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10/10/2011

Overview: A Review of Monetary Policy and the Policy Targets Agreement

Introduction

The following discussion brings together several papers written as part of a work programme that examines possible changes to the Reserve Bank of New Zealand's (RBNZ) policy target's agreement (PTA)[1] (RBNZ's 2012 Policy Targets Agreement: Scoping Note II:2115349 refers). The overall purpose of this overview discussion is to provide an integrated view about a range of monetary policy issues for the Briefing to Incoming Ministers (BIM).

The focus being possible changes to the current PTA that expires with the new term of the Governor in September 2012, whoever that may be. However, the review also considers issues outside the scope of the PTA such as governance structures. Depending on the post-election feedback from Ministers, further work will be necessary to pursue Ministers' preferred approach prior to the new PTA being put in place.

This note has a particular focus on addressing:

- The issues that present with monetary policy as currently configured;
- Possible solutions to these issues; and
- Analysis about how these solutions fit with stated political preferences.

Links to the background papers are provided for completeness.

Summary of Findings

The main finding is that the Reserve Bank of New Zealand Act 1989 and the core elements of monetary policy are **sound with good but not excellent[2] monetary policy outcomes**. Overall, Parkyn (2011) found that monetary policy has performed reasonably well with respect to the expectations set out in the Policy Targets Agreement over the last decade. Nevertheless, three issues stand out as weak spots:

- Average CPI inflation outcomes and medium-term inflation expectations at uncomfortably high levels, albeit just within the target range.
- A tendency to look through positive temporary shocks to CPI inflation to a greater degree on average than with respect to temporary negative shocks.

[1] The PTA is an agreement between the Governor of the RBNZ and the Minister of Finance setting out the targets for meeting price stability, and how they should be met.

[2] Excellent is a subjective judgement call referenced against objective criteria (i.e. achieving price stability at least cost)

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- With hindsight, monetary policy appeared to be insufficiently tight at certain times during the last decade. Clause 4b, in combination with other elements of the PTA, appears to have played a role in enabling this outcome.

While many of the problems associated with monetary policy are symptoms of problems of wider economic policy settings**, to make the transition to excellence** we have identified several issues in the way the way monetary policy is being operationalised,

[Withheld under s.9(2)(g)(i)]

- An inflation rate that sits at the top of the target band, so shocks or errors in judgement tend to cause the inflation rate to sit outside the target band. This is reflected in two year ahead inflation expectations, which increases the cost of responding to macroeconomic shocks;
- mounting supply side problems from greater tax distortions (in the absence of indexation) and uncertainty for economic agents about how to respond to possible future states of the world, when higher average inflation is further clouding real price signals, especially with respect to long-term investment decisions;
- An economy that has swings in interest rates and exchange rate, which are not solely due to exogenous factors beyond the control of monetary policy, but reflect monetary settings that turn out to be in error with the benefit of hindsight. The exogenous factors include commodity prices, international risk appetite, or fiscal policy. However, to some degree errors are also inevitable given real time uncertainties when dealing with shocks;
- Aided by a culture that risks further complacency in the future, an economy prone to significant and credit driven asset cycles that leads to significant and damaging economic cycles; and
- Governance arrangements that may be inadequate and so accountability for inflation outcomes risks becoming too weak .

However, the possible solutions to these issues **involve evolutionary rather than revolutionary** changes. Possible reform options include:

- **Reduce monetary policy discretion by moving to a point target** – The PTA could be amended to move to a point target of future inflation of 2% on average over the medium term, rather than the current 1 to 3 percent band. This would better anchor inflation expectations and reduce the Governor's wide discretion in setting the future path for inflation, but without comprising desirable flexibility to shocks. This would be an effective tightening of monetary policy given recent inflation outcomes and expectations, but this is necessary as higher inflation is associated with higher costs especially when the tax system is non-inflation indexed. It may be possible to reduce the transition costs by pursuing this over a period of time to encourage the Bank to reduce inflation opportunistically. Importantly, moving to a point target will make it more difficult for the Governor to respond asymmetrically to shocks, which to date has contributed to the upwards drift in inflation. As is the case now, the Governor would still need to explain deviations from the 2% target that exceeded 1% either way, including setting a path about how to get back to 2% inflation. This would be a move closer to towards the approach of the UK and Canada. More radical changes to the target

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regime such as price level, nominal GDP or non-tradable CPI targeting have at this stage been ruled out as unnecessary and facing some practical challenges, although targeting non-tradable inflation may not be too costly and could be an area for the Reserve Bank to investigate further.

- **Enhanced mandate for macroprudential** –The PTA could be amended to make it clearer that the Government expects the Governor to more explicitly manage credit induced asset cycles, which in the long-term have been shown to significantly complicate price stability management and can lead to costly financial crisis. As is the case now, how and when to do this are technical judgements that are better left to an independent RBNZ. This is consistent with the generally permissive approach to flexible medium-term targeting agreement. Indeed, at the moment the current wording of the PTA implicitly permits the RBNZ to focus more on credit cycles as part of existing monetary policy or financial stability mandates. The judgement call to be made is whether a change is necessary to guard against complacency through a stronger accountability hook. More prescriptive mandates have been ruled out at this stage as unnecessary and likely to be unhelpful.

- **Enhanced governance practices to reduce the risk of errors** – Governance is fundamentally about the nature of decisions and how judgement can be systemically improved to raise quality and reduce the likelihood of mistakes Given the discretion under a medium –term inflation target, scrutiny of the Governor's performance is very important, especially if there is a risk of a novice Governor that could initially make rogue decisions. [Withheld under s.9(2)(g)(i)] To reduce the risk of a rogue Governor, the Board in its recommendations to the Minister on Governor appointments could weight monetary expertise highly in its decision criteria. This could require building expertise in prudential expertise and executive management skills in specialist Deputies if needed.

  [Withheld under s.9(2)(g)(i)]

  Lastly, the internal advice the Governor receives could be made available in a timely but not attributable way to make the debate over appropriate monetary conditions more transparent. Other more radical options such as moving to a Committee decision making process common internationally have been ruled out at this stage as the gains not big enough yet.

Elements of these solutions are intertwined so are better considered as a package deal. For example, a point target would help enhancing the accountability of monetary policy. These solutions are consistent with general views expressed by external stakeholders (see Annex 1). However, we are yet to gauge the views of the bank or the Minister on these solutions as we are keen to first get wider buy in with the rest of the Treasury.

Going into the project the Minister set a high hurdle for change to the PTA because he does not believe that there is anything fundamentally wrong with monetary policy and continual tinkering

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with the PTA is itself costly. We are sympathetic to the Minister's view. In particular, while as outlined above we consider there are possible improvements to monetary policy, these are likely second order issue to improving policy settings in the wider economy. Monetary policy has to manage the economy as it presents, and many of the challenges it faces are symptomatic of poor policy settings elsewhere rather than being monetary in origin. For example, if fiscal policy is pro-cyclical monetary conditions need be tighter then otherwise causing bigger cyclical volatility in interest rates and exchange rates.

In short, monetary policy needs more supportive wider economic policy settings or "mates". Moreover, these wider changes in policy settings are likely to be more effective in raising growth towards aspirational targets through improving the supply side of the economy. While it is beyond the scope of this paper to discuss these changes to economic policy settings in detail, candidates for improvement, which have strong cross linkages with monetary policy include fiscal policy, taxation of returns to saving and housing, and immigration policy. The opposition parties agree with this perspective too within an overall framework of independent monetary policy that retains a focus on price stability. This provides some commonality for Treasury on engagement if need be. However, the opposition parties also have views that we do not share regarding monetary policy, including multiple statutory objectives and more active exchange rate management.

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[Withheld under s.9(2)(g)(i)]

Before we spend too much effort regarding implementation, we need to know Treasury's preferred options. The PTA needs to be in place by September 2012. In case we are seeking significant changes, these would need to be signalled around Budget next year so the Governor new or incumbent knows what to expect. In the unlikely case legislation is needed, 3-4 months time will need to be built in for this process. Given the need to deliver on time and the high reputational stakes involved, the Treasury and the Minister of Finance will need to be confident not only about any policy changes, but capability to deliver. This underscores the high hurdle test set by the Minister.

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Core Framework Sound but Operational Issues

Monetary Policy Objectives

Treasury has an overarching goal of higher living standards for New Zealanders (http://www.treasury.govt.nz/publications/research-policy/tp/higherlivingstandards refers). The focus of monetary policy should be the role it can usefully play to this end.

Based on the evidence to date[3], the longstanding view of the Treasury and widely accepted by political parties is that the main role that monetary policy should play to further living standards is to seek price stability. In the long-run, this is all it is effective in achieving. In doing this, monetary policy seeks to smooth cyclical demand fluctuations that may otherwise adversely interfere with the supply side of the economy through inflation. In particular, inflation does this by blurring long-term investment signals. But in general, its effect is to reduce the efficiency of resource allocation decisions to the detriment of living standards, especially if taxes are not inflation indexed. Inflation also has negative distributional impacts.

A major source of potential fluctuations in demand can be shocks to monetary conditions either through policy induced changes to the monetary supply, or through changes to the velocity of money from shocks, to the banking system. Therefore, one of the key aims of monetary policy is to seek to avoid money being the cause of shocks, i.e. minimise self harm. Indeed, **attempting to raise average rates of long-term economic growth through monetary policy will only lead to inflation.** In addition, monetary policy should be operationalised independently from government because it increases the likelihood of policy settings being consistent with price stability compared to more cumbersome politicised operations, i.e. monetary policy should essentially be a technocratic exercise.

In a nutshell, monetary policy's current focus on price stability allied with central bank independence is not under threat politically or intellectually. However, a complicating feature of monetary policy is that in the **short-term monetary conditions have real effects.** This is the cause of the on-going political debate about monetary policy over the last 40 years, which would otherwise not exist if it only ever had nominal impacts in all time periods (discussed more below). The temptation is to try to use monetary conditions to fine tune economic activity to some desired growth path even though this may be inconsistent with what is necessary for price stability (i.e. time inconsistency). Moreover, uncertainty in the lags between monetary conditions and economic activity makes fine tuning in practice difficult and perhaps even counterproductive.

For this reason monetary policy authorities have taken the position that it is better to take short-term decisions that are consistent with medium-term price stability. The medium term is the preferred time horizon because this is where there is greater certainty about the level of interest rates required for price stability (i.e. the neutral real rate of interest - NRR). A medium-term price stability focus generally involves moving policy interest rates (i.e. official cash rate or OCR) according to a path relative to the NRR that is expected to result in economic activity consistent with price

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[3] Svensson 2001 argues that international and historical evidence overwhelming points to monetary policy over the long-term impacting solely on the price level.

stability in 18 months to two years time. In the absence of wayward inflation expectations away from the target or the risk of shocks that may impact on CPI outcomes , this is likely to be achieved if actual one-year ahead economic activity is close to what the economy can produce when all idle resources are fully deployed (i.e. actual activity is close to potential economic activity or an output gap of zero). Of course this involves a good understanding of how interest rates impact on the economy, i.e. it is a technical modelling exercise.

A medium-term focus also has the advantage of allowing policy makers to look through the impact of most shocks as they can be expected to only have temporary price level effects. Otherwise policy interest rates would need to change rapidly and significantly in response to shocks such that economic activity changed in sufficient magnitude to have offsetting price level effects. For example, with a short-term focus, any oil price shock would need a large and rapid increase in interest rates to ensure non-oil prices such fell quickly. Such a stop start path for economic activity would be costly to living standards.

Ironically, experience shows that if monetary policy is conducted with a medium-term focus, both price stability and medium-term economic stability can be simultaneously achieved (i.e. CPI and GDP grow in harmony) because to some extent shocks work in both directions and so cancel each other out. However, to achieve this from time to time, it will be necessary to slow or speed up the economy until harmony is reached again.

Operational challenges

Consistent with the Treasury's view about the role and responsibilities for monetary policy, the PTA does not define price stability in terms of zero aggregate price movements (absolute price stability). Instead it is defined in terms of keeping future inflation between 1-3% on average over the medium term. The lower bound of the target recognises that the CPI typically has a 1% bias because it does not take into account quality improvements in the baskets of goods of services well. Furthermore, some inflation is useful to facilitate relative prices changing more easily (nominal prices exhibit downwards stickiness). But a CPI that rises to quickly has costs as discussed above, hence the upper bound of 3%. Furthermore, in recognition of the high cost of trying to stay within the band at all times when responding to shocks, the targets have a future on average medium-term focus. This is bolstered by additional clauses that provide specific outs for temporary shocks to prices and require the RBNZ to seek paths to medium-term stability that avoids unnecessary instability in output, interest rate and the exchange rate (Annex 1 refers).

The logic for this type of PTA configuration is still sound, and has led to the characterisation of New Zealand's monetary policy as being consistent with a medium-term inflation targeting regime. However, this logic is not set in stone it reflects an evolution in thinking as reflected with incremental changes in the PTA since first put in place. Nevertheless, alternative formulations for what could constitute price stability are considered for completeness. However, how would you know whether monetary policy has been successful as it could be, what are the criteria?

The CPI target lends itself to objective numerical measures that are easy to assess, i.e. inflation is either in the band or not. However, to the extent that the definition of achieving price stability require some interpretation (i.e. on average over the medium term) then more subjective judgement will always be necessary. The forward looking dimension to the target is also a challenge

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since objective measures of inflation are historical while forward looking forecasts are not (discussed more below).Subjectivity is certainly an issue when assessing whether monetary policy has harmed the economy unnecessarily, it implicitly assumes there is a counterfactual benchmark to assess whether there could have been alternative monetary settings that would have been superior. The Taylor rule for monetary policy potentially provides some insight here. It sets out a path for desired policy interest rates based on equally weighting movements of inflation and economic activity away from desired levels.[4]

Another possible criterion for success could be that the public's inflation expectations reflect the definition of stability. Inflation expectations are important because of their impact on the amount of work required to achieve price stability. For example, when inflation expectations reflect the target, it means that prices are more likely to be set in ways that reinforce price stability (i.e. a self fulfilling prophesy),which is especially important when the economy faces shocks. However, to some extent this criteria could be redundant, as inflation expectations will generally reflect actual and expected inflation, so if price stability is being correctly targeted, implicitly so will expectations. That means inflation expectations can better thought of as an indicator[5] of success rather than the target.

Another piece of work Review of the 2000s business cycle and monetary policy (Treasury:2137860) Add to worklist considers some of these issues in detail. Overall, this review has suggested that monetary policy has performed reasonably well with respect to the expectations set out in the Policy Targets Agreement over the last decade. Nevertheless, three issues stand out as weak spots:

- Average CPI inflation outcomes and medium-term inflation expectations at uncomfortably high levels, albeit just within the target range.
- A tendency to look through positive temporary shocks to CPI inflation to a greater degree on average than with respect to temporary negative shocks.
- With hindsight, monetary policy appeared to be insufficiently tight at certain times during the last decade. Clause 4b, in combination with other elements of the PTA, appears to have played a role in enabling this outcome.

In addition to concerns expressed by external commentators (see Annex 2) and well respected international commentators (e.g. Svensson) about governance, from this review we recognise that monetary policy faces the following operational challenges:

[4] This focus is also consistent with what is colloquially called the "misery index", which adds the unemployment rate and the inflation rate to assess the desirability of economic outcomes. However, some commentators make the case that the misery should not be linear in formulation, but should be measured by some sort of quadratic loss function in recognition that significant movements in actual economic outcomes from desired levels have particularly high costs.

[5] Inflation expectations are not a suitable criterion for success, because it is theoretically possible but not likely for there to be good outcomes even if there is a divergence between outcomes and expectations or vice versa. For example, if inflation expectations are low because of a new monetary policy regime with greater credibility, but recent inflation outcomes have been high, it would be difficult to conclude that monetary policy had been successful, but you could say there was hope for the future.

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- An inflation rate that sits at the top of the target band, so shocks or errors in judgement tend to cause the inflation rate to sit outside the target band. This is reflected in two year ahead inflation expectations, which increases the cost of responding to macroeconomic shocks as well as increasing the distortionary costs of inflation as discussed above;

- An economy that has had significant swings in interest rates and exchange rate, which are not solely due to exogenous factors beyond the control of monetary policy(commodity prices, international risk appetite, or fiscal policy), but reflect monetary settings that turn out to be in error with the benefit of hindsight;

- Aided by a culture that risks further complacency in the future, an economy prone to significant and credit driven asset cycles that leads to significant and damaging economic cycles; and

- Governance arrangements are perhaps inadequate and so accountability for inflation outcomes that risks becoming too weak.

These challenges have one common theme, the PTA allows for too much discretion. Significant discretion in the target and potentially asymmetric responses to shocks (i.e. too slow to tighten and too quick to loosen in response to shocks), in combination with too little attention to the credit-induced asset cycles, may have contributed to the strong and persistent inflation pressures that caused inflation to inevitably drift up. In addition, if monetary conditions were too slow to react to building pressures, then eventually a stronger response than otherwise was needed to control inflation pressures creating larger swings in monetary conditions than originally necessary. These discretions may also have weakened the accountability for outcomes.

However, it is important to recognise that monetary policy is not easy given the real time uncertainties when setting monetary conditions that are appropriate for the circumstances, but also importantly many of the problems that present as monetary in nature can be are symptoms of structural problems elsewhere in the economy. These policy settings can include tax policies that discourage saving and encourage investment in housing, immigration policies and pro-cyclical fiscal policy that all place pressure on demand in the economy that monetary policy needs to counteract through tighter monetary conditions. Addressing these issues fully is beyond the scope of the paper, but could be a focus for finding common ground with the political critics of monetary policy who have partially misdiagnosed monetary policy as being the major cause of a weak tradables sector (see below).

Solutions

We want excellent great monetary policy outcomes not just good, so these operational challenges need to be addressed. However, the possible solutions to these issues involve evolutionary rather than revolutionary change. Possible reform options include:

Reduce monetary policy discretion by moving to a point target –

A point target of future inflation of 2% on average over the medium term, rather than the current 1 to 3 percent band, would have the following benefits:

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- better anchor inflation expectations. Well anchored inflation expectations strengthen transmission mechanisms and thereby allow monetary policy to achieve its inflation target with less aggressive policy changes. It may also allow the Reserve Bank to respond more aggressively to negative shocks without risking exceeding its inflation target. Inflation expectations in New Zealand have trended upwards over the last 20 years, which may partly reflect increases in the target midpoint over this time[1], and external engagements indicate a perception of an "erosion of the PTA" over time.
- reduce discretion for the Governor in setting the future path of inflation. This will help avoid the bias towards easier monetary policy that appears to have resulted from combination of the wide discretion for the Governor in the current target and the clause 4b requirement to avoid unnecessary instability (Parkyn 2011). By reducing discretion it may also help enhance accountability for achieving the target.

A *medium-term* point target will still capture the key benefits of a range target, such as providing flexibility for inflation to move around over time and allowing the Governor to respond to shocks gradually. We expect the Governor would need to explain deviations from the 2% target that exceeded 1% either way, including setting a path about how to get back to 2% inflation. This would be a move closer to the inflation targets of the Bank of England (a 2% midpoint with a requirement to explain outturns below 1% or above 3%) and the Bank of Canada (a 1-3% target band with an explicit requirement to aim at the 2% midpoint).

Although 2% is the midpoint of the current target range, a 2% point target would be likely to require an effective tightening of monetary policy given that the current implicit target seems to be in the upper half of the range (based on the fact that inflation outcomes have averaged above the midpoint and the Reserve Bank's inflation forecasts have usually been above 2% at the end of the forecast horizon). However, we think setting the target at the current midpoint of 2% would help improve credibility of the framework and help to anchor inflation expectations by avoiding yet another increase in the midpoint, which appears to have contributed to public perceptions of erosion in the PTA over time (see Annex 2). It would also help reduce costs associated with higher inflation, especially when the tax system is non-inflation indexed. It may be possible to signal that this transition to a lower average level will be made over a period of time to encourage the Bank to reduce inflation opportunistically to help reduce any transition costs of disinflation.

The PTA would retain allied provisions that set out the rational for temporary deviations from the target (e.g. supply shocks and taxes), and the ancillary objective of avoiding unnecessary instability in output, interest rates and the exchange rate (clause 4b), as these are a useful communications tool. Although we consider there have been some costs through the asymmetric use of clause 4b, we consider that these are likely to be addressed through adoption of a point target. However, this could be supplemented by clarifying the type of instability that should be avoided – in particular, *medium-term* instability.

We have considered the following alternative specifications:

[1] The mid-point was increased from 1% to 1.5% in 1996 and to 2% in 2002.

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- Targeting a fixed increase in the price level (which, unlike an inflation target, would not treat past target misses as bygones); while this has some theoretical benefits (e.g. greater certainty of the price level for long-term planning), these are partly captured by targeting an average inflation level over time. It also has a number of practical and implementation difficulties, with a key weakness being the difficulty handling supply shocks

- Targeting nominal GDP; this has many theoretical benefits, and although it is more appealing than price level targeting (because it is better able to handle supply shocks), the concept is less well understood and nominal GDP data is less timely and subject to revision

- Targeting non-tradables inflation; although a number of advantages can be identified with this approach, in practice these can probably be captured by a flexible medium-term CPI target, and in addition non-tradables inflation may also be less well understood. However, this approach is unlikely to be costly, and may have some political economy benefits. We would probably need to look at this more in-depth to make a recommendation for it, and it could be something we suggest the Reserve Bank could look at in future.

An allied paper elaborates on these issues in greater depth (PTA review - Target specification (Treasury:2152685) Add to worklist refers)

Enhanced mandate for macroprudential

The global financial crisis (GFC) has shown that financial crises can be very costly and persistent, and markets cannot be relied upon to self regulate the risks that they are taking[6]. It is no longer credible for central banks to take a laissez faire attitude to credit-induced asset cycles and ignore unjustifiable and significant deviations in credit and asset markets from longstanding norms because of some likely upfront costs associated with taking corrective action. This is especially the case when there is a limit to their ability to manage the severe and dire economic consequences from crisis. Macroeconomic stability cannot be divorced from financial stability it a necessary condition like price stability. Accordingly, there is an argument that monetary policy settings should not only taking into consideration economic conditions that impact on medium-term stability in prices , but also should keep an eye on managing credit and asset cycles to avoid bubbles that can have longer-term impacts on financial stability.[7]This is often described as “lean” vs. “clean” monetary policy.

Clean is consistent with recent history. It involves largely ignoring credit and asset cycles on the grounds it is too hard to identify unsustainable situations, and even harder to predict when they will crystallise into crisis.[8] The risk from moving away from a clean strategy is needlessly adjusting

[6] The GFC has shown that the market is not always right in pricing, judging, and ultimately managing risk, and the cost of getting it wrong are large and persistent.

[7] So called bubbles are when asset prices no longer reflect fundamental value drivers such as earnings. They can arise from market euphoria phenomena from market momentum.

[8] The Efficient Market Hypothesis (EMH) suggests that market prices for assets over time incorporate all relevant information and so on average will be priced correctly. It is only shocks that can lead to price

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monetary conditions to possible long-term financial stability threats that are only remote possibilities, but at the same time causing adverse medium-term impacts on price stability, i.e. possible future financial stability threats lead monetary conditions to be inconsistent with what is likely needed to stabilise medium-term inflation. Moreover, in the event of financial risk crystallising, monetary authorities can always respond as is necessary to avoid financial and medium-term price instability, i.e. reactively clean any financial crisis mess that might occur.

However, while this may work for some time, the risk is that this clean strategy leads to even larger cycles of crisis that cannot be cleaned. This could work through investors being lulled into a false sense of security about risk through successful past cleaning episodes, i.e. moral hazard arises from the central bank being too successful in the past! This could explain the success of the clean strategy over a long period until financial instability built to a level that became too big to clean.

The lean philosophy also recognises that identifying long-term financial crisis risks is difficult and may cause some short-term costs that could be avoided under a clean strategy, but this is a necessary cost to avoid rare but very costly financial crises, i.e. a form of insurance against financial disaster. The lean philosophy does not go as far as to ignore medium-term price stability. Monetary conditions are not set solely on long-term financial stability considerations alone, but instead only partially take into consideration long-term financial risks when setting medium-term monetary conditions.[9] In practice, this may mean in an economic and credit market boom that monetary conditions are slightly tighter than would otherwise be necessary for just medium-term price stability, so as to lean against a building unsustainable credit and asset cycle through reducing the demand for credit. In addition, leaning can achieved through supply side measures designed to adjust the availability of credit through macroprudential tools. Towards a view on macroprudential tools (Treasury:2004258)looks at these tool in more detail.

Clearly, a lean philosophy has deliberately countenanced the likelihood that from time to time monetary conditions may need to be inconsistent with medium-term price stability. However, conflict is not very likely, i.e. it is feasible to target both medium-term price stability and long-term financial stability together. This is because, economic upturns that require tighter monetary conditions for medium-term price stability will often be associated with strong credit and asset cycles. Therefore, a monetary tightening would be warranted based on both medium-term price stability grounds and for long-term financial stability. Symmetrically, downturns that require looser monetary conditions for medium-term price stability will often be associated with weak asset and credit cycles that may also need specific assistance to avoid crisis. Therefore, a loosening would be warranted based on both medium-term and long-term views.

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fluctuations, which by definition must be random and unbiased otherwise they would be anticipated and so be reflected in prices. Therefore, to suggest that prices are no longer sustainable, when the market does not, is to suggest that the EMH does not hold, and central bankers have foresight the market does not. This may be possible if the market is prone to myopia as a result of self-fulfilling manias, which may result in difficult to justify deviations in credit and asset markets from long-term trends.

[9] Drawing on the insurance analogy further, if monetary conditions are only set by long-term considerations, the insurance premium may turn out to be very costly if monetary conditions are very different from what would have otherwise been chosen to achieve medium-term price stability.

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However, future credit and assets cycles are unlikely to be the same as past, is there likely to be a time persistent issue that needs to be addressed i.e. the lean approach may not be usefully endure into the future. The much derided line "This time is different..." is evidence that history does not repeat exactly, but also the lessons are forgotten. Therefore, the likelihood of the economy facing a leveraged boom at sometime in the future is high. Not heeding the lessons of the GFC would be a mistake. Policy makers should not be indifferent to economy wide leverage, prima facie it is a problem that needs to be addressed early even if it can be expected to have some medium–term costs. This is better than the possible alternative of even more costly later financial crises.

This means while central banks need some humility in second guessing the market, it should be willing to act to reduce the risk of financial crises as well as responding to the price stability implications that eventuate when asset and credit cycles significantly and unjustifiably deviate from longstanding norms, even if this course of action has some attendant medium term costs. How and when to do this are technical judgements that are better left to an independent central bank. It might be the case that the RBNZ uses some combination of the official cash rate to manage the demand consequences of asset cycles for inflation, and macroprudential tools to manage the supply of credit that feed cycles. Accordingly, any prescription on the part of the government about how the RBNZ should approach its tasks can be ruled out at this stage as likely to be unhelpful. The Reserve Bank has indicated publicly that it intends to contemplate using macro-prudential tools in appropriate circumstances, and is working to develop a decision-making framework.

However, it should be made clear by amending the PTA that the Government expects the central bank to make these judgements, and it accordingly it will hold the bank to account for them. The change in the PTA may be quite permissive as is the general tenor of a flexible medium-term targeting agreement, and may just involve a simple addition to the current instability clause. Indeed, at the moment the current wording of the PTA implicitly permits the RBNZ to focus more on credit cycles as part of existing monetary policy or financial stability mandates. The judgement call to be made is whether a change is necessary to guard against complacency through a stronger accountability hook. The detailed design of any change is an issue that can be addressed later.

An allied paper PTA project: Role of Monetary Policy in Credit Cycles II (Treasury:2167257) Add to worklist provides more detail on these issues.

Enhanced governance practices to reduce the risk of errors

The art of governance is about the way decisions are made, the accountability mechanisms for those decisions, and the sanctions available to change behaviours to improve decision making over time. Monetary conditions reflect choices by the decision maker as to what is necessary to achieve the PTA. Therefore, a choice that is unhelpful to achieving the PTA can be considered a mistake .Given the discretion under a medium –term inflation target, scrutiny of the Governor's performance is very important, especially if there is a risk of a novice Governor that could initially make rogue decisions.

While clearly, it is desirable to avoid mistakes, defining a mistake is not easy. Apparent mistakes may actually reflect deliberate choices by the decision maker to trade-off greater price instability for less unnecessary volatility in the economy or vice versa. Moreover, over time what seemed like a mistake initially may seem wise with longer hindsight. In addition, there are numerous other non-

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monetary factors that can have considerable impacts on stability that monetary policy can do little to counter, but still complicate monetary policy judgements considerably. This is especially the case for unanticipated shocks like acts of god, and international turmoil. Given this uncertainty about shocks it is hard to avoid any mistakes in practice.

Nonetheless, mistaken choices should be a focus, as governance is fundamentally about the nature of decisions and how judgement can be systemically improved to raise quality and reduce the likelihood of mistakes. The irony with a focus on operational mistakes is that solutions are to be found in changes to the framework. While the present single decision maker provides for the greatest accountability for monetary policy settings, it would be wishful thinking to just hope future Governors will be wise in their decision making. Instead, it is change in incentives or institutional structures that would have greater likelihood in having this desirable outcome.

However, we are not seeking changes to the RBNZ's governance arrangements for the sake of change, or because somehow it is broken as it stands. A recommendation for change needs to be based on compelling reasons that would indicate the prospect of a materially improved RBNZ performance. A rationale that would meet this test would be a high very level of confidence that a change in governance arrangements would, on average and over time, reduce the likelihood of mistakes in judgement about the appropriate stance of monetary given anticipated states of the world and related financial sector regulatory settings. If this were the case, it would significantly progress the goal for a sustainable and stable macroeconomy, as mistakes can be very costly.

The possibility of a new Governor makes it an opportunistic time to consider governance arrangements. However, it should not be predicated on this basis since for instituting good policy it is always a good time for change. The implementation issues will depend on Ministers' preferred governance arrangements. However, enhancements to the status quo of a single decision would be relatively straight forward as no material changes to the form of the PTA would be necessary. Possible improvements to the governance arrangements for consideration include:

- **Ensure monetary policy expertise is given a higher weighting in the appointment process. This could require building expertise in prudential expertise and executive management skills in specialist Deputies if needed -** A prerequisite for good judgement and ultimately good decisions is a deep understanding of the New Zealand economy and expertise regarding monetary policy. Finding a person that fits this bill is not easy and is an on-going core challenge of the selection process if there is a need for a new governor. This is exacerbated by the growing scope of the RBNZ's activities and the need to find a suitable single candidate that can cover the range, including sole decision rights over monetary policy settings. The risk is that monetary policy expertise is downplayed relative to the other roles and the new single decision maker does not have the necessary expertise, or at least as poor judgement for some time while learning on the job (i.e. a "rogue" governor). A focus on monetary policy on recruitment helps deals with the possibility of a novice single decision maker not have the necessary expertise to make good decisions, or at least for some time after appointment, leading to costly mistakes.

[Withheld under s.9(2)(g)(i)]

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[Withheld under s.9(2)(g)(i)]

- Creating the correct incentives is crucial to getting the best possible decision making over time. Sanctions are the rewards and penalties for the quality of decision making. They are important to incentives and therefore the feedback loop between current performance and future decision making. Other than reappointment, existing rewards are generally non-pecuniary, praise from the Board, the Minister himself or Parliamentary Committees, or economic commentators. Penalties, other than dismissal, also tend to be non-pecuniary, chiefly criticism from the above list of stakeholders.

[Withheld under s.9(2)(g)(i)]

However, criticism and praise can be routinely expected from private economic commentators, which is likely to feature in decision makers' self assessment of performance.

[Withheld under s.9(2)(g)(i)]

- **Timely publishing of OCR Advisory Group (OCRAG) minutes**[10] - Transparency is about outsiders being able to easily understand how and why a decision is made. It is an important part of the policy feedback loop because it facilitates the use of sanctions because it helps lay bare good and bad decisions. A single decision maker makes clear the rationale for their decision in the monetary policy statements. What is not available are the counter views the decision maker may have heard and the ensuing debate. This can be important to understand

[10] At the time of the Svensson review, the RBNZ responded to concerns about the quality of decisions reliant on the judgement of a single person by the creation of OCRAG

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more clearly how the decision maker weighed risks and so exercised judgement. [Withheld under s.9(2)(g)(i)] Publishing the minutes of the advice the governor receives may provide better clarity on how and why decisions are made,[Withheld under s.9(2)(g)(i)]

At this stage we do not believe the arguments for going to a committee structure standard abroad are compelling over an enhanced status quo. The following sets out the pros and cons.

The main reason to go to a Committee decision making process is because of greater continuity of service leading to better collective institutional memory (all members are unlikely to be replaced simultaneously), and there is likely to be greater debate and transparency in decisions making (assuming meeting minutes are published). This means a Committee can be expected to collectively have more experience and variety of views, and therefore judgement and expertise is likely to better with less likelihood of errors than the single judgement of one person, which can be prone to personal bias.[Withheld under s.9(2)(g)(i)]

However, Committee decisions are subject to group dynamics that can lead to dominance by one member, or "group think" especially when accountability is defused amongst the group , i.e. the Committee owns the decisions not individuals. This is especially the case for a RBNZ Committee that may see the Governor as ultimately taking accountability anyway.[Withheld under s.9(2)(g)(i)]

Committee decisions would require a change in the form of the PTA to reflect what would become a multi-lateral agreement. The RBA would also need to change to this end[11]. For example, in England where the BOE Board makes the decisions, the Chancellor sets out the annual targets for the BOE, and the Board operationalises monetary policy to these ends. It would also likely require a new look at sanctions for performance, such that they are more appropriate for a group (i.e. is it possible to remove a Committee?).

[11] *Section9 of the Reserve Bank of New Zealand Act 1989 would need to be changed to reflect the move to Committee*

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A game changer that would swing our views towards a committee would be if we had difficulty finding a suitable candidate for Governor.

An allied paper RBNZ's 2012 Policy Targets Agreement: Governance IV (Treasury:2161497v2) Add to worklist provides more detail on governance issues

Linkages and Consistency

The changes to monetary policy above have inter-linkages that reinforce each other, i.e. it has elements of a package deal . Reduced discretion is likely to favourably impact on governance by providing a stronger hook for holding the governor to account for inflation outcomes, and may help prevent credit induced asset cycles by preventing accommodative monetary policy associated with an inflation rate that drifts to the top of the range. An enhanced mandate also helps governance by providing a more public hook for holding the Governor to account about the interface between financial stability and monetary policy.

Political Views and Alternatives

The Minister has stated that he is generally happy with current money policy arrangements. One of the first changes the new government made in 2008 was to change the context to the Policy Targets Agreement. The statement of Government's wider economic policy objectives (not the objective of monetary policy) was altered. It now emphasises that the purpose of monetary policy is about promoting an open and competitive economy to deliver permanently higher incomes and living standards through price stability. The previous objective had a sustainable growth emphasis too, but also had a distributional and employment focus.

To move beyond this initial change, there would need to be compelling reasons. Implicit in this view is that monetary policy is not the key issue facing the country, and continual tinkering of it undercuts focus away from the key issues. The National Party website has no specific policy position on monetary policy.

In contrast Labour and the Greens, while not promoting changing monetary policy's key focus on price stability or central bank independence, are advocating sensitising the RBNZ to broader economic objectives in the belief that this can lead to low inflation at lower cost. Common themes include:

- **Currency and Exports -**There is a concern that a sole focus on price stability has and will continue to have adverse impacts on the exchange rate and investment through interest rates that are too high. This reduces the long-term viability of exports, especially in manufacturing and tourism. Their preferred solution is greater use of complementary policies that will help contain inflation pressures, or just looser monetary conditions aided by intervening with exchange rate markets.

- **Employment and growth -**The way monetary policy is conducted by relying on interest rates as the sole tool to control inflation is costly to economic activity, especially tradables and so ultimately impacts on employment and growth. Their preferred solution is broadening monetary policy objectives to sensitise the RBNZ to the problems it is creating from relying too

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much on interest rates, which may lead it to adopt a broader range of tools that may achieve the same ends at lower cost, i.e. direct exchange rate interventions.

- **Commodity prices -** Commodity price shocks make the job of the RBNZ harder by moving headline inflation away from targets. They are not affected by New Zealand's monetary conditions and are unpredictable, but their impacts need to be considered when setting monetary conditions alongside other necessary structural policy adjustments.

- **Co-ordination of policy -**Monetary policy needs help from other economic policy settings. Poor fiscal, tax, prudential, and housing policies can impact on the difficulty of the RBNZ's job. Wider economic policies should better take into account their impact on monetary policy.

The Treasury favours non-monetary policies as the best means to reduce New Zealand's high real neutral interest rates that are the primary cause of the interest rate differentials. Lower real neutral interest rates would also be good for investment. This is because the problems with monetary policy and exporting are not its single focus on price stability, but that it is being undermined by broader economic policy settings (i.e. lack of co-ordination). This happens through these policy settings creating demand pressures in the economy, which need to be offset by the central bank raising rates to levels that are consistent with price stability. To lower demand the government could adjust fiscal policy and/or encourage private savings (increases in national saving would also be good for keeping a lid on offshore liabilities). The changes to monetary policy advocated above would also help but are likely to be second order to the non-monetary changes.

Generally, political parties are more resolute about objectives than means, unless means have a particular symbolic value or are important to their ideology or branding. Therefore, the Treasury is likely to be more persuasive in advising about alternatives means to the same ends over debating monetary policy objectives. Treasury's concurrence that co-ordination of policy is vital provides considerable common ground with the political critics of monetary policy, who have partially misdiagnosed the cause of weak tradables.

Fiscal policy needs to be better co-ordinated with monetary policy, with greater weight assigned to counter cyclical policies. This should be helpful to price stability through helping to take cyclical demand pressures off resources and so reduce the work that the OCR would need to do over the cycle, meaning less cyclical variation in interest and exchange rates. Medium-term faster fiscal consolidation would help to raise the national saving rate at each point in the cycle (i.e. average national savings would rise over the cycle from higher government saving – assuming away full Ricardian equivalence). To encourage private saving better tax policy can help by reducing private disincentives to financial saving, including examining measures to avoid asset price booms especially in property. Other policies worth examining include housing policy that focuses on supply and demand factors that can lead to periodic booms. In a general sense, measures to raise productivity would also be useful, as for any given level of excess demand the output gap would be smaller and so less inflation pressures and less work that OCR would need to do in future. However, it is beyond the scope of this paper to discuss these changes to economic policy settings in detail.

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[Withheld under s.9(2)(g)(i)]

An allied paper PTA project: Reviewing Political Manifestos for Monetary Policy III (Treasury:2169289) discusses these points in greater detail.

Implementation

The new PTA and any associated governance changes need to be put in place by 20 September 2012 when the Governor starts the new five-year term. Any significant changes would need to be signalled early as part of the Governor's selection process, so it is not an unwelcome surprise. The Reserve Bank Act (RBA) could need to be altered if there are significant changes in the PTA necessary. It is not clear whether the existing PTA could be rolled over for a period until the new

ones is put in place because of some legislative or other hold up. Nevertheless, there should be little doubt come September 2012 what the new regime will look like.

Given the importance and profile of the PTA, significant changes to it carry substantial reputational risk for the Treasury and Minister of Finance. This means we need to be sure of our ground regarding the substance of the advice and be confident about our ability to deliver on it in a timely way. In turn, Ministers will also need to be comfortable with any proposals before detailed implementation actions are undertaken. As stated before, the Minister has already made it clear that he is broadly comfortable with existing monetary policy arrangements, so there is a high hurdle to clear before he would countenance change. This suggests that an on balance recommendation would be insufficient to meet the hurdle, there needs to be strong and clear reasons for change.

Government decisions are needed in Q1 2012, so there is time to influence and inform the selection process for the Governor, but also to enable legislation be changed if need be The key role of RBNZ in ultimately implementing and operationalising any changes means that they need to understand the motivations and key policy trade-offs early in the process. This should ensure that any changes are practical and have buy-in so they can be properly implemented. This means the RBNZ needs to be informed about key developments before Ministers see any advice. Tentative key dates and milestones include:

- Internal discussion and thinking – Completed October 2011
- Consultation with RBNZ – November 2011, but ensure they are kept abreast as we go to avoid surprises and provide quality assurance
- BIM write-up - November 2011
- Policy refinement – Completed by March 2012 so can inform governor selection process
- Cabinet process – April, so could announce in Budget 2012
- Legislation if need – June – August 2012
- PTA Signature - September 2012

Once Ministers have made initial decisions, a paper will need to be written that considers the legal issues involved with their preference and in particular whether the existing PTA can be rolled over for a period until the new one is put in place (this needs to be researched as a fallback position if there was to be some legislative or other hold up).

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Annex 1 – Current Policy Targets Agreement

This agreement between the Minister of Finance and the Governor of the Reserve Bank of New Zealand (the Bank) is made under section 9 of the Reserve Bank of New Zealand Act 1989 (the Act). The Minister and the Governor agree as follows:

1. **Price stability**

a. Under Section 8 of the Act the Reserve Bank is required to conduct monetary policy with the goal of maintaining a stable general level of prices.

b. The Government's economic objective is to promote a growing, open and competitive economy as the best means of delivering permanently higher incomes and living standards for New Zealanders. Price stability plays an important part in supporting this objective.

2. **Policy target**

a. In pursuing the objective of a stable general level of prices, the Bank shall monitor prices as measured by a range of price indices. The price stability target will be defined in terms of the All Groups Consumers Price Index (CPI), as published by Statistics New Zealand.

b. For the purpose of this agreement, the policy target shall be to keep future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term.

3. **Inflation variations around target**

a. For a variety of reasons, the actual annual rate of CPI inflation will vary around the medium-term trend of inflation, which is the focus of the policy target. Amongst these reasons, there is a range of events whose impact would normally be temporary. Such events include, for example, shifts in the aggregate price level as a result of exceptional movements in the prices of commodities traded in world markets, changes in indirect taxes, significant government policy changes that directly affect prices, or a natural disaster affecting a major part of the economy.

b. When disturbances of the kind described in clause 3(a) arise, the Bank will respond consistent with meeting its medium-term target.

4. **Communication, implementation and accountability**

a. On occasions when the annual rate of inflation is outside the medium-term target range, or when such occasions are projected, the Bank shall explain in Policy Statements made under section 15 of the Act why such outcomes have occurred, or are projected to occur, and what measures it has taken, or proposes to take, to ensure that inflation outcomes remain consistent with the medium-term target.

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b. In pursuing its price stability objective, the Bank shall implement monetary policy in a sustainable, consistent and transparent manner and shall seek to avoid unnecessary instability in output, interest rates and the exchange rate.

c. The Bank shall be fully accountable for its judgements and actions in implementing monetary policy.

Hon Bill English **Dr Alan E Bollard**

Minister of Finance Governor

Reserve Bank of New Zealand

Dated at Wellington this 18th day of December 2008

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Annex 2 - Summary of External Stakeholders views

	BNZ	Westpac	NZIER	Infometrics	BERL
Framework	Overall framework sound	Framework not robust from political influence	Overall monetary policy works well, flexibility is key	Overall framework is sound but operationalising it is a problem	Does not support single target, tradables are important in a current account constrained economy / separating monetary policy from other govt objectives
Inflation outcomes	Not sure if slightly higher inflation outcomes are a problem	Been creeping up; this is costly due to tax distortions	Inflation is not a problem at 2% or 3%	3% inflation is more costly than 2% due to tax distortions and uncertainty	Inflation below 5% is not a problem
Expectations	Their expectations are around 2.75%	Their expectations are around/above 3% (increased from 2% previously) – "dovish creep" in PTA	Not a problem at top of the band, but to quick to act on expectations, should wait for more evidence.	Expectations have increased and credibility has fallen (erosion of the PTA). This weakens the transmission mechanism	

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Targets		Prefer a point (3% as don't consider 2% to be politically feasible).	Prefer a range because a point target gives false expectations about accuracy. Medium term could be longer than two years. Prefer CPI as it is easy to communicate. Exchange not a monetary issue (real not nominal). 4b is a useful signal	Target is too opaque. It should be well defined, e.g. 2% non-tradable inflation on average over a 5-year period. Prefer non-tradables to CPI for numerous reasons, may have avoided errors and asymmetries to shocks. Exchange rate not a target, 4b redundant	Prefer a vague target, but markets prefer clear targets. Would be comfortable with target for non-tradables. Can use jaw boning for targeting exchange rate.
Accountability		Governor should be held account for a measure of future inflation outcomes e.g. Consensus forecasts. Too many outs now like 4b	Accountability is weak, not sure how it works	Accountability is weak. There should be more scrutiny by the Board and clear criteria on which the Governor is judged (too many outs)	

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Communications			Disconnect in MPS between policy assessment (meanders) and the rest of the document (tight). The Bank paints itself needlessly into corners by saying too much about the direction of the future OCR path.	Increasing overlap between Financial Stability Report and Monetary Policy Statement is not appropriate. CPI easier to communicate	Assessment in the MPS needs to be clearer about the costs/benefits of the decision being considered. Instead, MPS is more focused on the forecasts and markets are left to read between the lines
Board		Board is under-resourced and reliant on Bank's own analysis to hold the Governor to account	Independent smarts needed	Board should consist of monetary economists not industry representatives	Board report is more an assessment on the Governor's role as the CE of the Bank
Decision maker	Committee internal to RBNZ would ensure against risk of a future rogue Governor	Committee, as groups likely to make better decisions than individual	Committee, to reduce asymmetric risk in decisions / avoid personal biases	Committee, to reduce risk of future rogue governor	Independence is not necessarily desirable. A Committee will test a range of views and should include reps from Treasury and potentially other public sector bodies. If advisory committee only, also include industry reps.

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Policy co-ordination				Financial stability should be separate from monetary policy and fronted by Head of Financial Stability. Comments by the Bank on broader economic structure are misleading – adds to the perception that these are within the control of monetary policy	Need greater coordination between monetary policy and other areas of govt policy (part of the reason for not preferring independence – e.g. variable contributions to KiwiSaver to help manage inflation pressures
Macro-prudential			Could add sub-clause referring to the need to take account of credit cycles in setting monetary conditions, to provide stronger mandate for macro prudential	Does not support macro-prudential to manage the cycle (; macro-prudential is a financial stability tool	Not clear that the RB think they have sufficient mandate as they have been reluctant to use alternative tools

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