

The Great Moderation and the Great Confusion

Treasury Presentation
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Michael Cullen

Pride

The Great Moderation, c 1985-2007/8

- much reduced volatility in economic cycles
- sustained period of relatively stable low inflation

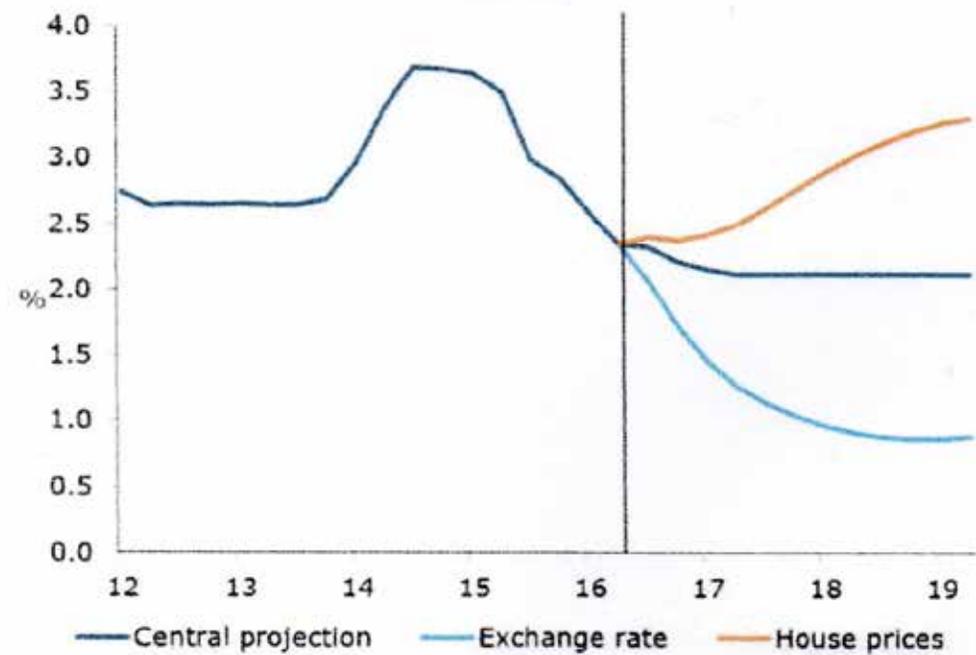
Attributed by many to successful innovation in monetary policy:

- Inflation targeting
- Central bank independence
- Indicative interest rate setting
- No impact on sustainable rate of growth

Is this all true?

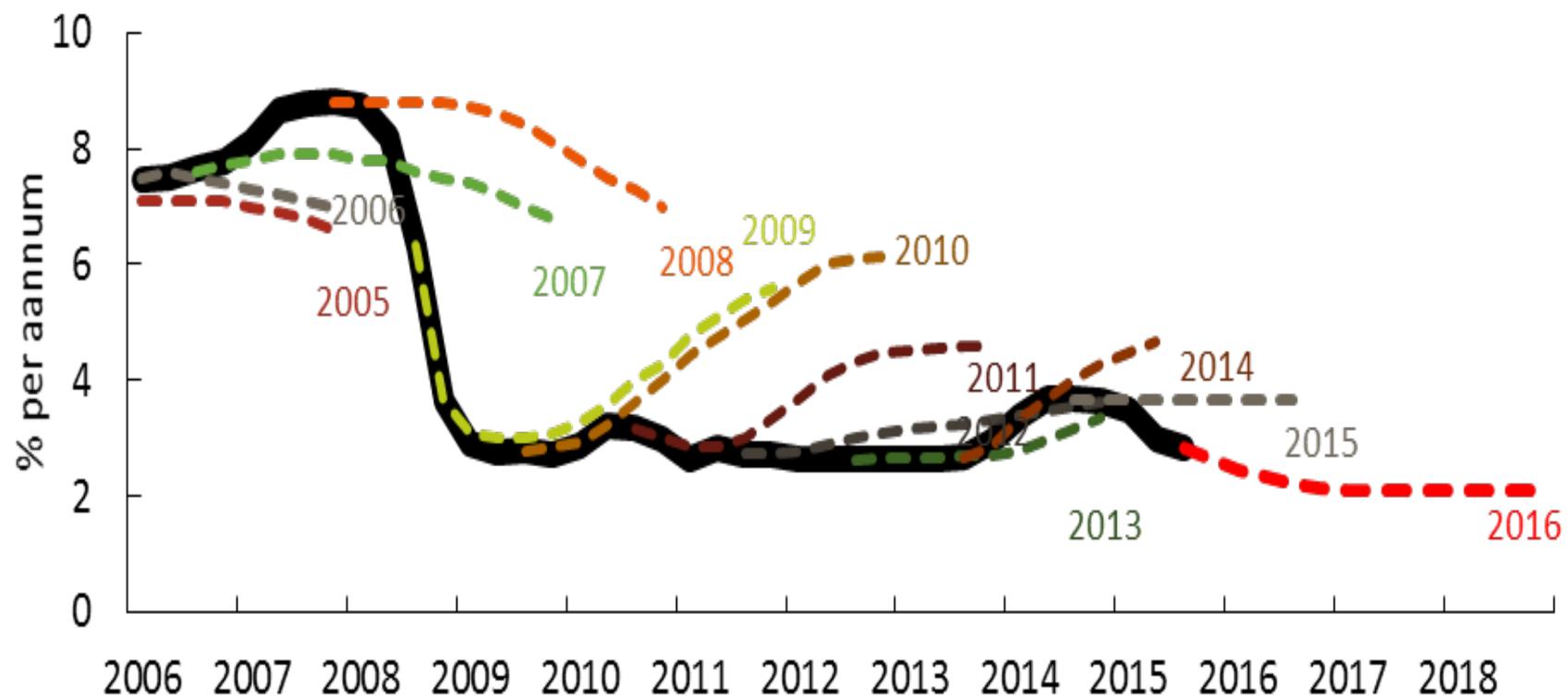
- other factors
 1. shift from manufacturing to services
 2. information
 3. flexible labour markets
- what was really targeted?
- managing forward inflation expectations

RBNZ June Monetary Policy Statement Alternative Scenarios



Source: RBNZ, ANZ, Eriksens

90 Day Bank Bill: Actual versus RBNZ forecasts



Average growth not equal to sustainable rate

- could be significantly lower
- monetary policy could affect downwards, not upwards in small, open economy
- sustainable growth rate not fixed

Fall

- credit expansion
- new instruments
- classic financial collapse 2007-8
- followed by the Great Confusion

Responses

- saving of financial system
- monetary policy easing
- quantitative easing
- counterbalanced by fiscal austerity – especially in Europe
- Europe now stuck in Japan-style low growth trap

Raises crucial questions

- can equilibrating monetary and fiscal policy work in a full-scale financial crisis?
- what are relative roles of monetary policy and fiscal policy in downturns?
- what other approaches can be taken?
 1. monetary policy tools
 2. fiscal policy
 3. tax
 4. spending

Distinguish between "normal " cycles and financial crises.

Normal business cycles: monetary policy most appropriate (agree with neo-Keynesian consensus).

But still needs friends:

- avoid contradictory fiscal policy
- variable Kiwisaver contribution rate
- flexibility
- recognise effective lower band above zero

Financial crises

- monetary policy quickly runs out of room
- Need unorthodox monetary policy tools:
 1. QE
 2. fiat money
- Fiscal policy comes into play
 1. Implies strong countercyclical fiscal policy on upside
 2. Has to be able to be temporary and /or phaseable
 3. Infrastructure
 4. Housing (both requiring long term programmes)
 5. Coordinated income policies possible?

Big Issues

- fit for purpose financial system
- serious commitment to balanced countercyclical fiscal policy
- how to have “projects in pocket”
- direct fiscal injections need to be focused on lower paid
- changes to welfare system
- building a “better globalisation” that manages change

Summary: longer term, flexible thinking