The Treasury

Macro-prudential Policy Memorandum of Understanding Information Release

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Release Document

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Date: 4 August 2011

To: Minister of Finance

THE TREASURY
Kaitohutohu Kaupapa Rawa

AIDE MEMOIRE: MACRO-PRUDENTIAL POLICY AND REVIEW OF MONETARY POLICY

This aide-memoire provides an overview of some of our recent thinking on macro-prudential policy, and work we have planned around the monetary policy framework. We intend to discuss this with you at the Macro and Fiscal Issues meeting on Thursday 11 August at 5.15pm.

Our over-arching view is that the monetary policy framework has served New Zealand well in delivering low inflation. However, a number of concerns have been raised by various people, some of which have prompted various reviews over the years:

- The inflation rate sits at the top of the target band, and this is reflected in two year ahead inflation expectations;
- The economy sees significant swings in interest rates and the exchange rate;
- Monetary settings have sometimes turned out to be in error with the benefit of hindsight;
- The economy is prone to significant credit and asset cycles that lead to significant economic cycles; and
- The single decision making structure creates a risk that monetary policy outcomes are specific to the person responsible.

Although the aim of our review is to look for ways to improve upon some of these underlying issues, there are unlikely to be any silver bullets. In addition, policy settings in other areas have an important role to play in assisting monetary policy to meet its price stability objective. For example, ensuring that fiscal policy is not procyclical and that distortions in micro policy settings do not contribute to macro cycles.

Macro-prudential policy

We have looked at the scope for macro-prudential policies to contribute to more stable credit and asset price cycles in addition to their benefit in enhancing resilience of the financial system. This differs from the current international debate which is more focused on reducing the costs of a financial downturn. Based on modelling work by the Reserve Bank and international experience with macro-prudential tools, we think there is probably some scope for such tools to moderate credit cycles, although the benefit in terms of smaller interest rate and exchange rate cycles is most likely to be at the margin. However, we acknowledge that there are large uncertainties around both the costs and benefits of macro-prudential policies, and we cannot rule out that the benefits could be larger than we assume, particularly if a number of tools are used in combination.

We think it is important that the Reserve Bank has sufficient mandate to use such tools during the next credit upswing. The current mandate allows the Bank to use macro-prudential tools to promote the soundness and efficiency of the financial system. The Reserve Bank would need to establish that asset market imbalances had become exceptional and unsustainable and/or that credit growth had become excessive, and that this was likely to contribute to macro imbalances in the future. Our view is that this mandate should be sufficient to allow the Reserve Bank to use macro-prudential tools in the circumstances when these tools are likely to be most effective (i.e. during credit-fuelled asset-price booms). Assuming that the Reserve Bank will use the tools in response to credit/asset prices cycles along the lines it has indicated to date, we do not think there is a strong case for broadening the mandate at this time.

However, there is a risk that in future the Reserve Bank could be overly conservative in its interpretation of its mandate or its use of such tools in practice; for example, a cautious approach could be adopted by a future Governor. We do not think broadening the Reserve Bank Act in a permissive way will necessarily address this risk, and in the current framework with an independent central bank there are no direct levers to *require* the Reserve Bank to use macro-prudential policies. 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. There could be some value in having this formalised in some way, for example, in a Memorandum of Understanding with the Reserve Bank (as with exchange rate intervention), or a statement by the Reserve Bank setting out its intended approach. An increased level of transparency about the Reserve Bank's intentions is likely to happen in time as the Reserve Bank further develops its macro-prudential policy framework, and this should be encouraged.

Although we do not think there is a strong argument for broadening the Reserve Bank's mandate at the present time, we also do not think there is a strong case against changing the mandate, although we note there would be a number of issues to be worked through and risks that would need to be managed. This includes the risk of over-promising the extent to which macro-prudential policies may be able to stabilise cycles. If the mandate were to be extended, a bottom line would be that the use of macro-prudential tools for broader purposes should not undermine financial stability. In addition, it would be important to avoid reducing the Reserve Bank's independence and to ensure strong accountability mechanisms. The main benefit of extending the mandate would be to remove any doubt about the ability to use such tools.

Given that the credit cycle remains weak, there is no urgency to using these tools. This gives us time to learn from other countries experiences. We will continue to monitor the international debate.

Monetary policy framework review

A new Policy Targets Agreement (PTA) will be required on the appointment of the Governor in 2012. To inform potential changes to the PTA, we intend to undertake a relatively broad review of aspects of the PTA and monetary policy framework. We periodically undertake such comprehensive reviews in the lead up to a new PTA.

In the first instance we plan to undertake a review of the 2000s business cycle. This will include a review of the cycle itself, and an assessment of the performance of monetary policy relative to the PTA. Following this work, we expect to finalise the specific areas to focus on further, although we expect these to cover the following types of issues:

- ***What to target*** – including considering the type of target (e.g. CPI inflation (status quo), nominal GDP, price level).

- ***How strictly to target*** – including examining the form of target (range or point, level, timeframe), the value of sub-targets (e.g. the current clause to avoid unnecessary instability in output, interest rates and the exchange rate), whether greater weight should be placed on asset prices, and the interaction with macro-prudential instruments.

We also intend to look at governance, including whether OCR type decisions should be made by the Governor or a committee, in light of the additional responsibilities of the Reserve Bank now compared to when the Act was passed in 1989.

We are seeking your feedback on whether the scope is wide enough, whether anything is missing, and the relative priority you place on different strands.

The Reserve Bank will also be undertaking its own review of the PTA. The aim of this work is to inform a new PTA, which is required to be in place by 20 September 2012.

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