The Treasury

Reviewing the Reserve Bank Act Information Release

Release Document December 2017

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: New Zealand's Flexible Inflation Targeting Framework

Date:	30 November 2017	**Report No:**	T2017/2634
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	Read and refer to Ministers Parker and Jones prior to meeting with officials on 6 December 2017	Wednesday 6 December 2017 3:15pm

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Daniel Wills	Senior Analyst	9(2)(k) (wk)	N/A (mob)	✓
Renee Philip	Manager	9(2)(k) (wk)	9(2)(a) (mob)	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Refer the signed report to Ministers Parker and Jones (if required)

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: New Zealand's Flexible Inflation Targeting Framework

Purpose of the Report

1. This paper sets out how the Treasury views the operation of New Zealand's flexible inflation targeting regime. We would like to discuss your goals for the operation of the monetary policy regime with you at the upcoming officials meeting on Wednesday 6 December as part of the first phase of the Reserve Bank Act Review.

Framework Role and Objectives

2. New Zealand's monetary policy framework is created by the Reserve Bank of New Zealand Act 1989 (the Act) and the Policy Targets Agreement (PTA). The Act sets the Reserve Bank's overall objective in conducting monetary policy. The PTA is an agreement between the Minister of Finance and the Reserve Bank Governor specifying the detailed target(s) of monetary policy.

3. While the Act provides for a sole focus on price stability (and requires the Bank to have regard to financial stability), the PTA provides for a flexible inflation targeting regime. It does this by requiring that the Bank have regard to the efficiency and soundness of the financial system, and seek to avoid unnecessary instability in output, interest rates and the exchange rate in pursuing a medium term price stability objective.

4. Flexible inflation targeting is practiced in over 30 countries, including Canada, Australia, the United States, and most recently India. The key element of "flexible" inflation targeting, as opposed to strict inflation targeting, is that the monetary policy decision-maker also takes account of the near term impact of monetary policy on economic activity and employment and focuses on achieving the inflation target in the medium term. Thus, under flexible inflation targeting deviations of inflation from target are allowed in order to mitigate impacts on the real economy. In practice, this means that central banks are flexible about the time they expect inflation to return to target. Flexible inflation targeting has been adopted by central banks with a variety of legislative mandates, including by central banks with a dual price and employment objective. Countries implementing monetary policy by other frameworks tend to have some form of managed exchange rate regime.

5. The singular focus on price stability in the Act in New Zealand was a response to high inflation in New Zealand and internationally in the 1970s and 1980s. Inflation control was imperative to New Zealand at this time to improve exporter competitiveness and economic growth. The single objective also recognised developments in academic literature on the limits of monetary policy. In particular it recognised that stimulating economic activity through monetary policy (i.e. decreases in short term rates) cannot be used to permanently increase a country's ability to produce output or the sustainable employment rate. In the long run, conditions in product and labour markets are affected by supply factors that are mainly outside the Reserve Bank's control including: the structure of the labour market; bargaining and contractual arrangements; and the education, skills and mobility of workers. There will be "natural rates" of employment and unemployment determined by these factors which monetary policy can only indirectly effect. Attempts to use monetary policy to permanently stimulate the economy beyond these natural rates have been shown to lead to higher average inflation rates with output and employment returning to their natural rates (which may be lower due to the drag from high inflation).

6. In the short run, however, monetary policy has important effects on economic activity and employment, which mean monetary policy may have indirect effects on a country's ability to produce output. There are two lenses through which these short run impacts of monetary policy could be viewed.

7. First, monetary policy is generally seen as having a role in stabilising economic activity and employment in response to business cycle fluctuations; i.e. in stabilising the level of output and employment around its 'natural' level. This role is important because, while periods of high unemployment are costly and socially disruptive in themselves, extended periods of unemployment (of both labour and capital resources) can also reduce a country's long-run ability to produce output due to "hysteresis" impacts. Hysteresis refers to skills erosion and low investment arising from a period of under-utilised resources.

8. In general, inflation targeting is consistent with this output stabilisation role. This is because inflation and demand-driven output fluctuations move in the same direction. For example, in a recession demand for an economy's resources is generally low, and below the level at which the economy can supply goods and services. This leads to the under-utilisation of labour or capital resources (unemployment), putting downward pressure on wages and prices. The current framework (Act and PTA) does not clearly recognise this stabilisation role of monetary policy, which is achieved at present through the coincidence of inflation targeting and output/employment stabilisation.

9. The second lens through which to view the impact of monetary policy on output and employment is in how monetary policy responds to supply or temporary price shocks. In the case of supply or price shocks, inflation and output may move in opposite directions. For example, in the event of a supply side shock (such as a drought), prices of the effected good may go up (due to a supply shortage) but output of that good may go down (also due to the supply shortage). This situation could therefore give rise to conflict in the price and full employment objectives.

10. The PTA provides guidance as to how to deal with these circumstances. Where the inflationary impact of such a shock is temporary, the Reserve Bank must "look-through" the inflationary impact of the shock and focus on the medium term inflation target. The PTA also requires the Bank to avoid unnecessary instability in output, interest rates and the exchange rate in pursuing the price stability objective – and therefore the Bank is required to not unnecessarily exacerbate negative shocks to economic activity in pursuit of price stability. However, if the inflationary impact of a shock is likely to be longer-lived and has the potential to affect inflation expectations, then 'looking through' the shock in the short-term may mean the Reserve Bank has to change interest rates by more in the future to bring inflation back under control – resulting in higher volatility in output in the medium term. Having the scope to interpret the shocks affecting the economy and decide how much weight to place on stabilising output versus inflation is the essence of flexible inflation targeting.

11. While the PTA requires the Bank to avoid unnecessary instability in output, output and employment are directly related to one another. Therefore in implementing the current requirements of the PTA employment data helps inform the Bank's views as to the degree of spare capacity in the economy and thus inflationary pressure. These views help the Bank form its policy on how quickly it attempts to return inflation back to target.

12. A key advantage of the flexible inflation targeting framework, and the retention of the medium term price stability as a goal, is that it helps to strengthen expectations that the central bank will act consistently to maintain stability in prices over time. The anchoring of inflation expectations reduces the extent to which monetary policy needs to respond to meet the medium-term inflation objective, therefore reducing volatility in output and employment.

13. The introduction of credible inflation targeting frameworks internationally has been associated with lower inflation and output volatility. New Zealand saw a significant reduction in the rate of inflation following the adoption of inflation targeting. More broadly, empirical evidence suggests that inflation targeting countries saw significant reductions in the rate of inflation following the adoption of inflation targeting[1]. Empirical evidence also suggests that easy monetary policy during "normal" downturns leads to faster recoveries.

14. New Zealand's choice to have control over domestic monetary policy – and inflation control – also means that New Zealand needs to maintain a floating exchange rate. This requirement reflects the fact that in practice it is possible to have only two of the following at any one time: a fixed exchange rate, control over domestic monetary policy; and free cross-border capital movement – the so-called monetary policy "trilemma". This constraint implies trade-offs between these three objectives. For example, putting greater weight on reducing volatility in the level of the nominal exchange rate comes at the cost of a losing control over domestic monetary policy, increasing volatility in output, employment and inflation.[2]

15. As a small comparatively open economy, relatively free cross-border capital movement is important to sustained growth and economic development in New Zealand. The relevant "trilemma" choice for the country is thus between the level of control over domestic monetary conditions versus the exchange rate. Flexibility in the exchange rate is viewed as particularly important in New Zealand's context, assisting in buffering the impacts of movements in international export prices. Reduced control over domestic inflation also diminishes policy control over the real (inflation-adjusted) exchange rate as domestic price variability increases. The level of the real exchange rate is a key determinant of international competitiveness via its impact on exporter price competitiveness in international markets.

Framework challenges

16. Internationally, monetary policy has been subject to challenges in stimulating economic activity over recent years. Economic growth has been weaker in advanced economies in the post-Global Financial Crisis (GFC) period than following past recessions, and growth in real GDP remains below past norms in many countries. Given this, central banks have kept monetary policy interest rates low for a sustained period. In some countries monetary policy interest rates have reached the "effective lower bound (ELB)", with policy rates at zero or below in some countries. At the ELB the scope for further lowering of short term interest rates to stimulate economic activity is limited/constrained.

17. As conventional monetary policy has run out of policy space, several central banks have entered into new unconventional operational techniques for monetary policy such as "quantitative easing" (the purchase of financial assets). International literature suggests that such measures have generally been effective at easing financial conditions. Their impact on output is less certain. These policies can incur costs not seen with conventional policy (e.g. limiting government bond availability).

18. Monetary policy in New Zealand has not been subject to the same extent of challenges as have occurred abroad. Although the Official Cash Rate (OCR) is at historically low levels, the ELB has not been reached. But New Zealand faces some risk that a large contractionary shock in the future could push the OCR towards zero. Given the potential constraints on monetary policy at the ELB, there may be a role for fiscal policy stimulus if New Zealand faces a high risk of an ELB episode. Fiscal policy at the ELB

[1] Roger (2010) "Inflation Targeting Turns 20" IMF Finance and Development Volume 47, Number 1

[2] West (2003) "Monetary policy and volatility of real exchange rate in New Zealand" Reserve Bank Discussion Paper, 2003/09.

may be more stimulatory than at other times as monetary policy would accommodate, rather than offset, fiscal stimulus. The Treasury is reviewing institutional arrangements for ensuring an optimal fiscal-monetary policy response at the ELB.

19. A further challenge for macro-economic policy frameworks is that the long period of low interest rates globally has encouraged debt accumulation, posing risks to financial stability in the longer term if interest rates rise. Given this, some commentators argue that monetary policy should have regard to financial stability – or even seek to limit credit growth. We consider that financial stability concerns should not displace price stability as the primary objective for monetary policy, although monetary policy should take account of its impact on financial stability, as is required under the Act and PTA in New Zealand. This is because most studies find that the extent to which higher official interest rates impact on the risk of a financial crisis is small (except when risks are high). Very large increases in interest rates are needed to meaningfully reduce in the probability of a financial crisis[3]. These higher interest rate levels result in large output/employment losses. Prudential/macro-prudential policies directly reduce financial stability risks, making them preferred financial stability tools.

20. During the post-GFC period New Zealand has also experienced a rise in household debt and asset prices, particularly house prices. The Reserve Bank has stated on numerous occasions that it took these financial stability risks into account in the conduct of monetary policy, as per the requirements of the Act (and PTA, since 2012) – although the Bank is not required to state how it did so. The Reserve Bank has also put in place macro-prudential measures to counter these financial stability risks. A review of New Zealand's macro-prudential framework will be included as part of phase 2 of the Reserve Bank Act Review.

Implications for the Reserve Bank Act Review

21. The Treasury and the Reserve Bank consider that flexible inflation targeting continues to deliver significant macro-economic benefits to New Zealand. Under flexible inflation targeting the central bank aims at stabilising inflation around the inflation target in the medium term but also puts some weight on stabilising the real economy.

22. The Reserve Bank Act does not recognise the short term role of monetary policy in stabilising output and employment. There is therefore merit in considering amending the Act to recognise the consideration monetary policy decision-makers should give to economic activity and employment in the conduct of monetary policy. This has the potential to increase accountability and transparency for monetary policy decision-making.

23. In updating the Act consideration needs to be given to the role of the Act versus the role of the mechanism to set intermediate targets and operational guidance, currently the PTA. Given that legislation should be enduring, the Act should provide high level, stable long-term objectives for monetary policy.

24. A secondary instrument (a "target-setting mechanism") such as the PTA is the best mechanism to clarify the detail of government expectations of how monetary policy should be implemented. The target-setting mechanism should provide clear operational guidance for the Reserve Bank on matters such as the inflation target, the weighting to place on the stabilisation of prices versus output and employment at a point of time, and guidance on the treatment of shocks that create conflicts between price and output stability objectives. Under a dual target, this guidance would guide the Bank in determining the appropriate trade-off between inflation and employment and the period

[3] Habermeier IMF (2015) "Monetary Policy Spillovers and Leaning Against the Wind" presentation to Federal Reserve Bank of New York 2015 Central Banking Seminar

of time inflation may deviate from target in order to support the real economy. This legislative structure acknowledges that monetary policy implementation is likely to evolve as economic circumstances change, with differing weights attached to employment versus inflation stabilisation being appropriate at different times.

25. The Review should consider whether the PTA in its current form remains the best target-setting mechanism for monetary policy. The PTA is currently set as an agreement between the Minister of Finance and the Governor (or designate). Other methods of target-setting are possible, with a variety of mechanisms used in other jurisdictions. For example, the agreement could be set as a directive from the Minister of Finance following recommendations from the Bank. In our view current arrangements provide limited scope for broader consultation and input from a range of stakeholders.

Next Steps

Officials will discuss options for a dual employment price stability target with the Independent Expert Advisory Panel and will report back to you following that meeting.

Consultation

The Reserve Bank was consulted in the preparation of this report.

Recommended Action

We recommend that you:

a **note** the contents of this report

b **refer** this report to:

- Hon David Parker, Associate Minister of Finance

Refer/not referred.

- Hon Shane Jones, Associate Minister of Finance

Refer/not referred.

Renee Philip
Manager

Hon Grant Robertson
Minister of Finance