantities on set dates.
Term lending	The provision of collateralised long-term loans to banks in order to support monetary policy transmission through the banking sector. The loans could be provided with conditions that require banks to increase their credit supply.

Deployment Strategy: How The Tools Might be Used

The Monetary Policy Committee’s choice of tools will be guided by the principles, above, and will depend on its assessment of the prevailing economic and financial conditions. A likely scenario is that the Committee will continue using conventional monetary policy until it is exhausted, i.e. when the OCR reaches zero.

Once this point is reached, the Committee may consider tools that work in the most similar way to the OCR, i.e. mainly by influencing interest rates. These include forward guidance, a negative OCR, and interest rate swaps. As these tools operate in a similar way to conventional monetary policy, their impacts and side-effects may be better understood. These tools are also likely to have a smaller financial impact on the Reserve Bank and Crown balance sheet.

The effectiveness of these tools could be reduced if they are used after other tools which vastly increase the supply of central bank money, such as large scale asset purchases or foreign asset purchases. This reduction in effectiveness reflects that bank profits are more sensitive to very low interest rates if the money supply has been inflated, and so an inflated money supply may reduce the ability of banks to pass on low interest rates to borrowers.

The Committee could choose to use a combination of tools, should significant stimulus be required. Such packages of tools have been common in other economies.

The sequencing described should not be taken as a final ordering of preferences from the Reserve Bank. Rather, this indicates our current thinking in response to the scenario of a gradual downturn. The principles and economic environment will ultimately inform which tools would be adopted by the Committee, if required.

ANNEX: THE CHANNELS THROUGH WHICH THESE TOOLS AFFECT INFLATION AND EMPLOYMENT

(This diagram shows the different channels through which different these tools ultimately end up affecting inflation and employment. It builds on the monetary policy transmission mechanism shown in the Monetary Policy Handbook (p52))