

# Gentlemen's agreement

## What to expect from the RBNZ's new Policy Targets Agreement

- **Incoming RBNZ Governor Graeme Wheeler is likely to sign a new Policy Targets Agreement this week.**
- **While this will be an important first step in establishing the direction of Mr Wheeler's governorship, it only covers a narrow aspect of the Governor's role.**
- **We don't expect substantive changes to the text of the agreement. There are some significant changes on the way in terms of how the RBNZ operates, with the potential for more to come, but they will be the product of several years of development.**

On 26 September, Graeme Wheeler will replace Alan Bollard as Governor of the Reserve Bank. This means that in the next few days he will need to sign a new Policy Targets Agreement (PTA) with the Finance Minister, setting out how he will meet his legal obligation to maintain price stability. For his part, Finance Minister Bill English has said that he doesn't envision major changes, although he wants to ensure that the agreement reflects "best practice". However, Mr Wheeler does not have a background in central banking and his views on monetary policy are unknown, so the new PTA (and the supporting material that is typically disclosed along with it) will be an important clue as to how he intends to approach the role.

This note briefly reviews the scope for change in the existing agreement. We don't expect any substantive changes, but the broader point we'd like to make is that the PTA's scope is actually fairly narrow, and is far from the only avenue for change in the way that the RBNZ operates. Indeed, there are already some major developments in the pipeline – but they will play out over a timeline of several years, and there's no need to shoehorn them into the signing of a new PTA this year.

### Details

Monetary policy in New Zealand is governed by two documents. The first is the Reserve Bank of New Zealand Act 1989, which states that price stability is the primary goal of monetary policy, and holds the Governor solely to account for meeting this goal. The Act in turn requires the Governor and the Finance Minister to sign a PTA, setting out what 'price stability' means in practical terms, and the conditions for meeting this goal. Since 1990

there have been eight variations of the PTA, although only three have involved substantial changes (see the box below).

This clues us in on three factors that are outside the scope of the PTA. The first is that the PTA cannot remove price stability as the primary goal, or put other goals such as employment or the exchange rate on an equal footing. The Governor can be (and is) directed to consider such aspects, but only as mitigating factors in the pursuit of price stability.

The second is the Governor as sole decision-maker on monetary policy. The RBNZ is relatively unusual in this aspect – most central banks decide by vote among a committee or board. It also has a fairly unique enforcement mechanism: the Governor can be removed from office for failing to meet his price stability target. The Governor can (and again, does) form an advisory group on monetary policy, but he is not bound by any vote or recommendation, and by the same token can't pass the buck for failing to meet his target.

These two features are embedded in the RBNZ Act, so any change would have to go through Parliament, not just an agreement between the Governor and the Finance Minister. That's not to say that it can't be done, it's just that legislative change can be a laborious process – moving to committee decision-making would be particularly complex, as it would require new mechanisms for holding the committee accountable. That said, if there were an appetite for change, the way to do it would be to appoint a Governor who was amenable to such changes, and could shepherd them through during the first few years of their term. And appointing an outsider – as Mr Wheeler is – would help to smooth the process.

### Major changes to the PTA

1990: Inflation target set at 0-2%.

1996: Target widened to 0-3%.

1999: Added the condition that the RBNZ "shall seek to avoid unnecessary instability in output, interest rates and the exchange rate".

2002: Target redefined as future inflation of 1-3%, on average, over the medium term.

The third factor is one of omission. There have long been calls for the RBNZ to develop tools other than interest rates to control inflation, given the collateral damage that can arise, such as an overvalued exchange rate. And in fact the RBNZ has spent several years investigating the use of 'macro-prudential' tools such as varying bank capital and funding requirements – these are largely aimed at reducing risks to the financial system, but in some circumstances they might bolster monetary policy too. Make no mistake, these new policy tools are coming, and we will have more to say about them in the near future.

The point here, though, is that the RBNZ doesn't need to be 'given' these tools. In fact, the PTA has never specified the tools that the RBNZ can or should use – its focus is on the ends of monetary policy, not the means.<sup>1</sup>

So what could be changed? We list some possibilities, from least to most plausible:

**Inflation targeting:** The PTA defines 'price stability' in terms of the rate of increase in the Consumer Price Index. But there have always been alternative definitions, such as targeting a level of prices rather than a rate of change, or targeting nominal GDP (which includes both prices and volumes). We'd put this in the "too radical" basket: there is currently a lively debate around such alternatives, but more as a signalling mechanism for central banks that have already hit the zero lower bound for interest rates. There's little agreement as to how they would perform under normal conditions.

**The target range:** As we've noted, the RBNZ's inflation target has been watered down several times over the years. Any further softening can't be ruled out, though there's little reason to think that this would bring any long-term benefits. The current range is broadly in line with other central bank's targets, and past research has concluded that at low rates of average inflation (less than 3%) no one rate is better than another.

That said, raising the target range to 2-3% to align it with Australia would have interesting near-term implications. The RBNZ's most recent forecasts have inflation averaging just below 2% over the next three years. Faced with an Australian-style target, would Mr Wheeler feel obligated to cut the OCR immediately? In our view, the mere fact that it would put the new Governor in such a position makes it unlikely.

**Variations from target:** The PTA has always given the RBNZ guidance on how to absorb shocks and one-off factors such as commodity price spikes, tax changes and natural disasters. It's possible that this list could be extended, but we think the value-added would be fairly low. The current PTA's focus on inflation over the medium term means that these days the RBNZ is better described as an inflation *forecast* targeter; shocks that have already occurred treated as by-gones, except to the extent that they could affect the public's expectations of inflation over longer periods.

<sup>1</sup> The Act is not terribly prescriptive about policy tools either, but it does state that the RBNZ will use its powers for the purpose of "promoting the maintenance of a sound and efficient financial system". An overly intrusive new policy tool could face a legal challenge on those grounds.

**Secondary objectives:** Aside from looking through one-off shocks, the PTA also instructs the RBNZ to avoid "unnecessary instability" in cyclical factors, namely output, interest rates and the exchange rate. Again, it's possible to add to this list. The obvious candidates would be asset prices and/or credit growth, given the experience of last decade – around the world, asset prices soared and financial imbalances piled up, while only mild goods and services inflation meant that central banks had little mandate to respond.

We think that some acknowledgement of the role of asset prices is possible in the new PTA. However, including it under the 'avoiding instability' clause would be unhelpfully vague, and would vastly underplay the amount of work that the RBNZ has put into developing macro-prudential tools. It would be better to give asset prices their own separate consideration – for example, noting that the formation and bursting of 'bubbles' can hinder price stability over the longer term, even if it doesn't affect CPI inflation over the medium-term forecast horizon.

### Market implications

Over the last two decades, RBNZ policy has moved unerringly in the direction of greater complexity – from a strong focus on reducing inflation (and more importantly establishing its inflation-fighting credibility), to embracing a broadening range of concerns about the economy and the financial system. Regardless of the content of the new PTA, one thing we can confidently predict about Mr Wheeler's first five-year term as Governor is that policy will become more complex again. Macro-prudential tools will become part of the arsenal in coming years – and to the extent that they are used in a cyclical manner, they will make it tougher to describe and predict the overall stance of monetary policy. But this increased complexity is something that will evolve over several years; it doesn't hinge on the signing of a new PTA this week.

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