

A new era

The RBNZ's new PTA and governance arrangements

26 March 2018

Today we finally received details on the new Government's intended changes to the Reserve Bank Act. The Minister of Finance and incoming Governor Adrian Orr signed a new Policy Targets Agreement. This sets the definition of price stability under current Reserve Bank legislation, but was seen as a precursor to changes to the Reserve Bank Act. And the Minister of Finance released a range of further details about intended changes to the Reserve Bank Act.

There were two main aspects of monetary policy that the new Government had signalled it wanted to change: (1) a shift to a dual mandate under which the RBNZ targets both employment and inflation; and (2) a shift to committee decision making rather than monetary policy decisions being (legally) the sole purview of the Governor.

Double the trouble

Shifting to a dual mandate had the potential to be damaging if it caused the Reserve Bank to go soft on inflation. Last century, misguided (or cynical) short-run attempts to buy a few more jobs in exchange for tolerating a bit more inflation backfired, resulting in higher long-run inflation and no lasting gain in employment. Nobody would want a return to that type of monetary policy.

In the event, the details released today were reassuring. The PTA wording and comments released today were all fairly orthodox, and tended to emphasise that the Reserve Bank will maintain its current flexible inflation targeting approach.

Employment was mentioned three times in the new PTA. The conduct of monetary policy must contribute to supporting maximum sustainable employment; monetary policy must avoid unnecessary instability in employment; and the RBNZ must explain how it is contributing to supporting maximum sustainable employment. The first thing we noted about this is that the wording is symmetrical – that is, it allows for the RBNZ to raise interest rates because the labour market is overheating, as well as to lower interest rates when the labour market is slack. The wording also allows for the fact that the best long-term contribution monetary policy can make to employment levels is to maintain low and stable inflation.

The new PTA retains the inflation target of 1% to 3% inflation, with a focus on the two percent midpoint. Retaining the two percent midpoint was not guaranteed,

and was important. Removal might have signalled a softening of the focus on inflation.

Other details of the inflation target were a mix. Previously, the wording was that the RBNZ must keep “future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term.” That has been simplified to “future annual CPI inflation between 1 and 3 percent over the medium-term”. Removal of reference to “average” arguably provides one less excuse for inflation deviating from target. However, the RBNZ is now explicitly required to implement a flexible inflation targeting approach.

Surprising to us was that the reference to “monitoring” asset prices was removed from the PTA. This reference was a nod to the role low interest rates have played in boosting house prices. In recent years, fear of stoking the housing market has arguably been the reason the RBNZ has been reluctant to reduce the OCR, and the consequence has been persistently below-target inflation. However, the RBNZ is still required to have regard to the efficiency and soundness of the financial system when setting monetary policy, so presumably its actual OCR-setting behaviour won't change.

Adrian Orr's first comments in the press release were to reiterate the RBNZ's focus on 2% inflation and to explain the importance of low and stable inflation – no suggestion here that Orr will be softer on inflation than his predecessor. He said that the RBNZ has long considered employment in its decision-making. What he did say is that the RBNZ must now account for the labour market transparently – in other words, it will need to communicate more about the labour market.

How will the Reserve Bank behave under the new Policy Targets Agreement

Our initial interpretation is that the new PTA will make no immediate difference to the RBNZ's behaviour. We still expect the OCR to rise only in late-2019, later than markets anticipate.

The technical limits of monetary policy mean that, in reality, the employment mandate is only going to affect how rapidly the RBNZ tries to return inflation to target. Right now, the labour market is currently roughly at or above “maximum sustainable employment,” whereas inflation is below target.

Therefore, having regard to employment means that the Reserve Bank should choose a slow return to the inflation target. In other words, the Reserve Bank should avoid lowering the OCR too far even though inflation is below target, because doing so would risk overheating the labour market to a level that is above maximum sustainable employment.

But this is functionally equivalent to the Reserve Bank's current approach. It has already chosen a slow return to the inflation target, justified by the directive to avoid unnecessary instability in output, interest rates and the exchange rate (retained in the latest PTA). It has also said that lowering the OCR could imperil financial stability, which it is still required to consider.

Over the course of business cycles, we also doubt that the dual mandate will be much different to the RBNZ's current flexible inflation targeting approach. The RBNZ already takes account of whether the economy is overheating or operating below capacity, because this is a good indication of what is going to happen to inflation in the future. Where the dual mandate will make a difference is in the assessment of the economy – the RBNZ will presumably now pay more attention to indications that the labour market is slack or overheating than to GDP-based concepts like the output gap. Indeed, the only situation we can think of in which the dual mandate will result in a different OCR setting is one where the labour market is at a different point in the cycle than the economy in general – difficult to imagine, but not impossible given the changing nature of work and the aging of the population.

Too many cooks, or not enough?

The second big change announced today was that the RBNZ's unusual legal structure of vesting all monetary policy decisions solely with the Governor has been altered. The RBNZ will shift to a committee of five to seven members in 2019, with a majority of RBNZ internal members and a minority of external members. There will also be a non-voting Treasury observer. External members will be appointed by the Minister of Finance on the recommendation of the Board for staggered four-year terms, while internal members will be appointed the same way but for staggered five-year terms. This will be a voting committee, with non-attributed vote counts published and non-attributed records of the meetings published. The Governor will chair the committee, and will be its sole spokesperson.

We regard these changes as a nice balance. Groups make better decisions than individuals. However, published and attributed voting can impede free and frank discussion among the group, for example if an individual member wants to make a splash. And allowing all members of the committee to speak has sent confusing and contradictory signals to markets in the United States and United Kingdom – New Zealand will avoid that by making the Governor the only spokesperson for the group.

This committee will not be as much of a curb on the Governor as committees overseas, but it will still be a big change from New Zealand's status quo.

Signalling is hugely important in monetary policy – being the sole spokesperson puts the Governor in a very powerful position. In addition, the internal members of the committee will all be employees of the RBNZ, with the Governor as Chief Executive (ie, their boss). Together with the Governor they will have a voting majority. However, the internals will have the power to protest via a dissenting vote, and could be a safeguard against the possibility of a rogue Governor.

Perhaps more importantly, the new arrangements alter the influence that the Minister of Finance will have on monetary policy. In terms of appointments, the Minister's potential powers will change in nature. Currently, Ministers of Finance might or might not be lucky enough to appoint (on the Board's recommendation) an all-powerful Governor to the Reserve Bank. In future, they will have more of a guaranteed opportunity to slowly change the composition of the Monetary Policy Committee via the staggered appointment structure.

However, the Minister's powers to influence monetary policy have increased. Currently, price stability is defined in a Policy Targets Agreement agreed between the Minister of Finance and the Governor. The new arrangement will be that the Minister of Finance dictates the operational objectives of the Monetary Policy Committee. This means that the Minister of Finance could raise or lower the inflation target without the agreement of the Monetary Policy Committee or Governor. The only curb on this power is that the Minister must first take and publish advice on the operational objectives from the Treasury and Reserve Bank.

Dominick Stephens
Chief Economist

Contact the Westpac economics team

Dominick Stephens, Chief Economist +64 9 336 5671

Michael Gordon, Senior Economist +64 9 336 5670

Satish Ranchhod, Senior Economist +64 9 336 5668

Anne Boniface, Economist +64 9 336 5669

Paul Clark, Industry Economist +64 9 336 5656

Any questions email: economics@westpac.co.nz

Past performance is not a reliable indicator of future performance. The forecasts given in this document are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Disclaimer

Things you should know

Westpac Institutional Bank is a division of Westpac Banking Corporation ABN 33 007 457 141 ('Westpac').

Disclaimer

This material contains general commentary, and market colour. The material does not constitute investment advice. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. This material may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Country disclosures

Australia: Westpac holds an Australian Financial Services Licence (No. 233714). This material is provided to you solely for your own use and in your capacity as a wholesale client of Westpac.

New Zealand: In New Zealand, Westpac Institutional Bank refers to the brand under which products and services are provided by either

Westpac or Westpac New Zealand Limited ("WNZL"). Any product or service made available by WNZL does not represent an offer from Westpac or any of its subsidiaries (other than WNZL). Neither Westpac nor its other subsidiaries guarantee or otherwise support the performance of WNZL in respect of any such product. The current disclosure statements for the New Zealand branch of Westpac and WNZL can be obtained at the internet address www.westpac.co.nz. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement at www.westpac.co.nz.

China, Hong Kong, Singapore and India: This material has been prepared and issued for distribution in Singapore to institutional investors, accredited investors and expert investors (as defined in the applicable Singapore laws and regulations) only. Recipients in Singapore of this material should contact Westpac Singapore Branch in respect of any matters arising from, or in connection with, this material. Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking licence and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activities. This material is intended only to "professional investors" as defined in the Securities and Futures Ordinance and any rules made under that Ordinance. Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking Regulatory Commission (CBRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

UK: The contents of this communication, which have been prepared by and are the sole responsibility of Westpac Banking Corporation London and Westpac Europe Limited. Westpac (a) has its principal place of business in the United Kingdom at Camomile Court, 23 Camomile Street, London EC3A 7LL, and is registered at Cardiff in the UK (as Branch No. BR00106), and (b) authorised and regulated by the Australian Prudential Regulation Authority in Australia. Westpac is authorised in the United Kingdom by the Prudential Regulation Authority. Westpac is subject to regulation by the

Disclaimer continued

Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

This communication is being made only to and is directed at (a) persons who have professional experience in matters relating to investments who fall within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (b) high net worth entities, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(2)(a) to (d) of the Order (all such persons together being referred to as "relevant persons"). Any person who is not a relevant person should not act or rely on this communication or any of its contents. The investments to which this communication relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this communication or any of its contents. In the same way, the information contained in this communication is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Conduct Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on the information in this communication to any third party. In particular this communication and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction. This communication is made in compliance with the Market Abuse Regulation (Regulation(EU) 596/2014).

Investment Recommendations Disclosure

The material may contain investment recommendations, including information recommending an investment strategy. Reasonable steps have been taken to ensure that the material is presented in a clear, accurate and objective manner. Investment Recommendations for Financial Instruments covered by MAR are made in compliance with Article 20 MAR. Westpac does not apply MAR Investment Recommendation requirements to Spot Foreign Exchange which is out of scope for MAR.

Unless otherwise indicated, there are no planned updates to this Investment Recommendation at the time of publication. Westpac has no obligation to update, modify or amend this Investment Recommendation or to notify the recipients of this Investment Recommendation should any information, including opinion, forecast or estimate set out in this Investment Recommendation change or subsequently become inaccurate.

Westpac will from time to time dispose of and acquire financial instruments of companies covered in this Investment Recommendation as principal and act as a market maker or liquidity provider in such financial instruments.

Westpac does not have any proprietary positions in equity shares of issuers that are the subject of an investment recommendation.

Westpac may have provided investment banking services to the issuer in the course of the past 12 months.

Westpac does not permit any issuer to see or comment on any investment recommendation prior to its completion and distribution.

Individuals who produce investment recommendations are not permitted to undertake any transactions in any financial instruments or derivatives in relation to the issuers covered by the investment recommendations they produce.

Westpac has implemented policies and procedures, which are designed to ensure conflicts of interests are managed consistently and appropriately, and to treat clients fairly.

The following arrangements have been adopted for the avoidance and prevention of conflicts in interests associated with the provision of investment recommendations.

- (i) Chinese Wall/Cell arrangements;
- (ii) physical separation of various Business/Support Units;
- (iii) and well defined wall/cell crossing procedures;
- (iv) a "need to know" policy;
- (v) documented and well defined procedures for dealing with conflicts of interest;
- (vi) steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission ("CFTC") as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC ("WCM"), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 ("the Exchange Act") and member of the Financial Industry Regulatory Authority ("FINRA"). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. All disclaimers set out with respect to Westpac apply equally to WCM. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not be subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.