THE TREASURY
Kaitohutohu Kaupapa Rawa

Modernising the Three Pillars of New Zealand's Macroeconomic Framework

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20 February 2018

Good evening everyone.

Recently, the Treasury has been talking a lot about an evolution in the way we do economic policy. I've spoken about my ambition to weave an understanding of wellbeing into the way we do public policy – especially weaving together different strands of evidence and analytical frameworks – and my Chief Economic Adviser has been explaining just how we intend to develop our Living Standards Framework to achieve this goal. And in supporting the incoming Government over the last few months, we've been focussed on some of the core issues where we believe better policy can make a difference to the wellbeing of New Zealanders. This ranges from considering the balance and efficiency of our tax system, supporting changes to improve the functioning of our housing market, and designing targets to provide a focus on sustained reductions in child poverty.

These types of issues tend to attract plenty of attention in public debate, and it's easy to see why. They all have a direct influence on how New Zealand firms are making their way and how families are striving to improve their own standards of living. In all of this, there are challenges we still have to overcome and successes that we need to be grateful for.

But there is one area of policy that isn't always at the front of everyone's minds, even as it underlies a fair degree of New Zealand's economic stability, and it is what I want to focus on today. I often say that it's a fundamental truth that successful economies need a stable and sustainable macroeconomic framework and, in particular, a sound monetary policy, a prudent fiscal policy, and a well-regulated financial system.

New Zealand’s current macroeconomic framework is over a quarter of a century old. In my remarks today I want to address the work the Treasury has been doing to review the state of the framework and ensure it is fit for purpose for the next 25 years and even beyond.

Our macroeconomic policy framework is built on three institutional Pillars:

- sustainable public finances based on principles of responsible and transparent fiscal management
- stable prices delivered by a central bank that makes independent monetary policy decisions, and
- a financial system that is well-regulated so it is stable and resilient to shocks.

In recent years, the Treasury has been reviewing the solidity of each of these Pillars. We’ve been exploring where they might need minor repairs or indeed whether more significant strengthening might be needed. The aim has been to assure ourselves that the Pillars remain durable to support the New Zealand economy. Tonight I want to put the Treasury’s work into context and set out some of the emerging conclusions that we believe would help to modernise our macroeconomic policy framework.

But first let me answer the question that some of you may be asking: what has prompted all this reflection? Certainly it isn’t any sense that our current frameworks have been failing. Indeed whenever I speak to visiting economists from international rating agencies or global policy bodies like the IMF or the OECD, they confirm that New Zealand’s macroeconomic settings remain as solid as ever. And my peers in other countries often look on at how we do things in this corner of the Pacific.

However, in my view, apart from good practice, fulfilling the Treasury’s stewardship responsibilities requires us to challenge ourselves, especially in those policy areas that we tend to take for granted. This applies in particular to those areas that are cornerstones of our overarching economic framework. And the foundations of our macroeconomic management fall squarely within that category. We should never be complacent about the risks that we face as a small economy at the edge of the world. Having a discussion at a time of relative calm allows us to look out at – and learn from – the state of macroeconomics, in New Zealand and across the world, enriching our understanding of the economy and ensuring that our foundational frameworks remain robust.

The State of Macroeconomics

The reality is that economists are in the middle of a vigorous international debate on the state of macroeconomics. As we approach the tenth anniversary of the collapse of Lehman Brothers – and the full onset of the Global Financial Crisis (GFC) – the debate is stuck in what we might call a 'Hamlet loop’. There is a sense that something is rotten in the state of macro, plenty of deep thinking about the thousand natural shocks that we’ve been heir to, and an utter lack of decisiveness about what we do next.

I jest, but only a little bit. And certainly there has been a new persistent genre of critique that has confused at least three separate things. One: how well can we forecast the economy? Two: how solid is the academic theory in macroeconomics? And three: are our policy frameworks set up to help us respond well to the next crisis?

I don't want to talk much about forecasting, except to note that the Treasury's forecasts of the NZ economy have consistently been amongst the best of other forecasters, and that we continue to apply our best independent and professional judgment in producing them. Importantly, what we produce is open to scrutiny by market forecasters and economic commentators, and we welcome the challenge that provides us. But of course, our forecast are only as good as our judgement and models, and like others, it is likely that we won't always have perfect foresight to predict major events like the GFC.

What about the challenges within academic macroeconomics? Here the debate is ongoing and is largely, as far as I can judge, still unsettled.[1] Nevertheless, there have been a number of puzzles raised that go to the core of our understanding of the economy that have received attention over recent years. To give you a flavour of these discussions, let me pick out just a few examples:

- ***Why is inflation so low?*** The relationship between spare capacity and inflationary pressure is part of the basic framework that policymakers use to understand the economic cycle. But as inflationary pressure has remained subdued around the world, many have begun to ask if relationship has shifted.[2] In technical terms, has the 'Phillips curve' become flatter, so that we now might expect less change in inflation for a given change in the level of unemployment? As Janet Yellen has mused, it is possible that "our framework for understanding inflation dynamics could be misspecified in some fundamental way".[3]

- ***How are exchange rates influenced by global patterns of trade and finance?*** It has long been accepted that there is a fundamental 'trilemma' that underpins internal economic policy. This is that if countries want to maintain an openness to capital and an independent monetary policy, then it is critical to maintain floating exchange rates. But it is also an area of debate: some scholars have explored how US monetary policy influences the global financial cycle and how the dominance of global trade denominated in US-dollar terms places limits on the influence of domestic monetary policy and the impact of flexible exchange rates.[4]

- ***How does the financial cycle affect the real economy?*** The GFC has led to a lively debate about how well we understand the impact that the financial sector can have on the macroeconomy – under the banner of 'macrofinancial linkages'.[5] Some of the issues are the ways that credit cycles and asset prices affect individual consumption and investment decisions. Other questions raised include whether our macro models take sufficient account of the role of the financial sector and how imperfections in financial markets can affect the normal fluctuations of the economy.[6]

The Treasury may not be an academic institution but we are a learning institution. We are interested in the outcomes of these debates, because we want to make sure that academic rigour underpins the frameworks that guide our thinking and our advice to Governments. But intellectual paradigms don't change overnight, and if we look back at the history of economic

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1 See for example Oxford Review of Economic Policy (2018)
2 Spencer (2017)
3 Yellen (2017)
4 Rey (2015) and Gopinath (2017)
5 Claessens & Kose (2018)
6 Borio (2017)

thought, it can take much more than a decade for a settled interpretation to emerge about major economic events.

Keynesian economics was born after the Great Depression in the 1930s but it took a textbook by Paul Samuelson in 1949 for its ideas to really propel themselves around the profession. Anna Schwartz and Milton Friedman didn't publish their own influential book about the effect of the money supply on the business cycle – and its role in the Depression – until 1963. Similarly, the response to the stagflation and high unemployment of the 1970s took some time to filter themselves into the New Classical Theory that emerged with force in the 1980s.

Ultimately, macroeconomics can give us genuine insight, but it can't predict the future. In light of all this, my instincts are that we need a sense of humility – as Olivier Blanchard suggested a few years ago – about how the economy operates and an openness to be challenged as new data and theory emerges. The tape of history doesn't just play on repeat, and we need to make sure we are prepared to respond to the next crisis and future challenges, which will have their own unique causes and consequences.

Learning Lessons on Macroeconomic Policy

In the meantime, one thing is certain – we can't just put down the policy tools we have and wait for the dust to settle in these academic debates. The impact of the GFC and the international response to it – whether by Governments, international financial institutions, regulators in addition to academia – makes that clear. We need to distil some pragmatic lessons that can help guide policymakers, so we can respond to events and learn as we go.

Here are four lessons that the Treasury has been applying as we've been reflecting on the macroeconomic pillars.

Lesson 1: Transparency, Accountability, and Social Licence

Macroeconomic policy in New Zealand is already characterised by a high level of formal transparency. But I believe we need to keep pushing ourselves beyond a system which prioritises the publication of technical reports, public accounts and statutory documents. We need to recognise that the expectations around transparency have changed in the digital age and after thirty-five years' experience of the Official Information Act. We need to be able to explain policy judgements as quickly as possible and as simply as possible, and to expose the genuine uncertainty that we are often grappling with. We shouldn't shy away from doing more to enable effective scrutiny and thoughtful discussion in the public domain.

At a basic level, this recognises that macroeconomic policy plays a huge role on the living standards of New Zealanders, and policymakers wield significant influence. Our country has done well to maintain a high degree of trust in our public institutions. But this trust should rightfully come with accountability, and we need to make sure we refresh and renew the social licence that underpins our macroeconomic policy frameworks.

Lesson 2: Diversity of Perspectives

Like many areas of public policy, the judgments and trade-offs we are facing are becoming more complex. There are a range issues where intelligent practitioners can reasonably disagree, and no single institution can hope to grapple with these in isolation. Ensuring that a range of experiences are brought to the table is critical to add voices to these debates and guard against the biases we all carry with us.

Part of that means that within policy agencies, we need effective decision-making structures, which encourage openness and healthy challenge. We also need to look outwards, and engage with businesses and civil society and the insights they can bring to our understanding and analysis.

Lesson 3: Good Regulatory Practice

We need to apply standard principles of good regulation to macroeconomic policy as in other areas of economic policy-making. The Treasury has a role as a steward of the overall economic framework, and we actively consider how we can follow best practice for managing it. That means, amongst other things, ensuring that the system has clear policy objectives, is designed for practical and clear implementation, and there are regular and open processes for monitoring and reviewing what we do.

In many ways, this is just common sense, and part-and-parcel of what we've been doing. Macroeconomics can so often appear to be arcane and especially technical. So it is always worth keeping ourselves grounded and not forgetting about the value of applying our best regulatory discipline to the three pillars of macroeconomic policy, just as we do for any other sphere of government activity.

Lesson 4: Coordinating Macroeconomic Policy

One important lesson following the GFC is the growing recognition of the overlapping roles that fiscal and monetary policy and financial stability have in achieving sustainable growth and high employment. The three Pillars are more like the columns of an Athenian temple than three freestanding Egyptian obelisks – independence does not mean isolation. The direction of travel should emphasise how to better integrate and coordinate the Pillars in a way that engenders greater stability of the whole.

This does not mean conflating roles and forgetting about what each area of policy is best placed to achieve. But we know that there are overlaps and dependencies, and decisions in one area can impact significantly on others. For example, in New Zealand, we have debated whether fiscal policy has exacerbated business cycles by putting undue pressure on the tradable sector. And we have also been focussed on the resilience of the financial sector to the housing market, and how macroprudential policy can affect this. Understanding these interlinkages will require an ongoing focus on cohesion in our overall macroeconomic settings, as well as understanding the impacts they can have on economic policy settings in general.

The question I suppose is this: would better coordination of fiscal, monetary and financial stability policy help lift the economy's performance over the cycle as well as help lift the economy's sustainable growth rate?

The State of the Three Pillars

So how have we applied those four lessons as we have examined each of the pillars of macroeconomic policy? What are our emerging conclusions on the state of our fiscal policy, monetary policy, and financial stability frameworks? Do they need minor repair or more significant strengthening?

What I'm setting out tonight is the Treasury's current view. We want to continue to deepen our understanding through engaging with experts and interested stakeholders before we finalise our advice to Ministers, particularly in those areas where we see the need for substantial change.

Fiscal Policy Framework

Let me start with the fiscal policy Pillar. The Public Finance Act is the primary legislation which governs New Zealand's fiscal policy framework. The framework is based on two key planks: transparency and accountability. It achieves this by requiring governments to be explicit about their long-term fiscal objectives and short-term fiscal intentions and to assess them against principles of responsible fiscal management. It also requires governments to report on a wider range of economic and fiscal information, including enshrining a role for the Treasury to produce independent forecasts and analyses of the Crown's balance sheet.

These principles promote sound fiscal policy and the reporting requirements promote fiscal transparency. The expectation is that this transparency will lead to a public discipline whereby Governments are held to account on whether they are meeting their self-imposed fiscal policy targets.

The fiscal policy framework we have is distinctive globally. There are no legislated numerical constraints on the fiscal policy that Governments can choose to adopt, and it is left to Parliament, markets and the public to pass judgment on whether these rules are being met. We have managed to develop a political economy in which this self-discipline has delivered credible and sustainable fiscal policy under successive Governments, in normal times and in response to crises.[7]

In 2014, almost twenty years after the Fiscal Responsibility Act came into force, and having weathered the effects of the GFC, the Treasury considered it a good time to review the fiscal policy framework, and our advice within that framework, to ensure it had been – and remained – appropriate to the characteristics of the New Zealand economy, and consistent with best international practice.

Teresa Ter-Minassian's review[8] – which is available on our website – showed that although New Zealand's fiscal policy framework differs from that in many other countries, and despite facing many economic challenges as a result of our small size and distance from major markets, the performance of the government's accounts has been strong in the face of substantial shocks.

The Review also considered whether New Zealand's fiscal policies and institutions could be further strengthened through the adoption of innovations, such as numerical fiscal rules

7 Bose, Philip, Sullivan (2016)
8 Ter-Minassian (2014)

and/or independent fiscal councils, which have become increasingly popular internationally in recent years. We continue to consider whether these could better support fiscal policy-making. Before recommending changes we would of course need to be confident that they are beneficial. This prompts questions like:

- Whether our existing institutional structures provide sufficient discipline over fiscal decision-making, including the scrutiny role of Parliament?
- How can we support more independent commentary on the current and long-term fiscal challenges that New Zealand faces?
- Can we can go further to promote fiscal transparency, including the way the Treasury communicates and how we enable broader participation in the way that fiscal policy is set?

These are open questions, but flow directly from applying the lessons of transparency, accountability and good regulatory practice to our fiscal policy framework. We expect the application of lessons to continue, and will be evident in our regular fiscal and economic updates, in our four-yearly Long-Term Fiscal Statements and Investment Statements, and in the way we support the Government in its Budget reporting and meeting its obligations under the PFA. New Zealand is already top of the global rankings for Budget transparency[9] but we are not allowing that to lull us into complacency.

Monetary Policy Framework

Last December, the Treasury published its advice to Ministers following our examination of the other two Pillars, on monetary and financial stability policy[10].

The RBNZ Act sets out our monetary policy framework. It provides that the Reserve Bank is to implement monetary policy directed at achieving and maintaining stability in the general level of prices. The Governor of the Bank is solely responsible for ensuring that the Bank seeks to achieve this objective. The Policy Targets Agreement (PTA) is the instrument by which the Minister of Finance and the Governor agree the more specific monetary policy target that the RBNZ will pursue in practice.

The Reserve Bank operates what is called a flexible inflation-targeting regime, which recognises the role of monetary policy in stabilising the economy as well as maintaining low and stable inflation. This means that it actively considers the impact that monetary policy can have on not just the rate of inflation, but the real economy as well. This flexibility has been recognised in successive PTAs over the past decade.

Ultimately, one of the outcomes we want from monetary policy is that it helps to stabilise fluctuations in the real economy, subject to making sure the inflation rate is under control. The Treasury considers that the flexible inflation-targeting regime has supported New Zealanders' living standards. We have seen low and stable inflation and relatively low volatility in output. But in applying our lessons, we see the benefits of amending the RBNZ

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9 International Budget Partnership Open Budget Survey 2017: https://www.internationalbudget.org/open-budget-survey/

10 The Treasury (2017)

Act to ensure that it clearly sets out the broader goals of monetary policy and that the system of flexible inflation-targeting we have is durable and transparent.

The Treasury has long held the position that the Act should be amended to provide for a committee-based decision-making model for monetary policy. Again, applying our lessons, we believe that the single decision-maker model is outdated. Indeed, the previous Governor recognised this when he set up an internal committee to support him to deliver his statutory responsibility. In our view it is important that a monetary policy committee includes external members to promote a diversity of perspectives in decision-making. There is nothing simple about the task of making monetary policy judgments and we support promoting healthy debate on some of the finer judgments involved in assessing the state of the economy and its likely future trajectory. In our view such a debate is enriched by drawing on different perspectives, while maintaining the wealth of expertise that sits within the Reserve Bank itself.

As you know, the Government has announced a review to implement changes to widen the objectives of monetary policy to give due consideration to maximising employment and institute a committee-based decision-making model. We are working with the Independent Expert Advisory Panel and the RBNZ to ensure that these changes are designed in the most effective way.

Financial Stability Framework

And finally to our third Pillar. The Reserve Bank is responsible for the stability of New Zealand's financial system based largely on legislation set out in the RBNZ Act 1989. The GFC has meant that this Pillar has had a lot of scrutiny, particularly its equivalents across the world's major economies. It has been a major programme of work for the IMF, the Financial Stability Board and the G20 countries in particular. The financial sector has seen major and significant change over the last thirty years and, following the GFC, there has been considerable debate across the globe on the best way to regulate the financial sector.

The IMF published a comprehensive assessment of New Zealand's financial system last year, its first in 13 years. While it found that the banking system was resilient, it recommended further work to ensure we were better-placed to supervise emerging financial risks, including giving greater clarity to operational objectives and responsibilities and increasing the powers and resources available for prudential supervision.

Prudential policy in New Zealand has developed over the last 30 years from a light-handed regulatory approach with a strong emphasis on disclosure to one that is broader in scope and more prescriptive. Changes in regulation reflect the nature of the underlying risk. But we agree with the IMF. In particular, we believe that greater transparency around the objectives and process of financial regulation would promote the resilience of the financial system.

As the Productivity Commission indicated in its 2014 inquiry into regulatory institutions and practices, regulatory regimes with clear objectives are more likely to enjoy high levels of compliance and credibility, and regulators with clear and well-understood roles can more easily be held to account. In our view, the financial stability framework would be strengthened if there was a clearer distinction between the objective setting by Ministers and the independent operational delivery by the regulator, similar to that which exists on monetary policy. These issues are important and I recognise that there are differences of view on exactly how broad any changes need to be when we look across our financial system.[11]

At the moment the Treasury and the Reserve Bank are scoping phase two of the RBNZ Act review in consultation with the Independent Expert Advisory Panel. This will include the review of macroprudential policy that was already scheduled for this year. We expect that this will involve stakeholders in the financial sector such as yourselves, and we look forward to more discussion on these issues in coming months.

The Three Pillars and the Wider Economy

Before I conclude, I want to say a few words about the role the three Pillars play in the economy of work, jobs and productivity.

A stable macroeconomic framework helps the community – whether Government, business, workers, retirees, indeed everyone – plan, invest and make provision for the future. It is an essential foundation of intergenerational wellbeing. It is part of a complex economic system that is becoming more complex still with the accelerating pace of change. To remain robust and effective, the Pillars need to work together, complimenting each other and with an eye on the ultimate objective, improving the living standards of New Zealanders.

Conclusion

Institutions matter for living standards and New Zealand's macroeconomic institutional Pillars have done well over the past quarter-century or so. But as I've said before[12], if we simply focus on preserving institutions we may in fact be weakening them. We need to make sure we learn the lessons of the past and not feel trapped by them. We need to make sure we understand the lessons of the present and not feel paralysed by them. And we need to be prepared to challenge ourselves and make changes that both increase opportunities and build resilience. We need to make sure our macroeconomic Pillars are fit for at least the next 25 years.

That is the background and context to the Treasury's reviews of New Zealand's macroeconomic Pillars.

[11] Hunt (2017)
[12] Makhlouf (2016)

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