Time to reform the governance of the Reserve Bank

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Introduction and summary

When Parliament passed the new Reserve Bank of New Zealand Act in December 1989 a key, and innovative, feature of the Act was that the powers of the Reserve Bank were to be exercised by the Governor, and the Governor alone. The legislation provided substantial operating autonomy to the Reserve Bank, and the establishment of a single decision-maker was seen as a way of providing effective accountability. If things went wrong, the Governor would have been responsible for any decisions, and the Governor could be dismissed, for cause, by the Minister of Finance.

But the model is out of step and out of date. It is out of step with international practice in respect of monetary policy and of financial system supervisory and regulatory policy. As importantly, it is out of step with approaches to governance used in the New Zealand public sector more generally.

The Reserve Bank governance model was developed, in part, to parallel reforms to core government departments that were going on at much the same time. Those reforms themselves have since been considerably modified. But even if that were not so, the conception of the Reserve Bank that the 1989 legislation reflected has not been borne out by reality.

The 1989 governance model might have been thought appropriate (if still unusual) for a very simple and uncontroversial most-monetary-policy agency. Today's Reserve Bank is a complex, multi-functional, organisation, exercising much more policy discretion in a range of areas, that are all characterised by considerable risk and uncertainty, than was envisaged in the 1980s. Vesting all that power in a single unelected person is too risky, and is inappropriate. It is not the way we do things in New Zealand.

In this note I will take as given both the range of functions the Reserve Bank has, and the allocation of powers between the Minister of Finance and the Bank. Aspects of both issues should probably be revisited, but here I focus simply on the weaknesses in the governance model given the responsibilities that Parliament has assigned to the Reserve Bank.

The rest of this note outlines the key aspects of Reserve Bank governance and explains the background to the governance choices made in the 1989 Act. It then focuses on how different things are today and why, even if it was a suitable model in 1989, it no longer is today. I outline some alternative options and conclude by outlining my own preferred option. Key aspects of any reforms should be (a) a move away from having policy decisions made by a single unelected official, and (b) the establishment of collective decision-making bodies which clearly distinguish among the main functions the Reserve Bank undertakes.

The nature of the 1989 governance model

For most of the Reserve Bank's history, formal authority was vested largely in the hands of the Board, whose members were appointed by the Minister of Finance. The Board, in turn, delegated some of that authority to the Governor (and to management more generally). A Board chosen by "shareholders" used a "managing director" (Governor) to give practical effect to the affairs of the Bank. Of course, in this case the Governor was directly appointed by the (shareholder) Minister, and many of the Bank's functions (notably monetary policy) were carried out by the Bank largely in accordance with directions (more or less explicit) of the (shareholder) Minister[1]. Consistent with international central banking practice, the statute made it very difficult to dismiss a Governor[2].

In passing the 1989 Act, Parliament replaced that model almost entirely:

- All the Bank's powers were vested in the Governor personally.
- For the Bank's "primary function" (section 8), monetary policy, powers were to be exercised under a public performance agreement (the document known as the Policy Targets Agreement).
- The Governor was still appointed by the Minister, but the Minister could only appoint someone first nominated by the Board.
- The Board, appointed by the Minister, was left with almost no role in the day-to-day conduct of Bank business or administration. Their formal role was now as an agent of the Minister (although with few obligations to him), and largely restricted to recommending the (re)appointment of a Governor, and reviewing the Governor's performance[3].
- In extremis, the Board could recommend that the Minister dismiss the Governor, and the Minister could also take such action without a recommendation, for failures of policy or administration.

The background to the 1989 governance model

In devising the 1989 Act it was common ground among officials and ministers that the Reserve Bank should have operational autonomy in respect of monetary policy - the ability to make discretionary adjustments to monetary conditions.

But the governance model chosen reflected several aspects of the international and domestic environment of the times.

a. Other central banks

First, at the time only a few other central banks had (both statutory and effective) operational independence. The ones New Zealand officials tended to be interested in were the central banks of the United States, West Germany, and Switzerland, and none of those were from the the British-based tradition of parliamentary and public sector governance. In other words,

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[1] The earlier framework governing monetary policy is discussed in, for example, James Graham and Christie Smith, "A brief history of monetary policy objectives and independence in New Zealand", Reserve Bank of New Zealand *Bulletin,* March 2012 pp28-37.

[2] Governors could typically be dismissed only for serious personal failings (mental incapacity, criminal convictions etc) and not for policy or administrative failures

[3] Anomalously, the Governor remained as chair of the Board, The current model, in which the Governor is a member of the Board, but not chair, was introduced followed the 2001 Svensson Report, commissioned by Michael Cullen when he became Minister of Finance..

there were few international models that could readily be adopted in New Zealand[4]. The Reserve Bank of New Zealand legislation was the first in what was a whole wave of new central banking legislation around the world over the following 10-20 years.

b. New Zealand public sector reform

The Reserve Bank was just one of many New Zealand public sector agencies to face far-reaching reforms in the late 1980s.

The governance of government-owned commercial operations had been reformed first (the SOE model came into effect in 1987). For entities operating under the SOE model, the governance was to be very similar to that in a conventional corporate: the Minister appointed Board members, who in turn appointed a CEO to conduct affairs under authority granted to him/her by the Board. For a time, the Treasury had been very interested in the possibility of applying the SOE model to the Bank[5].

The State Sector Act 1988 (and the Public Finance Act 1989) dealt with the non-commercial departments. The insights that shaped that legislation were more practically relevant to later discussions around the Reserve Bank.

Under the previous state sector legislation, heads of government departments had permanent appointments - a model which had both significant advantages (as regards free and frank policy advice) and significant disadvantages (all but impossible to get rid of weak performers). The new legislation put chief executives of government departments on fixed term contracts and provided for the establishment of performance agreements between chief executives and the respective ministers. It provided stronger operational autonomy (from Ministers and from the State Services Commission) for chief executives and agencies, and the focus was on being able to hold individuals to account.

A key part of this, at least conceptually, was the attempt at a clear delineation between, on the one hand, the "outputs" of government agencies (things agencies could directly control – e.g. volume and quality of policy advice; hours devoted to traffic patrols etc) and, on the other hand, "outcomes". Outcomes (e.g. a lower crime rate) were things that politicians and the public probably most cared about. Outcomes were typically affected by the actions of government agencies, but there was no direct and unambiguous mapping between specific actions of agencies and desired "outcomes". The conception was that CEOs could be held directly accountable for the achievement of output targets that were set by Ministers in performance agreements.

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[4] The Reserve Bank's own initial proposal to the Minister of Finance was based around the Australian statutory model. In that (1959) model the Reserve Bank of Australia's Board was formally the decision-making body, but the Federal Treasurer could override the Bank so long as this was done openly (tabled in Parliament). Appealing as the model may have looked on paper, it was a curious recommendation since, in practice, the RBA participated actively in the public sector policy debate but ultimately did as it was told from Canberra, and the formal override powers were never - and have never been - used.
For some discussion of this and some of the other historical material see my 1999 Reserve Bank *Bulletin* article "Origins and early development of the inflation target"
http://www.rbnz.govt.nz/research_and_publications/reserve_bank_bulletin/1999/1999sep62_3Reddell.pdf

[5] The ideas are discussed, not entirely impartially, in chapter 5 of the Singleton et al history of the Reserve Bank. Note that at the time there was no formal framework for Crown entities.

c. The conception of monetary policy

This outputs vs outcomes framework was an important factor in the debate around how the Reserve Bank of New Zealand should be governed[6]. From the original discussions around the possibility of converting the Reserve Bank into an SOE, through until at least a year **after** the Reserve Bank Act was passed, elements of the Treasury were heavily influenced by a strand of thought that reckoned that monetary policy could be appropriately, and perhaps best, configured as an "output" problem. If so, an autonomous decision-maker could be held clearly and directly accountable for delivering a pre-specified desired output.

At one stage, the idea of a statutory quantitative limit on the Reserve Bank's note issue was floated. Rather more persistent was the view that a target rule for growth in the money base - something that could be directly controlled by the Reserve Bank if it chose - was the appropriate basis for setting monetary policy. If so, it would have been easy to judge whether (or not) the Bank had done its monetary policy job.

Within the Reserve Bank and Treasury it was largely common ground that something like price stability was the appropriate medium-term desired **outcome.** However, it was also accepted that, in a market economy, inflation was not directly controllable by policy actions, and could be influenced (indirectly) by monetary policy only with fairly long and variable lags, and subject to a variety of exogenous shocks[7]. A robust relationship between the monetary base and medium-term price stability might have provided a suitable foundation for an outputs-based approach. But such a relationship never emerged.

The point here is not that the governance aspects of the 1989 Act mechanically reflected views of particular individuals about which operational targets the Reserve Bank should use to conduct monetary policy. It is more that the milieu inevitably, and perhaps even appropriately, affected the thinking about institutional design. On the one hand, public sector reforms processes put a strong focus on individualised accountability. On the other, there was a sense – perhaps rarely written down explicitly, but implicit in a lot that was written - that once low inflation had been achieved, the conduct of monetary policy should be relatively straightforward and not especially controversial. The implicit vision of monetary policy was of an important, but essentially technical, matter.

d. The conception of the responsibilities of the Reserve Bank

At the time Reserve Bank was thought of as being (in the process of becoming) a relatively simple institution. Exchange control had gone in 1984, direct controls had been removed by early 1985, and government banking, tendering and registry functions were gradually being removed from the Bank. No one in officialdom had much interest in foreign exchange intervention and the foreign reserves the Bank was allowed to hold were well-hedged.

The 1989 Act gave the Reserve Bank powers in a variety of areas, but the Bank was overwhelmingly seen as a monetary policy institution[8] Many of the clauses of the Act were

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[6] These issues are treated in Singleton, in a *Bulletin* article on the origins of inflation targeting http://www.rbnz.govt.nz/research/bulletin/1997_2001/1999sep62_3reddell.pdf, and in this Reserve Bank piece on monetary policy accountability and monitoring http://www.rbnz.govt.nz/monpol/about/2851362.html

[7] As the Bank itself noted in one 1988 paper, the problem with inflation targeting (relative to, say, money base targeting or a fixed exchange rate) is that it had a "trust us, we know what we are doing" dimension.

[8] Section 8 of the Reserve Bank Act still states that monetary policy is the "primary function of the Bank".

devoted to the registration of new banks, and the management of bank failures, but there was little or no sense that the Bank was likely to become a particularly active regulatory agency. People close to the work on the 1989 Act report that in detailed discussions around the drafting of the 1989 legislation, little or no attention was given to governance issues as they affected the regulatory responsibilities of the Bank. Thus, although the governance arrangements (single decision-maker, complemented by the monitoring role of the Board) covered all the Bank's responsibilities, it is clear that they were designed primarily with (the rather simple conception of) monetary policy in mind.

At the time, the emerging international view about monetary policy was that the public needed an independent central bank to protect them from Ministers of Finance who could never be trusted to keep monetary policy tight enough for long enough to maintain low inflation[9]. That meant putting day-to-day monetary policy decisions at arms-length from ministers. But, on the other hand, the approach that guided New Zealand public sector reform emphasised that ministers and the public needed protection from errant bureaucrats who would not necessarily serve the public interest, unless given clear goals and the prospect of serious accountability for non-performance.[10]

Against this background, it is not surprising that the Reserve Bank Act ended up establishing a single autonomous decision-maker. The Board was there to recommend appointment and dismissal, and to monitor performance – again putting the Minister at arms-length - but had no in making policy. The model closely paralleled the arrangements for heads of government departments, with the State Services Commission playing a role for respective ministers rather similar to that to be played by the Reserve Bank's Board.[11]

What has happened since?

Over time, perhaps few things play out quite as the designers of any system expect. Institutions evolve, as do expectations of them, and it is important that governance structures are kept in line with those changes. In the case of the Reserve Bank, a single unelected decision-maker does not now pass that test.

There have been significant changes under each of the four headings I discussed in the previous section:

- New Zealand public sector governance,
- The understanding of monetary policy,
- The range of functions, and discretionary activities, that the Reserve Bank is responsible for, and
- International practice.

a. New Zealand public sector governance

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[9] Thus Roger Douglas asked Spencer Russell (then Governor) and Graham Scott (Secretary to the Treasury) to devise something that was "Muldoon-proof".

[10] There is, of course, a tension between the two views – why would a Minister, apparently prone accommodating too much inflation, ever dismiss a Governor who delivered too high inflation? - and the governance structure adopted in the 1989 Act had elements of both strands of thought

[11] However, in the respective pieces of 1980s legislation the State Services Commission was at considerably more arms-length from the departments it monitored than the Reserve Bank's Board was from the Bank. SSC had independent reporting lines (its own minister) and control over its own resources.

Some aspects of 1980s public sector reform have proved resilient. The domestic SOE model proved relatively successful for commercial operations owned by government, and relatively enduring, in form as well as in substance. It is becoming less important, particular since the recent wave of partial privatisations, but the proposition that government business activities should be managed commercially, using fairly standard business governance models, has stood up well.

By contrast, in core government departments, the usefulness of the outputs vs outcomes approach as a guiding principle for assignment of responsibilities, and accountability, has probably not lived up to the hopes of the designers. And, not unrelatedly, the degree of effective operational autonomy for (single decision-maker) department chief executives is far less than was probably envisaged by the early advocates of the model. More recently, as a matter of active policy, departmental autonomy now appears to be consciously discouraged, with an emphasis on "whole of government" or "joined-up government" approaches - whether with a view to cost-savings, better policy outcomes, or both.

Much about the way policy is implemented is politically sensitive (i.e. voters expect politicians to be accountable for choices about both "whats" and "hows"). A government concerned to lift educational standards (an outcome) cannot conceivably simply leave to the Secretary of Education the question of whether to adopt, say, a National Standards regime as an "output" in support of the government's desired "outcome"

As a result, the clean delineation between outcomes and outputs has rarely worked overly well. Government departments still have single (unelected) decision-makers (i.e. their chief executives) but those individuals have little effective independence over outward-facing "how" decisions[12] (or, increasingly, over key aspects of the internal management of their own agencies).

There have always been many government entities beyond departments and SOEs. Numerous Crown entities exist to carry out a wide variety of public functions[13]. A consistent framework for these institutions did not exist in the 1980s but in 2004 the Crown Entities Act was passed. It was designed, in Treasury's words, to "reform the law relating to Crown entities and provide a consistent framework for the establishment, governance and operation of Crown entities. It also clarifies accountability relationships between Crown entities, their board members, their responsible Ministers and the House of Representatives".

The Reserve Bank is not, formally, a Crown entity, standing in a category of its own in the government organisation chart. There is no obvious reason for that to continue, since there is little obviously unique about the role or functions of the Bank. But the point I wish to make here is simply that, across the wide range of Crown entities (and various sub-categories within that grouping), I am not aware of any case where a chief executive has principal or exclusive decision-making powers Crown entities typically exist to give effect to:

- implement some aspect of government policy (e.g. EQC, ACC, FMA, NZQA),
- provide advice and/or participate in public debate (e.g. Productivity Commission, Retirement Commission, Law Commission), or
- carry out some function government has determined to fund and provide (e.g. NZSO, Te Papa).

[12] Of course "who" decisions (eg on prosecutions, or tax audits, or licenses etc) rightly remain far-removed from Ministers.

[13] http://www.ssc.govt.nz/state_sector_organisations sets out all current state sector organisations.

In some areas, of course, aspects of the application of policy will shade into policy itself, but matters with pervasive external effects are not simply decided by a CEO. Each of the significant entities I am aware of have a board which has ultimate responsibility for the conduct, and key framework decisions, of the organisation[14]. Board members, and typically the chair, are directly appointed by Ministers, and each chief executive exercises their delegated power under the direct authority of the respective board.

The practice of collective decision-making (and/or formal review or appeal rights) goes still broader, and is deeply entrenched in our system... Indeed, in New Zealand public life, it is difficult to think of any other position in which the holder wields as much individual power, without practical possibility of appeal[15], as the Governor of the Reserve Bank does. Judges, of course, have the power to imprison - but all lower court decisions are subject to appeal, and higher courts sit as a bench, so that no one person's view alone decides the case. Resource management consent decisions, which hugely and directly affect property rights and values, are subject to appeal. Individual Ministers exercise significant authority, although often requiring the involvement of Cabinet. In New Zealand, all ministers are elected MPs, and any individual minister serves only at the pleasure of the Prime Minister. The Prime Minister, of course, has huge power, but cabinet government is a key feature of our system, and (more hard-headedly) the Prime Minister holds power only while he commands the confidence of his own (elected) caucus. As Kevin Rudd found, that confidence can be withdrawn very quickly.

Typically, public policy decisions that have far-reaching ramifications or that are not customarily made within clear and prescriptive guidelines, are either made collectively, or are subject to appeal, or both. There is nothing comparable in respect of the Reserve Bank.

b How monetary policy is understood

Except for fixed exchange rate countries, output-based approaches to monetary policy do not work. That was fairly generally recognised internationally by the time the 1989 legislation was passed, but ideas around an output-based framework still had an impact on the New Zealand framework.

For a time perhaps, some hoped that even though an inflation target was for an **outcome**, it might still be amenable to **output**-like accountability regimes. If inflation outcomes were inside the target range, the Reserve Bank had done its job, and if not, then not[16]. But it has not proved to be that simple, for a variety of reasons. Even core inflation outcomes can be away from the target midpoint for years, and considerable amounts of judgement are required to interpret the Policy Targets Agreement (including, but not limited to, questions around avoiding "unnecessary variability" in output, interest rates and the exchange rate).

Monetary policy setting, in the forecast-based approach adopted across the advanced world, involves considerable discretion. Reasonable people can reach quite different views

[14] I have not attempted to work through the entire list of Crown entities to check their respective pieces of legislation, so if there are exceptions I would be happy to be advised of them.

[15] The override powers in Section 12 of the Reserve Bank Act do, of course, provide some scope for acting to deal with a Governor doing rogue things – but are not a routine part of governance (and have never been used). The Reserve Bank can induce, or materially worsen, a recession without significant threat of those powers being used. Perhaps, for example, it did in 1998, during the MCI fiasco.

[16] The high tide of this sentiment was Don Brash's unequivocal statement in a radio interview in 1993 that if inflation went above 2 per cent (the top of the then target range) he would lose his job (this statement is reproduced in an interview with Dr Brash included in the September 1993 edition of the Reserve Bank *Bulletin*).

And since Reserve Bank discretion involves choices that can materially affect output and unemployment, for periods of perhaps 1-2 years at a time, or the real exchange rate (and hence relative returns across major sectors of the economy), these choices matter to many people. To be clear, monetary policy choices materially affect only the price level in the long run, but transition paths (especially when discretionarily chosen) have real implications for real people.

At the time the 1989 Act was passed, monetary policy was highly controversial (as, of course, was much of the rest of the reform programme). But the implicit view was that once low and stable inflation was established monetary policy would be a fairly low-key matter, not exciting much debate or political contention. In fact, since 1989 there has not been a single general election in which at least one party has not been campaigning for change to the monetary policy aspects of the Reserve Bank Act[17]. Latterly, the tide has been rising, and at the last election for example all the parties on the political left were campaigning for change. The point here is not whether (or not) the advocates for change are correct, simply to highlight that monetary policy remains contentious, and that to vest all powers in such a controversial area in a single unelected official increasingly seems anomalous.

c. Changing activities of the Reserve Bank

The third aspect that has turned out materially differently than the designers of the 1989 legislation expected is the wider role of the Reserve Bank.

In the late 1980s, the Reserve Bank was envisaged primarily as a monetary policy institution, with a very limited - and well-hedged - balance sheet. Since then the Bank's roles have expanded considerably, but there has been no material change in its (single unelected official) governance. What are the changes in role?

The Bank has taken on substantial foreign exchange risk, including a more active foreign exchange intervention role. In crisis periods it has assumed substantial credit risk. And whereas in 1989 the registry business was in steep decline, the Bank is now the owner and operator of New Zealand's major securities clearing and settlement system.

But perhaps the most substantial changes have been in the supervisory and regulatory functions, which now take a much larger, and a more active, place. Considerable amounts of regulator discretion are now being exercised, as to policy and the implementation of policy. The change has accelerated in the last half-dozen years with:

- The move to Basle II and then Basle III capital models (involving approval of risk models, and the exercise of detailed discretion and judgement on risk weights etc)
- The introduction of the so-called macro-prudential (time-varying) approach to regulation of banks, including the 2013 residential mortgage LVR "speed limit" and the recent proposal for a ban on high LVR property investor lending in Auckland. Regional differentiation in the way prudential policy is applied is yet another new step in regulator discretion.
- The Reserve Bank becoming responsible for the regulation of non-bank deposit-taking institutions

[17] As far as I am aware, this degree of electoral debate over central banking, spanning multiple elections, is unique to New Zealand.

- The Reserve Bank becoming responsible for insurance supervision.The Reserve Bank becoming responsible for implementing anti-money laundering etc legislation in respect of the financial institutions it regulates, and
- The Reserve Bank's bid (not yet successful) for more payment system powers.

It is common ground that there no framework in the Act for defining **output-based** performance standards for these functions and that for most of them it is simply not possible to do so. That is not a criticism of the Reserve Bank, or of the roles Parliament has assigned, but simply a description of the difficulty all countries face in these areas.

So the Reserve Bank is now an organisation that, with the acquiescence of ministers and sometimes with the specific mandate of Parliament, has a wide range of functions and powers, but typically has rather ill-defined, and hard to measure, goals[18]. But that means it is very difficult to defend a conception of the Bank in which having a single (unelected) decision-maker provides for clear and decisive point of accountability across these multiple different functions and responsibilities.

d. International practice

The fourth aspect where events have unfolded differently has been in what other countries have done in reforming their central banks and financial regulatory institutions.

Take monetary policy first. Since 1989, there has been a substantial global shift, in both legislation and practice, to provide many more central banks with operational autonomy for monetary policy: Among the G7 countries, central banks in the UK, Japan, and France have been given independence, and the (new) ECB has the highest level of monetary policy autonomy of any modern central bank. Across eastern Europe (still mostly communist in 1989), and other parts of the emerging world, there have been similar trends. But not a single advanced country, of the many to have reformed their central bank legislation, has moved to a model with a single unelected individual as decision-maker for monetary policy[19]. Despite all the attention paid to the New Zealand reforms, no country has adopted the New Zealand governance model[20].

Governance models for banking regulation/supervision in other countries are quite diverse. In some countries many or all of these activities occur within central banks, and in other cases most of the regulatory functions occur in separate agencies. However, I am also not aware of any advanced economy in which Parliament has delegated the major policy decisions in respect of financial supervision/regulation to a single unelected official. A decision-making Board, advised by technical experts, is a much more common model, and in some cases many more of the policymaking powers (than in New Zealand) are reserved for ministers.

In sum, in no other advanced democratic country does a single unelected official exercise so much power in matters of monetary policy and financial regulatory policy. Only in Canada's case, with rather old legislation, does a single official exercise final legal power (in respect of

[18] In one or two areas there are memoranda of understanding with the Minister of Finance, but these documents have no legal status, and bind neither subsequent ministers nor subsequent governors.
[19] I am not aware of any developing countries having done so either, but have looked less deeply into the range of reforms in those countries.
[20] A few years ago Israel amended its central banking legislation to shift from a single decision-making Governor, to a decision-making monetary policy committee. For a useful survey of monetary policy governance in a range of advanced countries see http://www.rbnz.govt.nz/research_and_publications/reserve_bank_bulletin/2014/2014mar77_1aldridgewood.pdf

monetary policy), and the Bank of Canada has very much more limited functions than the Reserve Bank of New Zealand.

Some reflections

There is likely to be wisdom in the revealed preferences of other advanced countries. Why might they, when delegating decision-making to a level below ministers, almost all have chosen formal (legislated, or treaty-based) collective decision-making model for monetary policy and for financial regulatory policy?

Consider, as an extreme example, the ECB. Why would the leaders and peoples of the euro-area not have been comfortable with reposing all the ECB's powers in a single unelected person? Partly, of course, because that person would have a national passport - of one member country, but not of each the other countries. But that matters to people because they, correctly, think that monetary policy is more than just a computer programme, bloodlessly churning out the "correct" answer. Different people read data differently, and reach judgements differently, and one person will be more likely to take some risks than others etc. In a currency union like the euro-area that might be perceived as something about different national interests or temperaments. But even within national boundaries there are big differences in interests (short to medium term), and outcomes are significantly, and differentially, affected by the choices made by a central bank. If a central bank has discretion - and all modern ones (not adopting fixed exchange rates) do – then preferences and values come into play, and it is not obvious why the preferences of a single unelected official should be given such a high weight.

One previous Reserve Bank Governor sometimes liked to argue that he wasn't very powerful at all - that he was tightly constrained and really had little choice around the decisions he took. If he really believed it (and he was talking only of monetary policy in any case), I think he must have been the only one to have done so.

Reflect, for example, on the last boom during the 2000s. Core inflation ended up persistently well above the target midpoint (with no action taken against the Governor by either the Board or the Minister). That suggests that a different Governor could equally legitimately have made choices that delivered inflation as far below the midpoint of the target range. Over a 10 year view that difference might not have made much difference to the end-point level of GDP, but it almost certainly would have made a huge difference to the trajectory of GDP, and of many economic activity/price variables, including house prices, debt, the exchange rate, and exports.

Or consider the years since 2007. Actual decisions have been widely regarded as PTA-consistent, but different Governors could have made a plausible case for a materially looser stance. That is real, and largely untrammelled[21], power of the sort that societies such as ours very rarely repose in a single person - elected or not - no matter how able. (Indeed, this was the gist of Lars Svensson's case, in his 2001 review for the previous government, for a formal decision-making committee. Svensson thought very highly of the then Governor, but argued that we needed to build institutions to cope with the less good ones - less technically able, less inclusive, less good judgement or whatever.)

[21] The note on accountability and monitoring, referenced earlier, discusses some of the practical constraints on what appears in statute to be the Board's considerable freedom of action to hold a Governor to account.

And, of course, this is before we move on to consider that substantially increased administrative and regulatory powers that have been given to the Bank in recent years. Exercise of those powers directly affects the property rights and livelihoods of citizens and investors. For example, how appropriate is it that a single unelected official can not just impose higher capital requirements on major banks (who typically don't excite much public sympathy) but that he alone can decide whether, and to what extent, banks can lend to particular classes of borrowers, in some regions rather than others? There may be a sound case for such public policy choices and restrictions, but they are the sorts of distributional choices that democratic societies usually expect that only ministers, or legislatures, should make.

One could extend the point through many of the rest of the Bank's functions. Should a single monarchist Governor be able to impose his or her personal preferences and put the Queen's head on all banknotes (a legislated monopoly issuance)? Is it wise for a single unelected official to be able (as the Governor can under current law) to punt billions of dollars of public money in the foreign exchange market? A particular Governor might be a brilliant trader and market-timer, but if so he is probably in the wrong job. More generally, given a Governor's incentives and reward structure it is difficult to be optimistic about the likely long-run payoff to backing one person's large foreign exchange punts.

The current single decision-maker model was, at least implicitly, premised on the notion that the Governor would be someone relatively expert in matters macroeconomic/monetary. That might well have been a reasonable presumption when the Act was written, and supervision and regulation were a small part of what the Bank did. But given the way the Bank's responsibilities have evolved and increased, at some point it might well be the judgement of the Board and the Minister that it was important to have, say, a banker or a micro-regulatory expert as Governor. Such a person might well have a valuable role to play as part of a monetary policy committee, but would be less obviously suited to being (and being seen as) the single monetary policy decision-maker (and, hence, single authoritative spokesperson for that policy).

Finally, I am not arguing the case for change because I think the conduct of monetary policy or banking regulation here has typically been demonstrably poorer than that in other countries (although I am sceptical that the MCI fiasco could have occurred under most committee models). There is literature supporting the superiority of collective decision-making over individual decisions[22] and the Israelis referred to this literature in explaining their own change. I would not put too much weight on such literature in normal circumstances - since Reserve Bank governors have generally used somewhat-collegial processes for obtaining advice on monetary policy decisions. However, institutions need to be built not just for good times or good people, but to cope with tougher times and less excellent people. Laws are a key part of how, as a society, we do that.

So the argument for change is not primarily about ensuring better macroeconomic or financial regulatory outcomes, especially in normal times. It is primarily about establishing stronger legitimacy for the institution, and good and robust governance that aligns well with how we do things in New Zealand. Free and democratic societies are rightly reluctant to put too much power in one pair of hands, however capable that pair might be. Doing so exposes the

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[22] See, eg, Blinder, Alan S., and John Morgan, 2000. "Are Two Heads Better Than One?: An Experimental Analysis of Group vs Individual Decisionmaking." NBER Working Paper No, 790 and Lombardelli, Clare, James Proudman, and James Talbot, 2005. "Committees Versus Individuals: An Experimental Analysis of Monetary Policy Decision Making", *International Journal of Central Banking* 1(1) 181-205

country to far too much "key person" risk - in the Reserve Bank case, not the risk of losing a key person, but the uncertainty about the priors and preferences one powerful unelected official will exercise in juggling these numerous different roles, with no established output standards, and outcome standards that, if they exist at all, are useful only over the very long haul[23].

Alternative models

There are about as many models of central bank governance as there are central banks[24]. There is no ideal blueprint, even if agreement in principle had been reached that collective decision-making was desirable. That is partly because each model in other countries will reflect some combination of the constitutional structure, economic and political history, and so on of the country concerned. As I have illustrated, our current model arose from the specific history of New Zealand reform in the 1980s. The diverse range of models also reflects the very different range of responsibilities different central banks have.

So we need a governance model for the Reserve Bank of New Zealand that reflects the wide range of responsibilities the Bank now has and the huge influence the Bank has on economic and financial developments in New Zealand, and which fits well with the rest of public sector governance in New Zealand today. Whatever model is adopted can't conform to some "international standard". There is none, although the one near-universal feature is the absence of a single unelected decision- maker.

One can only fully evaluate the various options once they are each properly developed, and each model would have its own set of consequential, quite detailed, legislative changes[25].

But here I sketch out some of the arguments around three broad options:

1. *Internal (expert) management committee(s)*

In 2001, Lars Svensson's report to the Minister of Finance proposed legislating for a small committee of internal experts (senior managers of the Reserve Bank[26], working in executive roles in the monetary policy area, whether initially appointed from outside or within) to make monetary policy decisions.

Simply legislating for a committee of fulltime executives would have some modest advantages over the current situation. Whatever decision-making benefits might arise from committees, per se, would presumably be captured. However, without much more substantial structural change, it would represent a material further dilution of ministerial responsibility for monetary policy. The Minister appoints (and, in principle, can dismiss) the Governor, but has no involvement in appointing those in the Bank's management hierarchy.

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[23] If, as a country, we were comfortable with setting prudential policy to aim for a financial crisis no more often than once ever hundred years, events in any five year term are not going to shed much light on whether policy is set appropriately.

[24] The Reserve Bank last year published a useful *Bulletin* article comparing the governance arrangements for monetary policy across a range of inflation-targeting central banks. It is a useful collection of material, but its usefulness here is limited precisely because it is restricted to monetary policy governance..

[25] In the Appendix I note a few of other the other anomalous aspects of the current legislation, each of which reflects the prior choice to adopt a single decision maker model.

[26] Governor, Deputy Governor, Head of Economics, Head of Financial Markets

The Svensson solution was designed for monetary policy. In principle, there is no reason why there should not be a similar internal committee for prudential matters, probably with somewhat overlapping membership.[27]

But it is not clear why a model of this sort it would appeal to political decision makers (Minister of Finance, and MPs). The model was rejected by Michael Cullen in 2001, and has not since been revived by any politicians.

In such a model, the Governor would clearly be the dominant figure. He or she would be the chief executive to whom the other members work. The chief executive would presumably set their salaries, and determine resourcing for their individual departments. In practice, it is not a model which would provide much additional resilience in the face of a bad Governor, and it would remain well out of step with decision-making models elsewhere in the public sector.

As a decision making model, it would also seem to confuse the important role of technical expertise as an input to the decision-making process, and the policy decision itself. To illustrate the point, consider the role ministers play in decision-making in our system of government. Ministers (individually or in Cabinet) make policy decisions in a wide range of areas, in which typically only by chance are they technical experts. They can draw on a wide range of advice, technical and otherwise, whether from the public service or from outside.

Parliament has chosen not to have ministers making decisions on many of the Reserve Bank's areas of responsibility, but that is mostly about the incentives that politicians are perceived to face (electoral cycles). It has never been about a need to have all decisions made by executive technical experts[28].

It is important, and valuable, to keep a clear distinction between expert advice, and a decision-making process. Doing so helps ensure that a range of options is examined in a careful and balanced way. When the Governor and his/her own executive deputies are those making the monetary policy decisions, and are directly responsible for those generating the underlying analysis, there is a heightened risk that they will receive staff analysis tending to support their own known biases and predilections (staff respond to incentives). Similar risks arise around regulatory policy decisions. A very good Governor might be able to manage this risk, but it is not one that we generally take in public sector organisational design. In respect of fiscal policy, for example, there are two clearly separate roles - adviser and implementer (Secretary to the Treasury) and decision maker (Minister). The Secretary is responsible for the quality of the advice and analysis going to the Minister, but the Minister is responsible for the policy. There is no comparable separation of responsibilities in respect of the Reserve Bank's activities.

In short, simply legislating a series of internal semi-expert committees would still not represent particularly good governance. It would remain well out of step with conventional practice in the New Zealand public sector. Expert committees can, and do, play a valuable advisory role in policy development, and can play a decision-making role in technical implementation decisions, but – outside the Reserve Bank - I am not aware of any area of

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[27] In the current management structure, perhaps a Monetary Policy Committee made up of the Governor, Deputy Chief Executive, Head of Economics and Head of Financial Markets, and a Prudential Policy Committee made up of the Governor, Deputy Chief Executive, Head of Prudential Supervision, and Head of the Macro-financial Department.

[28] Otherwise, for example, there would presumably be much more stringent qualifications for a Governor laid down in the Act. Each of the three people who have held office under the current model have had a background in economics, but I don't think any of them would have described themselves as technical experts in monetary policy or banking regulation.

New Zealand policy governance in which material policy decisions (as distinct from the application of policy to particular entities) are delegated to an expert panel.

2. *Mixed internal/external expert committee*

In the United Kingdom, the supervisory and regulatory functions have recently been returned to the Bank of England. There are now three separate bodies for decision-making on each of the three broad policy functions of the Bank (the Monetary Policy Committee, the Financial Policy Committee, and the Prudential Regulatory Authority). These quite-large committees have members who are mostly appointed by the Chancellor of the Exchequer (and whose appointments are subject to parliamentary scrutiny, although not formal ratification). The committees have different, but overlapping, membership and a mix of insider and outsiders, all in addition to the Governor's powers as chief executive of the Bank itself. Some of the members would be considered experts in the specific subject matter of the committees, but all have been fairly expert in more general economic or financial matters.

It is still quite early days for the model, and so it is difficult to assess how well it is working. But, in principle, it appears to fit quite well with the sort of governance model one would want for an agency, in our sort of political system, responsible for a range of different important functions:

- Fairly clear lines of accountability exist, with each committee responsible for one area of policy (and its successes and failures)
- Overlapping membership, to reflect the reasons for having the functions in a single institution in the first place
- A Governor who plays an important central role, but is not - except perhaps by the strength of his arguments – a dominant figure. A significant part of the Governor's role is to facilitate the work of the various committees, in which he is (formally) no more than *primus inter pares*.

The model could also be said to reflect specific features of the United Kingdom. It is a fairly large country and so, it is presumably, not too difficult to fill the positions on the various committee. It is also a financial system with a huge array of types of institutions. If we were to adopt such a model in New Zealand, there would probably be a case for smaller committees. In addition, I don't think there would be a case for separate committees for so-called micro and macro prudential regulatory matters. The New Zealand framework has always sought to ensure that regulatory policy takes into account system-wide perspectives and risks. That partly reflects the history in which the banking system has been dominated by a few very large ("systemically significant") institutions.

3. *The Reserve Bank Board*

Perhaps the most straightforward route would be to convert the existing Board of the Reserve Bank from an ex post review role to a decision-making role. The Board would then become a more conventional corporate (or, more particularly, Crown entity) board, responsible for all facets of the organisation, and delegating to the Governor as chief executive (and probably managing director) various management responsibilities. This is, essentially, the model in place at the Reserve Bank of Australia for many years[29]

[29] The Payment Systems Board now slightly complicates the RBA picture.

Such a structure would, arguably, be a much superior use of the skills and talents of the members of Board. Past and present Boards have typically been comprised of people with a range of expertise, most of whom have had extensive corporate or Crown entity directorship experience. They are used to making decisions, and yet under the current Reserve Bank structure they have very few to make. The Board has typically had at least one member with a reasonably strong economics background (often an academic), to help scrutinise and review the technical input from management and staff.

If the Reserve Bank was responsible for only one main area of policy, I think this could be an appealing option. Nothing in monetary policy, or financial regulation, is more technically complex or difficult than issues that ministers and other Crown entity boards regularly deal with. However, it does not get around the issue of confused lines of accountability. Monetary policy and financial regulation are two quite different types of policy issues, required to respond to different statutory imperatives. It would be very difficult to hold the Board to account for decisions in such a wide range of areas - each member can only be dismissed once.

It would be a better model than we have now, but not as good as we could do.

In any of these three (or other) models there might be a role for the Secretary to the Treasury, perhaps with observer (rather than voting) status. Again, many overseas models still see such a role (whether the case is made in first or second best terms). In a current New Zealand context, with an emphasis on government agencies working closely together, the case might be persuasive.

Each model has some advantages and disadvantages. My strong preference, and recommendation, would be towards decision making bodies that are not wholly composed of "technical experts". It isn't how policy decisions are made in other areas of New Zealand public life. Perhaps as importantly, part of the sense of "legitimacy" around decisions that the Bank is making (be it on monetary policy or the various dimensions of regulatory policy), may arise from an ability to convince intelligent wise non-experts of the merits of a decision on the OCR or on prudential policy matters.

Considering the sorts of decisions that non-expert Ministers have to take all the time, nothing important that the Reserve Bank does is so complex that staff, led by the Governor, cannot make the case for it effectively in terms comprehensible to intelligent lay participants. The ability to articulate options effectively is a central part of the role of senior public sector adviser.

My preferred model

My main point in writing this note is to make the case for moving away from the current single decision-maker model. That model now suffers from an increasingly severe deficit of democratic legitimacy and lacks robustness.

However, in the interests of contributing to the debate, and providing an alternative model against which to look at the current system, I have outlined below the key features of an alternative model that seems to me best suited to the current responsibilities of the Bank, the size of our country, and practice in other areas of government.

Key elements of such a model would be:

- The Reserve Bank Board would be reformed to become more like a corporate (or Crown entity) Board, with responsibility for all aspects of the Reserve Bank other than those explicitly assigned to others (NZClear, foreign reserves management, currency, and the overall resourcing and performance of the institution).
- Two policy committees would be established: a Monetary Policy Committee and a Prudential Policy Committee each responsible for those policy decisions in these two areas that are currently the (final) responsibility of the Governor. Thus, the Monetary Policy Committee would be responsible for OCR decisions, for *Monetary Policy Statements*, for negotiating a PTA with the Minister, and for the foreign exchange intervention framework. The Prudential Policy Committee would be responsible for all prudential matters, including so-called macro-prudential policy, affecting banks, non-bank deposit takers and insurance companies. The PPC would also be responsible for *Financial Stability Reports*.
- Committees should be kept to a moderate size, and should comprise the Governor, a Deputy Governor, and between three and five others (non staff) all of whom would be appointed by the Minister of Finance and subject to scrutiny hearings before Parliament's Finance and Expenditure Committee. There should be no presumption in the amended legislation that these outside appointees would be "expert", although it might be reasonable to expect that at least one person with strong subject expertise would be appointed to each committee.
- The Secretary to the Treasury, or his/her nominee, would be a non-voting member of each committee.

A common argument against this sort of model is the small size of the population in New Zealand. I think this is a materially overstated concern:

- As noted earlier, ministers manage to fill countless boards and committees, covering a wide range of functions - some more important than others, some more technical than others.
- If it is difficult to find enough good people to serve as a voting committee, it is at least equally likely to be hard to consistently find a top-notch person to serve as Governor.
- No other small advanced economy has either a single decision maker, or a committee of internal management experts only.
- While I don't generally favour using foreign appointees on policymaking bodies, it is likely to be more feasible and acceptable to use foreign appointees in a system in which the foreign member is one vote of five or seven, than in the current system (which is all or nothing). Bank of England policy committees have had foreign members appointed by the Chancellor on several occasions.
- In respect of monetary policy, the Bank has managed for 10 years or more to fill two external monetary policy adviser positions

Conclusion

The governance features of the Reserve Bank of New Zealand Act reflected views of public policy, of the role of the Reserve Bank, and of macroeconomics and monetary policy that have simply not been borne out by time and events.

The current model governance is not well-suited to the modern forecast-based uncertainty-ridden nature of monetary policy or, for example, for the now-extensive use of discretionary and quite intrusive and pervasive powers in matter of financial regulation and supervision. There is simply too much discretion involved in each of these areas (and others for which the Bank is responsible) for decisions to be left to a single unelected official. Reflecting that, it is not a model other countries use. Many countries have reformed their central banking and financial regulatory legislation in the last two decades, but not one has adopted our single decision-maker model. Similarly, I am not aware of any other domestic public sector institution in which so much power over policy matters has been given to a single official. The current Reserve Bank model is therefore out of step, and out of time.

I should stress that nothing in this note should be construed as any criticism of past or present Reserve Bank personnel. Reserve Bank staff, including the Governor, are required to operate the laws Parliament has passed. The issues are also not about the individuals who have held the relevant offices since 1989 – as Governor or Minister or Board members. Indeed, to his credit, the current Governor appears to have recognised some weaknesses in the existing model, although it has been less clear whether he would favour legislative change and, if so, of what sort[30].

Documents released under the Official Information Act[31] show that (in 2012, when the current Governor was being appointed) The Treasury also favoured reviewing the current model. Institutional changes are rarely treated as urgent, however important they might be. But in the case of the Reserve Bank Act, the issue of the governance model has now been left to drift for so long that change is now becoming more urgent. It is now past time for the Minister of Finance to commission Treasury to undertake a critical review of the Reserve Bank governance model, and then to bring legislation to Parliament that would put the Reserve Bank under a more conventional, and appropriate, governance structure, allowing the public to have greater confidence in the decisions, and processes used to reach those decisions, of one of the most powerful government agencies in New Zealand.

Appendix

Other anomalous features of the governance aspects of the Act

Many features of the existing Act are built to reflect the chosen governance model, and also now look quite anomalous (as distinct, perhaps, from being seen as "innovative" when fewer central banks were independent and inflation targeting was in its infancy).

The anomalous features include:

- The fact that the Minister of Finance cannot appoint his own preferred candidate as Governor. The Governor is appointed by the Minister of Finance, but the Minister faces an unusually severely constrained choice. The Minister can reject a Board nominee, but any subsequent appointee must first have been nominated by the Board.[32] Board members themselves may largely have been appointed by the

[30]See, for example, Mr Wheeler's 2013 speech about his decision to introduce an internal Governing Committee as the forum in which he would make major decisions. Given that he has said nothing more in public on the matter, it might be reasonable to deduce that if Mr Wheeler favours legislative change, he probably favours legislating something like the internal semi-expert Governing Committee. The speech is here: .http://www.rbnz.govt.nz/research_and_publications/speeches/2013/5173515.html.

[31] http://www.treasury.govt.nz/publications/informationreleases/monetarypolicy/framework/pdfs/oia-21030351.pdf

[32] Of course, the Minister (or Prime Minister) can make clear to the Board what sort of candidate might, or might not, be welcome. This is rumoured to have happened following the departure of Don Brash

previous government. There may be some other countries where this model is used (I haven't found any, but I have not checked all the legislation), but it is not remotely common. The chair of the Federal Reserve is nominated by the President and confirmed by the Senate. The Governor of the Bank of England is appointed by the Chancellor. The Governor of the Reserve Bank of Australia is appointed by the Treasurer, and the head of ECB is appointed by eurozone heads of governments. Given the wide range of potentially highly controversial policy decisions the Reserve Bank is responsible for, it seems democratically-deficient (and out of step with international practice) that the elected government cannot appoint, every five years, someone as Governor in whom they have trust.

The double-veto model is a curious feature of the legislation, because much of the Reserve Bank of New Zealand Act (like the State Sector Act itself) reflects the insights of the principal-agent literature (where the principal needs to keep a whip hand over the agent), but this is a feature which might more naturally appear in legislation more shaped by a traditional central bank independence literature (built on a deep distrust of politicians in monetary matters).

- Only the Governor is appointed by the Minister[33]. Of course, this is consistent with the fact that in our framework only the Governor has formal decision-making powers but it is out of step with almost all the advanced countries I have looked at. In Sweden, Deputy Governor appointments (these are members of the Monetary Policy Committee, but without executive responsibilities) are made by the Governing Council of the Riksbank, not the Minister of Finance, but the Governing Council is itself a committee of MPs representative of the membership of Parliament).

- It is also unusual that the PTA is formally linked to the appointment and term of a Governor. Of course, there is an intrinsic logic to this (since the logic of the model is personalised accountability). However, it has also tended to personalise policy, and exposes the institution to some quite significant risks, especially if a headstrong new Governor were to be appointed. There is nothing in law to prevent a new PTA being signed by a Governor-designate and a Minister of Finance, before the incumbent Governor, the Bank's senior professional staff, or indeed the Bank's Board, has had any sight of the document or involvement in putting it together.

  This is very different from the Bank of Canada model - where there is no such thing as a PTA in legislation, but where the five-yearly agreement on inflation targets is reviewed at a time independent of the Governor's (re)appointment. In the UK case, the inflation target (and any change thereto) is announced in the government's Budget and so is also not tied to the term of (or appointment of) a Governor. In Australia, the practice has developed of announcing inflation targets with the appointment of a Governor - but, again, that agreement has no formal legal standing, and most Governors have been appointed from within[34].

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[33] It has long puzzled me that the Minister can sack a Deputy Governor, but has no role in the appointment of a Deputy Governor.

[34] The Australian arrangement is somewhat anomalous all round: the agreement is between the Treasurer and the Governor, even though the Bank's Board is the decision-making body. Of course, the Governor, Deputy Governor, and Secretary to the Treasury are members of the Board.