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.

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