Submission to the Finance and Expenditure Committee

on

Reserve Bank of New Zealand (Monetary Policy) Amendment Bill

by Michael Reddell

Thank you for the opportunity to submit on the Reserve Bank of New Zealand (Monetary Policy) Amendment Bill.

I worked at the Reserve Bank for many years (1983-2015) including a couple of decades on the Governor's OCR Advisory Group and three years as Head of Financial Markets. I was heavily involved in the preparation of Lars Svensson's report (to the then government) reviewing monetary policy, including institutional arrangements in 2001, and in the Reserve Bank's own advice to the FEC inquiry into such issues in 2007/08. I also spent time as Alternate Executive Director of the International Monetary Fund, working for The Treasury, and as resident adviser to two developing country central banks. These days I provide analysis and commentary on various issues, including Reserve Bank policy and governance, on my Croaking Cassandra blog. Many of the issues covered in this submission are dealt with in greater detail in posts at this link https://croakingcassandra.com/category/reserve-bank-act-reforms/.

I **support** the broad tenor of the bill in its two main objectives:

- amending the statutory objective of monetary policy to include reference to economic stabilisation considerations, and
- the creation of statutory Monetary Policy Committee, to bring New Zealand back into the international mainstream such that, by law, monetary policy decisions are made by a committee.

However, many of the details of the bill would benefit from amendment.

The mandate for monetary policy

The wording of the proposed new mandate (section 8(1)) should be revised to (a) focus on minimising unemployment (a natural excess capacity measure) and (b) to clarify how the current two limbs of the objective work together. The goal should be the lowest rate of unemployment consistent with maintaining price stability over the medium term.

This isn't a case of pursuing two objectives with one instrument, but of pursuing one objective subject to a binding constraint.

The case for having active discretionary monetary policy is – and always has been – about cyclical stabilisation. We don't need an active Reserve Bank to deliver broadly stable price levels over the longer-term. And nothing monetary policy can do makes any difference to unemployment in the longer-run. But there is a strong case for active monetary policy to limit the short-term downsides from severe adverse shocks - the Great Depression was the most stark modern example (and, indeed, it was the backdrop to the establishment of the Reserve Bank of New Zealand) but the argument holds in almost serious downturn. Monetary policy should do what it can to stabilise the economy, subject to a longer-term nominal constraint (eg price stability). And Parliament should be upfront with citizens about this (which is the way central banks typically try to operate in practice).

The formulation in the bill at present has a number of problems:

- the whole point of what discretionary monetary policy can do (not just here but around the world) is to avoid (or keep to a minimum, consistent with price stability) periods of significant excess capacity. Despite the attempt to argue otherwise in the Explanatory Note, "maximum sustainable employment" is not a measure of excess capacity. Unemployment is much closer to an excess capacity measure. It also has a considerably greater degree of historical and public resonance.
- the proposed wording treats employment as good in itself, whereas labour is an input (a cost, including to those who supply it). A high-performing high productivity economy might well be one in which people preferred to work less not more. By contrast, lower unemployment (people who want a job, are searching for it, are ready to start, but can't find a job) is unambiguously desirable, to the extent possible.
- the wording makes no attempt to integrate the two dimensions of the goal, and
- it continues to suggest that active monetary policy is primarily about medium-term price stability. But we do not need monetary policy for that goal (a Gold Standard or something similar would do fine). Instead, medium-term price stability is more like a constraint (a vitally important one) on the use of monetary policy to keep the economy operating close to capacity.

Accordingly, I argue that goal should be worded as something like:

"Monetary policy should aim to keep the rate of unemployment as low as possible, consistent with maintaining stability in the general level of prices over the medium-term."

It isn't anywhere near as radical as it might seem to some. The working definition of "stability in the general level of prices over the medium-term" (1 to 3 per cent inflation, with a midpoint focus on 2 per cent) could be kept exactly as it now. But it is clearer, and better aligns with what we should look for from the Bank and from the new MPC. Keeping unemployment as low as possible really matters for individuals and their wellbeing. But this formulation also keeps clear that the Bank cannot go pursuing its own views on what the unemployment rate can or should be if medium-term price stability is jeopardised.

The Monetary Policy Committee

Establishing a statutory Monetary Policy Committee is a sensible, well overdue, reform. The New Zealand model, innovative in its day, was not followed anywhere else, and the existing model is also out of step with how we run almost every other public agency (and most private ones).

Nonetheless, the Monetary Policy Committee provisions of the bill as drafted are likely to achieve relatively little. They retain a far too dominant position for the Governor - out of step with the typical chief executive role in other Crown entities - including enabling the Governor to be very influential in the selection process for all other MPC members.

This legislation is an opportunity for more far-reaching reform, enhancing transparency and accountability and better aligning the governance of monetary policy with practice in open democracies abroad. Doing so would strengthen confidence in the institution, and would also increase the chances of attracting consistently good potential appointees.

I propose a number of amendments.

1. In the bill (proposed new section 63C(3) the internal members of the MPC must be a **majority**. It would be very unusual for a statutory decision-making body for a government agency to be comprised largely of executive staff. It confuses roles and risks undermining the value in creating a committee. It is also an unusual - although not unknown - in central banks abroad (in some cases, outsiders fill executive roles during the term of their appointment). A better model for New Zealand would be to have the Governor and Deputy Governor and three externals as members of the MPC. The Committee would, of course, be expected to draw on staff expertise, but as advisers (in the same way that, for example, experts in Treasury advise the Minister of Finance).

2. In the bill, all **appointments** (internal and external) to the MPC would be made by the Minister on the recommendation of the Board. This is a very unusual model in New Zealand public life[1], where the standard procedure - for many important and very sensitive roles – is for direct ministerial appointment (Governor-General on advice of the Minister). That model should also be adopted for the MPC, including for the positions of Governor and Deputy Governor. Again, such an approach is typical in other countries. It is consistent with the fact that members of MPCs collectively wield a great deal of power, and although voters have no way of holding them to account directly, they should be able to hold to account directly those who appoint the MPC.

   To the extent that there was concern about partisan politicisation of such appointments, one option that could be considered would be statutory provision for public "confirmation" hearings conducted by FEC prior to MPC members taking office. This model has been adopted in the United Kingdom, and although the relevant committee cannot veto an appointment, a negative report can result in a re-think.

[1] As illustrated in detail here https://croakingcassandra.com/2018/03/28/how-key-appointments-are-made/

The provisions of the bill, as currently worded, are likely to result in continued effective dominance of the Governor, when a key element of the case for a committee is to make the system more open to a range of perspectives, challenging the perspectives of staff and management, and limiting the power of a single individual (however able). The bill provides for a majority of internal MPC members, in all of whose appointments the Governor will clearly have the dominant say (in respect of executive management roles that is right and proper, but not in statutory policymaking roles). There are risks that the internal majority will caucus (formally or informally), or that a strong-minded Governor will pressure internal MPC members not to disagree with him (the Governor holds various cards, including future remuneration increases and resources inside the organisation). To the extent such risks play out, the perspectives of the (minority) external members could easily be rendered largely irrelevant, in turn discouraging those people from making much effort, and discouraging good people from being willing to consider the roles.

In respect of the appointment of externals, the Governor himself is a Board member and the only Board member with any specialist expertise in monetary policy. The Board - which has long had a track record of protecting the Governor rather than challenging him - is highly likely to defer to the Governor's preferences, which risks resulting in a committee made up of people who the Governor will not find challenging. Really good Governors welcome challenge and encourage debate, but institutions and laws need to be designed recognising the probability of less than stellar (ie human) Governors.

3. As presently worded, the **role of the MPC** looks to be quite narrow ("formulating monetary policy" - a term not substantively defined, and possibly not even including OCR decisions). The MPC should be given explicit statutory responsibility for all aspects of monetary policy (including advice on the remit and, for example, foreign exchange intervention, liquidity provision, issuance of notes and coins), even if some operational aspects are then delegated by the MPC to the Governor. This issue may appear arcane, but will assume considerable salience if the effective lower bound on the OCR is reached in some future recession[2].

4. The **proposed 5-yearly review** of monetary policy (new section 15D) is a step forward, but the emphasis in the bill is wrong. The provisions require the Bank (in effect the Governor) to review monetary policy, even though it is the Governor's own conduct and policy leadership that will be being reviewed. We should expect the Bank to self-critically review its own performance and advice, but getting their own (inevitably somewhat self-interested) perspectives should not be the focus of the legislative provisions. External input will be critical if such reviews are to be useful and provision should be made for an external reviewer, perhaps appointed by the full MPC after consultation with the Minister and FEC itself.

[2] This point is discussed in more detail here https://croakingcassandra.com/2018/08/01/what-is-formulating-monetary-policy/

5. The **transparency provisions** around the MPC should be considerably strengthened, to require the publication of substantive minutes (including at least the numerical balance of any votes) and, with a suitable lag, the pro-active release of the staff papers submitted to the MPC. At present, aided and abetted by the Ombudsman (over decades), the Bank consistently refuses to publish any background papers until many years have passed (a striking contrast to the pro-active release of papers relating to each year's Budget). Making these amendments would largely remove the need for the proposed Charter (which implies direct ongoing ministerial involvement in how the MPC is run, and could in future be used to degrade transparency provisions), and allow the MPC to evolve its own processes and culture over time. If the Minister has concerns that the MPC is insufficiently transparent, s/he can makes their views known to the Governor, to the Committee, and to the Board (whose chair will, under this legislation, in future be directly appointed by the Minister).

Other institutional provisions

The two-stage review of the Reserve Bank Act is inevitably a bit unwieldy. There are numerous issues around the governance of the institution as a whole that need addressing (including the lack of statutory provisions guaranteeing spending controls and transparency around planned spending). These are probably better addressed in the Stage 2 process, including when decisions are made as to whether (as I favour) the Reserve Bank should be split into two agencies (one monetary policy and related, one financial regulatory). However, in respect of issues dealt with in this bill, I have the following suggestions:

1. The bill removes the **age restriction (age 70)** on the Governor. I am uneasy about totally removing the age restriction while the Governor personally still wields so much power (not constrained by a committee or a board) in the other policy areas the Reserve Bank is responsible for (even though his personal power is being diluted, at least formally, as regards monetary policy). Judges, for example, are required to retire at 70, and are eligible after that for only short-term acting appointments. A Governor wields, in effect, more power than a typical individual judge, without the possibility of appeal against his/her decisions. It would be very difficult - both as a matter of personal sensitivity and from the perspectives of market and public confidence - to remove a Governor whose powers were in decline, and rather than remove the age limit completely I would suggest, as an interim step pending the completion of Stage 2, that perhaps an upper age limit of 75 could be considered for now. That would, for example, reflect the improvements in life expectancy, and changes in workforce participation among older people, since the existing provisions were enacted in 1989.

2. Amendments to resolve the unsatisfactory provisions around the appointment of an **acting Governor** (new sections 48A and 48B) are welcome. We should never again find ourselves in a situation that called out for the appointment of an acting Governor, but where gaps in the legislation (unforeseen circumstances) led to an appointment that was probably unlawful. However, the specific proposals should be reconsidered. The current statutory provision requiring all initial appointments as Governor be for a minimum of five years should be retained - it is an important element in establishing the effective operational autonomy of the Bank, including around many of its regulatory functions. Instead, specific provision should be made for a single appointment of an acting Governor (for a term of no more than six months) if, for example, the timing of the general election interferes with making a permanent appointment. And, consistent with standard practice (but contrary to a specific provision in the bill), the outgoing Governor should be able to be retained in an acting capacity in such circumstances, if that person is able/agreeable.

3. The bill retains the **Reserve Bank Board** as the entity principally responsibility for holding the Governor to account, adding responsibility for holding the MPC to account. Successive boards have done this job quite poorly (more because of incentives and institutional design than because of individuals), and have tended to act as if their role is to defend and champion the Governor. It will be difficult to change that dynamic, and yet more important to do so with the addition of a statutory MPC and the potential tensions between the Governor and other members. The bill usefully provides for a more normal system in which the Minister directly appoints the Board chair. However, other helpful changes that could be considered include
    a. providing the Board with specific (limited) financial resources of its own (at present it relies on totally on the Governor),
    b. removing the Governor as a member of the Board,
    c. renaming the Board the Monitoring and Accountability Committee (MAC), to be clear that the entity is a quite different sort of beast than a corporate board or a typically Crown entity board (the mindset most Board members bring to the role)
    d. making clear in legislation that the MAC is not itself part of the Bank, and is primarily responsible to the Minister and the public, and
    e. requiring the timely publication of the minutes of Board meetings and the pro-active release of (most) papers presented to the Board.

Conclusion

The Monetary Policy Committee provisions of this bill are unambitious and disappointing, especially when set against the expressed aspiration of a once in a generation update to the legislation to reflect the way in which the world (including central banking) has changed since 1989. Among the features of our age are a much degree of openness, a greater recognition of uncertainty and of the benefit of an open contest of ideas, and less willingness to build institutions based on a deference. This bill reflects almost none of that.

In considering the bill, I would urge the Committee to look closely at the experiences of open central banks in the United Kingdom, the United States, and Sweden (in particular). All are more open than anything envisaged in this legislation, and in the way the Minister has described his intentions for how the proposed New Zealand system should work. Each of those central banks has had strong individuals willing and able to challenge consensus views, and to debate monetary policy issues thoughtfully and openly. They do so in part by avoiding designing a system where the Governor (chief executive) has a too-dominant formal role. The current bill does not really address that glaring weakness in the New Zealand system.

Officials, especially those at the top of the Reserve Bank, appear to find a more open model threatening, and have made various arguments against moving towards such a model here. But the interests of officials - including the protection of their own position - are rarely that well aligned with the interests of New Zealanders. New Zealand has the opportunity to learn from the successful models abroad, in three very different countries, adapting the insights to the specifics of New Zealand (system of government, size etc). By doing so, Parliament would, over time, greatly strengthen the institution itself, and New Zealand processes around the design and conduct of monetary policy. We would all be better for such change.

7 September 2018