Reflections[1] on

Grant Robertson's "Modernising Monetary Policy - The Need for Reform"

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10 April 2017

There are two strands to the speech:

- The proposal to add some sort of employment objective to the RB Act
- Specific proposals to reform the governance arrangements for monetary policy

I want to focus first, and with most of my time, on the governance issues.

Governance reform

When I picked up from the printer the outline of Grant's speech that he sent through on Friday, I uttered words never previously heard in our house: "Grant Robertson has just made my day". Coming just a few hours after learning that Steven Joyce had commissioned a review of Reserve Bank governance arrangements (albeit without commitment to reform), Labour's proposals for governance reform represents a major step forward. I welcome the broad direction of reform they are outlining. Really no one much is now left defending the extraordinary concentration of discretionary power - in monetary policy and financial regulation - that the Reserve Bank Act puts in the hands of one unelected official. In almost no advanced economy is there anything that comes close[2]. And there is also no other area of government in New Zealand where so much power is put in one person's hands, with few or no rights of appeal.

There is no one ideal alternative model. Other countries each organise decision-making for these functions in quite different ways. The Labour proposal has some very positive features:

- What I like most about the Labour proposal is that it involves a significant number of external appointees - part-timers, but involving "a substantial time commitment". Some reform proposals - whether that of Lars Svensson in his review for the previous Labour government 15 years ago, or that put forward to the Minister of Finance by Graeme Wheeler in 2014 - sought to do no more than legislate for an internal committee, or internal experts. And yet one of the constant challenges in monetary policy - which is riddled with uncertainty - is ensuring that alternative perspectives are injected into the process, and that group-think (including that perpetrated by a powerful Governor) is avoided. Good institutions are often more about limiting downsides - the bad episodes - rather than producing dramatically better results when all is going well.
- I also like the "substantial time commitment" point - what Labour is proposing doesn't seem to be just window-dressing (people who turn up for lunch to tick off whatever the Governor is proposing).

[1] These notes formed the basis for (much abbreviated) discussant comments on Robertson's presentation at Victoria University of Wellington, 10 April 2017

[2] In Canada, monetary policy power is vested formally in the Governor alone, but the Bank of Canada has a much narrower range of responsibilities (very limited involvement in regulation) than the Reserve Bank of New Zealand does.

- I'm also very pleased to see Labour talking of requiring the publication of the minutes, including any votes, of the Monetary Policy Committee within three of any decision. At present, by contrast, the Ombudsman has recently upheld the Governor's right to keep secret the balance of voting among his advisers, even a considerable time after the OCR decision to which they relate. Letting in the daylight is one part of enhancing accountability - these people exercise considerable power and their choices affect all our lives in one way or another.
- I'm also keen on their proposal to have a non-voting Treasury representative on the Monetary Policy Committee. It isn't done in many places, but it is done in some - and actually in Australia, the Secretary to the Treasury is a full voting member of the Reserve Bank's Board.

Having said all that, I hope that if they take office later in the year, Labour will treat what they are outlining today as one input in a fuller, and open, review of the relevant provisions of the Reserve Bank Act. The direction is right - and I suspect will command fairly widespread support - but some of the details could, I think, be improved on.

My most serious concern is that Labour proposes that all the other six voting members of the Monetary Policy Committee would be appointed by the Governor, and that the Governor would continue to be (in effect) appointed by the Reserve Bank Board. If the Governor appoints all the MPC members, it is going to be hard to get a consistently open and challenging process - particularly for any internal members, whose pay and prospects are directly set by the Governor.

There is yawning democratic deficit - one might even say "democratic chasm" there. These are really powerful positions, with the ability to substantially influence the short to medium term path of the New Zealand economy. Labour is proposing giving them even more discretion - the employment objective I'll come back to shortly - and yet not one of these seven people would be someone the Minister of Finance would choose. Sure, the Minister of Finance gets to appoint the Bank's Board, who in effect appoint the Governor, but they are all on five year terms. So if he becomes Minister of Finance in September, Grant will be working for several years with a Board appointed by his predecessors. I'm not aware of any precedent in any advanced economy for that sort of system. Even the ECB - most independent of all central banks, because by treaty rather than by legislation - the heads of the national central banks are typically appointed directly by the national Minister of Finance, and ECB Governing Board members are appointed by euro-area heads of government. In the UK, most of the MPC members are appointed directly by the Chancellor, and in Australia all the members of the RBA Board are appointed by the Treasurer. In the US, members of the Federal Reserve Board are all appointed by the President and confirmed by the Senate - and there is growing unease about the role of the regional Fed presidents who are not appointed by elected politicians.

It is fine to argue that monetary policy decisions should be made, day to day, independently of elected politicians, but any serious accountability to the public - on whose behalf policy is being made - surely should require that all (or at least most) of the voting members should be appointed directly by the Minister of Finance. If he becomes Minister of Finance, Grant should be able to do as his ministerial peers abroad typically can, and appoint someone he chooses and has confidence in as Governor. He shouldn't have to simply take a name wheeled up by faceless academics and company directors appointed to the Reserve Bank Board by the previous government. Personally, I'd like to see us adopt the UK system in which such appointees face confirmation hearings (although not binding confirmation votes) before taking up the role.

The importance of the issue is amplified by research evidence suggesting quite strongly that individuals matter to monetary policy outcomes. I've just been writing a review of *Bankers, Bureaucrats, and Central Bank Politics: The Myth of Neutrality* by American academic Chris Adolph. He put in a huge effort to compiling data on the careers of monetary policy decisionmakers for a range of advanced countries for the second half of the 20th century. Even allowing for all sorts of control variables, what he found was that the career backgrounds of monetary policy decisionmakers, and the roles they took up after leaving the central banks, made quite a difference to inflation (and short-term employment) outcomes. Decisionmakers with backgrounds in the financial sector tended to deliver low inflation and, all else equal, those with a bureaucratic government background tended to deliver higher inflation, even in central banks with the same degree of independence. One of the foundation myths of the existing RBNZ governance provisions is that individual chosen wouldn't matter very much (anyone from a broad class of moderately competent people) since the Minister would take the lead in setting the inflation target, and any Governor who didn't successfully pursue the target could be sacked by the Minister. That was never really true, and everyone now realises it. There is a lot of effective discretion within any feasible monetary policy target, and formal ex post accountability is hard (precisely because of the discretion and uncertainty) except at the point of potential reappointment. If individuals' backgrounds and preferences matter, surely it is only right that a Minister of Finance - elected to represent public preferences etc - should be the one making the MPC appointments?

I'd favour a system in which the Governor, Deputy Governor and any external appointees are all appointed by the Minister. If any other staff were to be formal voting members - eg the Chief Economist - they should probably be appointed by the Governor, but perhaps in consultation with the Minister. That would closely parallel the approach adopted in the United Kingdom over the last 20 years.

On the other specifics of Labour's proposal, I had only a few comments/questions at this stage:

- The proposal envisages the three external voting members being "independent experts". There is an argument for expert-only membership, but it shouldn't be taken for granted as the only sensible approach. After all, the Governor himself doesn't technically have to be a monetary policy expert - arguably, none of the three we've had were when they first took up the role. Perhaps more importantly, there is a good argument for the voice of the informed layperson, with sound judgement, at the decision-making table. Actually, it is typically how our numerous public sector boards work - including various formal decision-making ones. And it is how the Reserve Bank of Australia's Board has worked successfully over the years. I've argued for a model in which we leave it more open as to the qualifications of the external members. It might be desirable for at least one to be an expert - if only as a counterweight to staff - but probably shouldn't be necessary for them all to be, and in any case it might be hard to find enough unconflicted experts.
- The proposal clearly made a conscious choice to have four internals and only three externals, allowing internals to caucus and block vote to out-number the externals. Given the huge information asymmetries in favour of the Governor, it would be better to have a majority of externals. In practice, staff analysis will always (and typically should) play a big part in decision-making, but if we want the model to work, and don't want externals feeling disenfranchised from day one, it would be better to reverse the balance. I'd do it by having the Governor and Deputy Governor (deputy CE) on the committee, along with three externals. Other senior staff can play advisory roles in attendance, as they often do in other central banks.

- A detail to resolve is whether the external members have access to their staff or ability to commission independent research or analysis. There is a variety of approaches taken overseas, but if the model is going to work well - and these are really going to be substantial roles, not just a couple of hours a month - some provision for the externals to have analytical/research support would seem desirable.

There are numerous other details to consider. For example, would the PTA still be with the Governor, or with the committee as a whole, or should we shift to the UK system where the Minister of Finance simply sets the monetary policy target? Or what would happen to the dismissal provisions in the Act? I mention these not to quibble, but simply to highlight that there are a lot of details to get right in any legislative review of the governance arrangements.

But the most important omission seems to me to be the governance provisions for the Reserve Bank's extensive financial stability and regulatory functions, under various different pieces of legislation. There is no precedent anywhere for so much regulatory power to be in one person's hands. It wasn't even an outcome that was consciously deliberated on by Parliament - rather it grew up with a succession of amendments to the Act, and changes in regulatory philosophy over the years. And whereas a regulating Cabinet minister can be reshuffled or dumped whenever the Prime Minister chooses, a Governor of the Reserve Bank is secure for five years.

If individuals matter in monetary policy, even with something like the PTA, they are likely to matter hugely in the financial regulatory area, where there is nothing like the PTA to constrain or guide the Bank/Governor. The economic impact of regulatory choices can be as large - if less visible - than those around monetary policy. I really hope that Labour will be thinking hard about how to extend their governance reform ideas into the financial regulatory field. Personally I think there should be three strands to that:

- Removing some of the high level policy-setting power back to the Minister of Finance (so that the RB applies the rules etc and mostly doesn't make the high level rules),
- Move responsibility for the various pieces of legislation out of the Reserve Bank, probably to Treasury. This matter is already being touched in the Rennie review commissioned by the current Minister of Finance, and
- Establishing a Financial Policy Committee, paralleling the Monetary Policy Committee, as the entity empowered to exercise whatever policymaking powers reside with the Reserve Bank. Again, a five-person committee (Governor, Deputy Governor, and three externals seems like a feasible solution. The FPC would also be responsible for Financial Stability Reports.

Modifying the monetary policy objective

The second strand of Grant's speech was the proposal to broaden "the objective of the Bank (section 8 of the Act) from just price stability to also include a commitment to full employment".

Here I'm somewhat less convinced that there is a substantial economic problem that needs addressing with legislative reform.

Perhaps are three quite different classes of problems:

- First, there is an ill-defined but real unease about, and discontent with, New Zealand's economic performance over recent decades and a fear that perhaps something about the Reserve Bank Act is wrong. After all, we've typically had the highest interest rates among advanced economies, and we've had a stubbornly high exchange rate, and our tradables sectors has struggled. We know that the Reserve Bank sets short-term interest rates, and the exchange rate sounds like a monetary thing. It is striking that in the 28 years since the Reserve Bank Act was passed, there has never once been an election in which some party or other (and I don't just mean the remnants of Social Credit) was campaigning to change the Act or the PTA. Other inflation targeting countries have seen nothing like it. There seems to be a need felt to signal to constituencies an awareness of that discontent, even if not a conviction among those writing the policies that an alternative approach might make very much substantial difference. That was pretty much how I characterised Labour 2014's monetary policy. It was cleverly crafted to look quite different, but once one dug down into it, it didn't necessarily imply any material change at all.

- Second, clearly Labour is going into this election with a big focus on employment, including under the banner The Future of Work. That is understandable for various reasons - including because the unemployment rate has now lingered so high for so long since the recession - but when it is tied to monetary policy statutory objectives it does have feel of what I have, perhaps unkindly, previously described as "virtue-signalling. It would express something about felt pain, but isn't really clear that it would, or would really be expected to, make very much substantive difference at all. In fact, that sort of desire of product differentiation seems to have been the background to most of the many PTA changes put in place since 1990. Signalling, and reassuring your base, is no doubt a big part of politics - they help reassure people about where a party's priorities lie. But that is different from making much operational difference, especially in an area where we know that in the medium term monetary policy can really only affect inflation, and can't make much sustained difference to employment outcomes at all.
- Third, there is the track record of the last half dozen or more years. Inflation - core or headline - has been very low, and the unemployment has been (and still is) well above any reasonable estimate of the NAIRU. I'm from the "dryish right" of the spectrum, but I'm appalled that there is so little moral outrage at how high our unemployment rate is. 5.2 per cent might sound low if you say it quickly, but that is more than one in 20 people out of work (and yet ready and eager to start a job). Apply it over a 45 year working life, and it is equivalent to every one of us spending around two years unemployed. That's just an average - for most people here, probably we've spent no time unemployed, so think of the people who make up the other side of that average. Treasury estimates that the NAIRU is currently near 4 per cent. The gap between the NAIRU and the actual unemployment rate is what macro policy (especially monetary policy) can do something about. Even that gap means at least 25000 people now unemployed who really shouldn't be (even given all the details of welfare systems, demographics, labour market regulation etc). Lives blighted, to some extent permanently, because of macro policy mistakes. Monetary policy decisionmakers need to be held to account for that failure - including for example in the scrutiny opposition parties are supposed to pose at FEC.

But here's the thing. For several years prior to the 2008/09 recession - under exactly the same legislation - New Zealand not only had one of the lowest unemployment rates in the OECD, but our unemployment was well below all serious estimates of the NAIRU. That wasn't a good thing either - it helped sow the seeds for a nasty recession - but it does suggest that the formulation of the statutory objective for monetary policy isn't where the problem lies.

In his address, Grant notes that the US and Australia, for example, have references to full employment in their central bank legislation. There are quite a few other examples - a colleague and I documented them in a useful background *Bulletin* article a few years ago. But I'd note three points in response

- First, most of those references are in older legislation. Most of more recent reforms of central bank legislation have quite simple formulations focused on price stability, although some add a general obligation to support the overall direction of government economic policy, to the extent that doesn't compromise price stability. The Australian legislation dates to 1959. The US legislation dates to the 1970s, but it does not make full employment an independent objective - in effect it says "achieve price stability and in so doing monetary policy will make its best contribution to medium-term desirable outcomes, including sustainable full employment",
- Second, the Reserve Bank's own past research suggests that other Anglo central banks respond to incoming data in much the same way the RBNZ does. That research is now a little dated (the period at the zero lower bound in some other countries complicates analysis - we and the RBA had discretion to move, when the Fed and BOE didn't).
- Even on the unemployment side, our unemployment rate has typically averaged below that of Australia (and our employment is typically higher than theirs. In fact, I had a quick look at the other Anglo countries – and this century our unemployment has averaged lower than those of Australia, Canada, the US and the UK.

That suggests that if there is a substantive problem it probably isn't about section 8 of the Act itself, but about the decision-making choices of the Reserve Bank over the last five years or so. Not only is our unemployment rate well above our NAIRU - which just shouldn't be happening for sustained periods - but it is also above that in the US and the UK (two economies much more adversely affected by the 2008/09 crisis/recession. The substantive issues become much more specific - about people and culture - ie rather closer to the things the governance reforms discussed early should be designed to respond to.

Asked to explain on Q&A yesterday what difference his reformulation of the statutory goal might make, Grant Robertson cited that ill-judged and ill-fated 2014 tightening cycle. He argued that if the Reserve Bank had also been responsible for pursuing full employment, they might have cut the OCR rather than raise it. I doubt that is right (much though I wish it were otherwise). In fact, at the start of the 2014 tightening cycle, the Bank's published forecasts were projecting a sharp fall in the unemployment rate over the following couple of years - the period monetary policy can affect. So had the Governor been explicitly charged with promoting full employment, he'd probably simply have phrased his MPS a bit differently: we foresee inflation pressures building up and yet even with the OCR increases we are planning we expect to see the unemployment rate falling quite sharply towards the NAIRU". On the surface, it would have been a perfectly plausible argument to many.

So the problem typically hasn't been that the Reserve Bank doesn't care about unemployment - although they don't mention it often, and there is little sense in their rhetoric of visceral horror at waste of lives and resources when unemployment is higher than it needs to be. The problem was a mindset or model one. The Bank just had the wrong mental model of what was going on, and even as they slowly realised it wasn't serving them well, they were very slow to adjust very much. Even today, with the unemployment rate still well above the NAIRU we hear constantly about how stimulatory or accommodative monetary policy is. Their "models" - and I don't just mean mathematical representations – tell them so, but actually the best evidence of policy being highly stimulatory would be a subsequent economy that looked like it was overheating. After years of inflation below the target midpoint and of unemployment rates that are high by NZ standards, there is little or no sign of that. (Of course, many of the market economists have shared their mistake.)

So it was a mistake, and in a system of personalised responsibility - not my preference – the Governor personally (and those who are paid to hold him to account) need to take responsibility for that. Unemployment outcomes in recent years haven't been acceptable, and much of the responsibility for that rests with the Reserve Bank. Their analysis and decisions have, with hindsight, been flawed. Certainly, there are some powerful global forces at work - but they are the same forces affecting say the US and the UK, and they've had less discretionary room to use monetary policy in recent years than NZ (or Australia) have.

As I noted earlier, individuals matter. Yes, PTAs and statutory goals matter to some extent, but what will really make a difference if and when Grant Robertson becomes Minister of Finance will be putting in place quickly reforms that enable him to choose a good Governor, a good decision-making committee - and a "good Governor" here is one who will revitalise and overhaul the culture of the Reserve Bank, to help minimise the risk of a repeat of the mistakes of the last few years. A more resilient institution is more important than tweaking section 8.

All that said, I know that signalling is important, and Labour is both committed to adding some reference to employment/full employment, and yet is not currently being specific on how that could be framed. So in a constructive spirit I have a concrete suggestion for the Labour Party.

How about amending section 8 of the Act to read that the objective of monetary policy should be

To promote and safeguard price stability and the highest degree of employment [or lowest degree of unemployment] that can be achieved by monetary policy

We've been this way before. It is a very similar wording to that put into the Reserve Bank Act in 1950. It recognised that a whole bunch of other things mattered (to voters and to politicians) - in this case "production, trade, and employment" - but equally recognised the dangers of trying to pursue those other goals independently. A good monetary policy, that delivers something like medium-term price stability, will typically be one that also makes the best contribution to those other important real outcomes, including employment/unemployment. But if, say, other labour market regulatory changes drive up structural unemployment, that isn't something monetary policy can do anything useful about. It is a formulation that is very similar in substance to what is in the Federal Reserve Act, it is a formulation that reflects the substance of what the Reserve Bank of Australia thinks it is doing. It isn't far from how Don Brash might have expressed what he was trying to do. It recognises that we don't mainly pursue price stability as end but to help produce better outcomes, more broadly, for New Zealanders.

I rather like that 1950 formulation, and not just because a relative of mine was the Minister of Finance who put it in. But if Sid Holland isn't to Labour's taste, how about something like this

1. Price stability

a) Under Section 8 of the Act the Reserve Bank is required to conduct monetary policy with the goal of maintaining a stable general level of prices

b) The objective of the Government's economic policy is to promote sustainable and balanced economic development in order to create full employment, higher real incomes and a more equitable distribution of incomes. Price stability plays an important part in supporting the achievement of wider economic and social objectives.

That is an extract from the 2002 PTA signed between Michael Cullen and Alan Bollard. It would be easy enough to recraft it as legislation, stating that the primary objective of monetary policy is price stability, followed by a statement that "price stability plays an important part in supporting the achievement of wider economic and social achievements, and in shaping monetary policy the Reserve Bank should have regard to the government's wider economic goals including sustainable full employment".

And just two final comments:

- There are risks that, in extreme circumstances, adding a full employment objective could lead the Reserve Bank to respond badly in ways that delivered, over the medium-term, both higher inflation and no lower unemployment. That would be highly undesirable, and I'm sure is not what Labour has in mind. But that is why the wording of any change is quite important, and why something like the 1950 formulation, or the Fed formulation, remains appealing.
- As I've noted elsewhere, one way to help focus Reserve Bank attention on employment/unemployment issues would be to amend section 15 of the Act (covering Monetary Policy Statements) to require the Bank to publish at least every six months its estimate of the NAIRU and to explain what contribution monetary policy is making to any persistent deviations of actual unemployment from the NAIRU. Officials focus on what they have to report on, especially if Opposition members ask appropriate questions in the media and at select committees. I commend this option to the Labour Party for consideration.