

Economic Note

RBNZ Assistant Governor McDermott speech

12 April 2018

Viva la Evolution

- The RBNZ speech gave an historical context for past and new frameworks set for monetary policy.
- Policy targets and decision structures have evolved as low inflation has been bedded in over time.
- The take-out is the RBNZ sees the latest changes as reinforcing the flexibility of inflation targeting.

Implications

The key point is the RBNZ doesn't see the new Policy Targets Agreement (PTA) as materially changing the conduct of monetary policy. Assistant Governor John McDermott noted that inflation targeting has got increasingly flexible over time, and the change to including an employment objective is seen (at this stage) as reinforcing the flexibility that has built up over time. So at least until RBNZ Act changes are made, it is unlikely that monetary policy decisions will be made in a materially different fashion. **The upcoming May Monetary Policy Statement (the first under the new PTA and new Governor) will still be the first acid test.**

The change to a committee structure is viewed benignly. But the speech noted that a better decision-making success is not automatic, and getting committee processes right will be critical to good-quality decisions.

Impact of the added policy objective

The RBNZ's take on the impact of the added policy objective can be summed up with the following quote: **"to a large extent, the changes are a way of ensuring that the flexibility in our [monetary policy] approach endures"**. As the RBNZ sees it, the latitude allowed by recent PTAs (such as avoiding unnecessary volatility in output) has enabled more regard for the real economy – including the labour market. And understanding labour market developments has always played a part in determining the state of the economy and inflation pressures.

The RBNZ views the lack of a numerical target as good. In the RBNZ's words: " 'maximum sustainable employment' cannot be fully captured by a single indicator". The drivers of some labour market variables matters for whether changes are 'good' or not. The RBNZ noted that a fall in the unemployment rate can be because of a strong economy or because poor employment prospects are encouraging people to drop out of the labour force altogether. We'd also give a further example of the challenges of using any one variable. The US unemployment is 4.1%, lower than NZ's 4.5%. Outwardly that suggests the US has had more success in 'maximising employment'. But US labour force participation has dropped since the Global Financial Crisis and is currently 62.9% of the working age population. In contrast, NZ's labour force participation rate is 71%, around a record level. Arguably, NZ has been far more successful in maximising the number of people employed, but one single variable doesn't give a full context. **And on top of the 'what variable(s) problem is also the 'what level' problem.** A numerical target for inflation targeting has much clearer underpinnings for choosing an optimal numerical target.

The RBNZ will assess a number of labour indicators (as it has always done), but **will now provide more detail on the state of the labour market**. There is also likely to be more research that focuses on the labour market, which we see as a positive development for aiding future monetary (and government) policy.

Committee: yes, but please leave your biases at the door

Times have moved on, and the high need for accountability in the first days of inflation targeting has lessened – the single decision-maker model is less relevant and now out of step with practices elsewhere. **The speech indicates the RBNZ is comfortable with the proposed formal committee structure, but notes that a committee in itself doesn't guarantee better decisions.** It will be important to get the right processes in place to minimise the influence of various biases, such as: pressure to conform; confirmation bias; and the potential to put too great a weight on recent events.

Giving context

The first half of the speech provided historical context to the 1989 Reserve Bank Act, original Policy Targets Agreement and justification for the single-decision maker model. The speech notes that in “In the 1970s and 1980s, New Zealand had a very poor track record of price stability”. In the mid-1980s politicians finally made price stability a priority and sought measures to control inflation that reduced the political influence which had undermined previous attempts to control inflation. From there, the Reserve Bank Act of 1989 was born.

The initial set up was to ensure credibility – with a strict and sole inflation target of 1-2%. **Accountability was also seen as a key aspect of achieving success, hence the decision for a single decision maker.** McDermott notes this move was “highly influenced by the principles underpinning the reform of the wider public sector at the time, which gave individual public sector managers the authority to manage but made them directly accountable for outputs”.

The RBNZ Act and the PTA were seen as very successful in bringing inflation under control. As the RBNZ achieved credibility and anchored inflation expectations, it was able to gradually become more flexible in its framework over time. McDermott commented that “changes to the PTA have tended to reflect actual Bank practice at the time, but have also often been initiated by the government of the day.” These changes included various small adjustments to the inflation target itself, loosening the time frame in which the inflation target is required to be met and explicit allowance for the RBNZ to look through shocks. The PTA has also included other secondary considerations, including minimising volatility in output, interest rates and the exchange rate. These various changes have seen the RBNZ framework evolve to become the sophisticated flexible inflation targeting framework used today.

McDermott sees the upcoming changes to the RBNZ Act as another step in the RBNZ's inflation-targeting evolution, formalising its flexible approach to inflation targeting. The move to a committee decision-making body also fits in line with international best practice - a recommendation made back in 2000 but rejected at the time.

Internal members

Governor and Deputy Chief Executive
ex-officio members, Governor as Chair,
casting vote if required

5-year terms (staggered)
Max 2 terms in one role
Full-time



External members

Non-Bank staff with relevant
knowledge and experience
4-year terms (staggered)
Max 2 terms
Part-time

ASB Economics & Research

Chief Economist
Senior Economist
Senior Economist
Senior Rural Economist
Senior Economist, Wealth
Economist
Data & Publication Manager

Nick Tuffley
Mark Smith
Jane Turner
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