

Economic Note

The mechanics of changing the Reserve Bank's goals

31 October 2017

Gaining employment: RBNZ target change

Overview

The Labour-NZ First coalition agreement calls for "review and reform of the Reserve Bank Act". **The Labour Party's long-standing policy is for monetary policy's sole price stability objective to be augmented by an employment objective.** In addition, the Labour Party has expressed a **desire to shift the decision-making model** away from the sole decision-maker (and sole holder of accountability) **to a committee structure**, and one that likely involves non-RBNZ staff.

The impacts on policy decision-making of an added employment goal will depend on how it is effected. A soft word-based goal (e.g. "foster full employment") is unlikely to impact Official Cash Rate (OCR) movements that much. However, an explicit numerical unemployment rate target is likely to bring the inflation and employment objectives into direct conflict more often, eroding policy flexibility and leading to less optimal economic outcomes.

An internal decision-making committee would, in practice, be very similar to the informal arrangement instigated during Governor Wheeler's term. **A committee with external members** will bring a broader range of perspectives, and may also create some moments of dissention that defer OCR shifts that are finely in the balance. If meeting minutes were published that would cast a spotlight on any areas of contention. It would also mean internal staff are less in control of the public messaging which might contribute to unnecessary market volatility.

In this note we also provide some insights on which parts of the Reserve Bank Act (1989) would likely change to enable the Labour-led Government's policy, and likely practical outcomes. A fresh and thorough monetary policy review (as in 2001) would take time and it is unlikely that subsequent legislative changes would be in place prior to signing a new Policy Targets Agreement (PTA) with the next Governor. But that PTA would be able to accommodate a shift in focus.

Finally, we note that – even if monetary policy is run optimally – its influence on the economy is mainly cyclical, by smoothing out the economy's peaks and troughs. To quote a finding from the last full [NZ monetary policy review](#): "It is beyond the capacity of any central bank to increase the average level or the growth rate of real variables such as GDP and employment." **The heavy lifting for full employment and stronger productivity growth, and the prosperity they bring, lies elsewhere in the Government's policy basket.**

Overall policy implications

Overall we see inclusion of a soft word-based employment objective (e.g. achieve "full employment" and a committee-based decision structure as having only modest impacts on how monetary policy will be conducted. It is important that the targets provide an appropriate degree of flexibility. A hard numerical employment target is less

likely to achieve that.

We see only modest impacts from inclusion of a word-based employment target into the RBNZ's mandate. In practice we would expect that on occasion the added goal might shift the timing of interest rate moves by 3-6 months, but that the overall monetary policy cycle wouldn't change much. The RBNZ would still have a lot of flexibility and discretion. **Policy impacts would likely be more significant, however, if an explicit numerical employment-related target (such as aiming for a specific unemployment rate) was in place.** Conflicts between the two goals are likely to be more binding, and there would be the added risk of lurching from one goal to the other that could bring about more abrupt moves than a more flexible set-up.

The flexibility of monetary policy has evolved considerably from its early days of strict and narrow inflation targeting. It is important to note that the PTA already allows for a considerable degree of flexibility, including "seek[ing] to avoid unnecessary instability in output". Through this sub-clause the RBNZ is already implicitly taking into account volatility in employment over the cycle. The RBNZ has recently made good use of the excessive volatility clause in its monetary policy deliberations.

We don't see a formal decision-making committee structure as materially changing outcomes, other than at the margin. Those members will still be charged with meeting the goals in the PTA. It will be important for the quality of debate and decisions that any external members are suitably qualified for the responsibility, both technically and in the perspective they bring.

Does an employment target mean improved employment/unemployment outcomes? Not necessarily. Australia and the US have employment objectives. Australia's unemployment rate has averaged 5.7% over the last 20 years, while NZ's has averaged 5.4%. The US unemployment rate has averaged 5.95% over the past 20 years. And, since the Global Financial Crisis, the labour participation rate in the US has fallen while NZ's has risen to a record high – a further sign NZ has been more successful in pulling people into employment. The Eurozone, in contrast, with its sole inflation focus, has much higher unemployment than NZ with its history of a single target. Clearly, maximising employment opportunities is a complex issue, with many micro- and macro-economic policies making a difference. The new Government's regional economic development focus and the "Future of Work" focus on retraining workers are but some examples of ways to enhance employment.

Incorporating an Employment Target

There are two options for incorporating an employment target. One is amending the Reserve Bank Act to include employment as a goal and reflecting that in the PTA. The other is merely modifying the PTA.

At the moment the purpose of the RBNZ in the Act is defined as price stability, with no explicit reference to employment. Grant Robertson, the new Finance Minister, has a clear [preference](#) for including employment in the Act itself. Inclusion is not strictly necessary to get the RBNZ focussing on employment as well as price stability, though inclusion would remove any implicit priority given to price stability by the current Act or could be used to give clear guidance on the relative priorities. The current PTA refers explicitly to Section 8 of the Act (below) and its stated (and sole) goal of price stability.

1A) Purpose

(1) The purpose of this Act is to provide for the Reserve Bank of New Zealand, as the central bank, to be responsible for

- (a) formulating and implementing monetary policy designed to promote stability in the general level of prices, while recognising the Crown's right to determine economic policy; and....

8) Primary function of Bank

The primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices.

Modifying the Act to add focus on employment could be done by adding in (1) and (8) after "the general level of prices" wording such as "and foster/promote/sustain/maintain full employment".

NZ Policy Targets Agreement [\(link\)](#)

Regardless of whether any changes are made to the Act itself, the PTA needs to be modified – it is the RBNZ’s defined performance objective. The options range from a written acknowledgement of the goal through to setting a numerical target in a similar fashion to the way the inflation target is set.

There is plenty of scope to work a requirement into various parts of the PTA to set policy so as to foster/maintain full employment or include a numerical target, such as:

- Section 1(a): including employment as a goal for the RBNZ (if changing the Act as well);
- Section 1(b): adding employment into the Government’s economic objective;
- Section 2(a): adding employment as an objective, and what to monitor in relation to the objective;
- Section 2(b): adding an explicit numerical employment or unemployment target in this section (if desired) or creating an additional clause, along with adding a clause similar to 4(a);
- Section 4(b): adding employment as an objective.

These changes can readily be agreed to and incorporated into the PTA for the incoming Governor ahead of his/her March 2018 start. They can also be made ahead of any legislative changes to the Act, which presumably wouldn’t be made until after the proposed monetary policy review is completed.

The current PTA:

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 Government's economic objective is to promote a growing, open and competitive economy as the best means of delivering permanently higher incomes and living standards for New Zealanders. Price stability plays an important part in supporting this objective.

2. Policy target

- a) In pursuing the objective of a stable general level of prices, the Bank shall monitor prices, including asset prices, as measured by a range of price indices. The price stability target will be defined in terms of the All Groups Consumers Price Index (CPI), as published by Statistics New Zealand.
- b) For the purpose of this agreement, the policy target shall be to keep future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term, with a focus on keeping future average inflation near the 2 per cent target midpoint.

3. Inflation variations around target

- a) For a variety of reasons, the actual annual rate of CPI inflation will vary around the medium-term trend of inflation, which is the focus of the policy target. Amongst these reasons, there is a range of events whose impact would normally be temporary. Such events include, for example, shifts in the aggregate price level as a result of exceptional movements in the prices of commodities traded in world markets, changes in indirect taxes, significant government policy changes that directly affect prices, or a natural disaster affecting a major part of the economy.
- b) When disturbances of the kind described in clause 3(a) arise, the Bank will respond consistent with meeting its medium-term target.

4. Communication, implementation and accountability

- a) On occasions when the annual rate of inflation is outside the medium-term target range, or when such occasions are projected, the Bank shall explain in Policy Statements made under section 15 of the Act why such outcomes have occurred, or are projected to occur, and what measures it has taken, or proposes to take, to ensure that inflation outcomes remain consistent with the medium-term target.
- b) In pursuing its price stability objective, the Bank shall implement monetary policy in a sustainable, consistent and transparent manner, have regard to the efficiency and soundness of the financial system, and seek to avoid unnecessary instability in output, interest rates and the exchange rate.
- c) The Bank shall be fully accountable for its judgements and actions in implementing monetary policy.

Worded vs. numerical employment target?

Within the PTA there is the option to have a worded objective (e.g. “foster full employment”) or a numerical one (e.g. some targeted unemployment rate ceiling or average). These two options can also be looked at as “soft”, with plenty

of scope for flexibility, against a “hard” target that the RBNZ explicitly aims to hit (as in the inflation target). For several reasons we conclude a (soft) worded objective is preferable:

- Monetary policy (through its impacts on credit and the money supply) is intrinsically linked to prices, with a less direct link to employment outcomes;
- Neither the Reserve Bank of Australia nor the US Federal Reserve – the employment-targeting examples usually cited – have a numerical target.
- As a statistic, the CPI is far more accurately measured. Admittedly, that is partly because of the resourcing put into it because of its policy target status. But employment/unemployment will never be able to be measured with the accuracy that readily-observable prices can be;
- Consequently, employment and unemployment statistics are notoriously volatile from one quarter to the next and a liable to historical revisions, which runs the risk of policy reacting to volatility rather than a firm underlying trend;
- Defining full employment is far more challenging in practice than defining price stability, and a numerical definition is likely to shift over time as labour market dynamics evolve;
- A numerical target for full employment is much more likely to create policy conflict with the price stability target, particularly if the employment target isn’t calibrated well.

These last two points are particularly challenging. What would the target be set at and what rationale would be used? The average unemployment rate has been 5.4% over the past 20 years, and also 5.4% over the last 10 years – either of the two average calculations could be a long-term benchmark. Should an estimate of the Non Accelerating Inflation Rate of Unemployment ([NAIRU](#)) be used and, if so, how often should it be reviewed to ensure it is relevant? And, as a concept, is the NAIRU really sound enough for a policy target? Would a government target be used? The new Finance Minister has said full employment is most definitely below 5% (unemployment has been below that rate for around a third of the last 2 decades). The new Prime Minister has said unemployment should be below 4% (it has been below that rate for around a fifth of the last 2 decades), though was not speaking in the narrow context of a RBNZ target.

There will be times when an employment target and a price stability target come into conflict. A worded objective, as with the Reserve Bank of Australia and the US Federal Reserve, provides more flexibility to use judgement over the most appropriate policy setting. An explicit unemployment rate target is more likely to create situations when monetary policy is obliged to focus (overly) on one goal at the longer-term detriment of achieving the other. It is not easy achieving one goal with one policy instrument (the OCR), let alone achieving two goals with one instrument.

Indications from Finance Minister Robertson are that he favours a softer worded directive rather than setting the RBNZ an explicit employment-related target. We see that as a pragmatic approach, though we also come from a viewpoint that the RBNZ implicitly takes into account the state of the labour market and wider economy when setting the OCR.

Committee decision-making vs. Governor’s accountability

Currently the Governor is solely accountable for the RBNZ meeting the agreed target. If the Governor is not the sole decision-maker, then he/she cannot be held fully responsible for the decisions made by others and the subsequent outcomes, involving changes to the parts of the Act highlighted below. The Committee structure, and accountability of the Committee members, would also need to be defined in the Act.

11} Governor to ensure policy targets followed

It is the duty of the Governor to ensure that the actions of the Bank in implementing monetary policy are consistent with the policy targets fixed under [Section 9](#).

41} Duties of Governor

(1) It is the duty of the Governor to ensure that the Bank carries out the functions imposed on it by —
(a) this Act; and...

49} Removal of Governor from office

(1) The Governor-General may, by Order in Council, on the advice of the Minister, remove the Governor from office.

- (2) The Minister may tender advice under subsection (1) if the Minister is satisfied—
- a) that the Bank is not adequately carrying out its functions; or
 - b) that the Governor has not adequately discharged the responsibilities of office; or
 - c) that the Governor has obstructed, hindered, or prevented the Board from discharging its responsibilities under this Act; or
 - d) that the performance of the Governor in ensuring that the Bank achieves the policy targets fixed under section 9 or section 12(7)(b) has been inadequate;

How might a shift to a committee matter? If the committee is internal, then the impact is likely to be minimal.

Governor Wheeler operated an informal decision-making body, which is continuing under Acting Governor Spencer. The current arrangement would essentially be formalised.

A committee involving a minority of non-RBNZ personnel could at times see the timing of interest rate moves shifted slightly. Finely-balanced debates could see OCR moves deferred. External members would likely bring in different perspectives and are less likely to be as narrowly aligned as internal staff. And that is precisely the rationale for appointing them. But, if their role is part time then they may not be as up to date on developments nor as steeped in technical matters as internal staff.

If minutes of decisions were published it would cast the spotlight on the reasons for any contrasting views. That might enrich external understanding of the RBNZ's policy stance. However, it also runs the risk of the RBNZ itself no longer being able to fully control its external messaging. In that case, the potential for financial market misinterpretation – and unnecessary volatility – would be higher.

Appendix 1: Reserve Bank of Australia's employment goal

The equivalent Australian Act originally dates from 1959. It expressly includes “maintenance of full employment” as one aim for policy to best contribute to:

10} Functions of the Reserve Bank Board

- (1) Subject to this Part, the Reserve Bank Board has power to determine the policy of the Bank in relation to any matter, other than its payments system policy, and to take such action as is necessary to ensure that effect is given by the Bank to the policy so determined.
- (2) It is the duty of the Reserve Bank Board, within the limits of its powers, to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia and that the powers of the Bank under this Act and any other Act, other than the Payment Systems (Regulation) Act 1998, the Payment Systems and Netting Act 1998 and Part 7.3 of the Corporations Act 2001, are exercised in such a manner as, in the opinion of the Reserve Bank Board, will best contribute to:
 - a) the stability of the currency of Australia;
 - b) the maintenance of full employment in Australia; and
 - c) the economic prosperity and welfare of the people of Australia.

Appendix 2: The US Federal Reserve's employment goal

The Federal Reserve Act dates from the Reserve System's 1913 inception and includes “promoting effectively.... maximum employment”:

Section 2A. Monetary policy objectives

The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.

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