

Treasury Report: Independent Review of the Operation of Monetary Policy

Date:	23 March 2001	Treasury Priority:	Medium
Security Level:	In Confidence	Report No:	T2001/375

Action Sought

	Action Sought	Deadline
Treasurer/Minister of Finance	Read and discuss with officials	Prior to your meeting with officials from the Treasury and Reserve Bank at 10.30am on 12 April 2001
Associate Minister of Finance (Hon Trevor Mallard)	Note	None
Associate Minister of Finance (Hon Paul Swain)	Note	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
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23 March 2001

MA/4/1

Treasury Report: Independent Review of the Operation of Monetary Policy

Executive Summary

You have asked the Treasury to provide you with a detailed analysis of Professor Svensson's recommendations. At your meeting with Don Brash and Alan Bollard on 20 February you requested that this report consider options for including external advice on monetary policy decisions within the existing legislative framework.

A meeting to discuss this report with officials from the Treasury and Reserve Bank has been scheduled for 10.30am on 12 April 2001.

In Svensson's view the existing institutional structure works very well but carries with it some risks; in particular it relies heavily on the qualities of a single person. To address these risks Svensson makes a number of suggestions, each of which is small on its own, but together significantly change the current institutional structure.

Svensson's proposals for enhancing the Bank's governance structure and raising its public accountability has clear benefits – it promotes increased public discussion and understanding of monetary policy and helps ensure that the Bank maintains a medium term focus on inflation and avoids unnecessary instability in output, interest rates and the exchange rate. However we have some reservations about adopting his proposals for removing the Governor from the Board and for forming an internal decision-making committee.

In Table 1 (attached) we summarise Svensson's recommendations, provide a brief comment and conclusion and seek your views on the recommendations.

Table 2 (attached) summarises the options for changing the decision-making process including the involvement of external members. Should you wish to include external input into the decision-making process there are a number of detailed implementation issues that would need to be considered. You may wish to direct the Treasury, in consultation with the Reserve Bank, to report to you on these issues by 4 May 2001.

We suggest that you use Tables 1 and 2 as the basis for your instructions to the Treasury to draft a paper, in consultation with the Reserve Bank, to the Finance, Infrastructure and Environment Committee (FIN) on the Government's response to the review.

The Prime Minister's Department and the State Services Commission will also be consulted in the preparation of the FIN paper.

You have previously announced your intention for the Government's response to be announced by the end of May. This suggests that you should seek FIN agreement to your proposed response in early May to enable any outstanding issues to be addressed and put to Cabinet by the end of May. We suggest that you direct the Treasury to draft a FIN paper for you by 4 May 2001.

A number of the recommendations in this report may have cost implications. Any funding issues will be addressed in the FIN paper.

You have requested that a copy of this report be sent to the Hon Bill English.

Recommended Action

We recommend that you:

- a **indicate** on Table 1 whether you agree/disagree with Treasury's recommended response to the review's recommendations;
- b **discuss** the issues raised in this report with officials from the Treasury and Reserve Bank at your meeting on 12 April 2001;
- c **direct** the Treasury, in consultation with the Reserve Bank, to report to you on any implementation issues arising from your decisions on the review by 4 May 2001;
- d **direct** the Treasury, in consultation with the Reserve Bank, DPMC and SSC to prepare a Cabinet paper, including any cost implications, by 4 May 2001; and
- e **forward** a copy of this report to the Hon Bill English.

Struan Little

Chief Analyst, Macro Policy
for Secretary to the Treasury

Hon Bill English

Referred: Yes/No

Hon Dr Michael Cullen

Treasurer/Minister of Finance

Treasury Report: Independent Review of the Operation of Monetary Policy

Purpose of Report

1. This report seeks decisions from you on the recommendations contained in Svensson's review of the operation of monetary policy. These decisions will be incorporated into a paper for the Finance, Infrastructure and Environment Committee (FIN), which will form the basis of the Government's response to the review's recommendations.

Analysis

2. Svensson's report addresses all the terms of reference, but focuses predominantly on the performance of policy over the last decade and on issues of governance and decision-making. His major recommendations relate to governance, decision-making and accountability structures (the Bank's institutional structure).
3. In Svensson's view the existing institutional structure works very well but carries with it some risks; in particular it relies heavily on the qualities of a single person. To address these risks Svensson makes a number of suggestions, each of which is small on its own, but together significantly change the current institutional structure.
4. In most cases the potential benefits from adopting Svensson's proposals are clear. However we have some reservations about adopting his proposals for Board membership and for an internal decision-making committee.
5. Table 1 (attached) summarises all Svensson's recommendations, provides a brief comment and the Treasury's recommendation. For the purposes of drafting the Cabinet paper we suggest you indicate on the table your agreement/disagreement with the Treasury's recommendations.

The Board of Directors – Membership and Monitoring Monetary Policy

6. To clarify and simplify the present governance arrangements Svensson recommends that:
 - The Board of Directors should consist of non-executive directors only; and
 - The non-executive directors should select the chairperson of the Board.
7. We support the latter recommendation and agree that the Governor should not be chairperson of the Board. However, we favour retaining the Governor as a member of the Board.

8. Removing the executive members from the Board increases the Board's independence and places greater emphasis on the need for the Board to look beyond the Bank for information on which to assess performance. It also reduces the potential conflict of interest faced by the Governor and Deputy Governors in being part of a Board whose primary function is to monitor their performance.
9. However the Board's monitoring role is not limited to monetary policy: it is required to monitor all dimensions of the Bank's performance, which includes both purchase and ownership interests. Removing all executives from the Board may threaten the flows of information necessary to enable the Board's non-executive directors to operate effectively. To guard against this possibility and at the same time promote increased independence of the Board, the Governor should be retained as a member of the Board. Communication flows with the Deputy Governors can be maintained by inviting them to attend meetings, provide information and participate in discussions.
10. Legislative amendments are required to implement these changes. The amendments are relatively minor and are unlikely to be contentious. Amendments would be confined to those sections of the Act dealing with governance (sections 52-63).
11. Svensson also sees benefits from making the Board's monitoring functions more public. He recommends that the Board, with the assistance of experts if necessary, publish an annual review and evaluation of monetary policy. The Board's report could be incorporated into the Bank's Annual Report.
12. The Treasury supports this proposal. Coupled with the proposed increase in the Board's independence from the Bank, we see this as contributing significantly to the robustness and openness of the Board's monitoring.
13. We suggest that the requirement for the Board to publish an annual review be incorporated in legislation. This would reinforce the importance of this proposal as an accountability mechanism.
14. We note that this proposal may have some implications on the time commitment required by Board members. The use of experts may require additional financial resources to be made available to the Board. The Board's expenses are met by the Reserve Bank through their funding agreement with the Crown.
15. The proposed changes to the Board's membership and its monitoring process are summarised in Table 2 under option A.

Decision-Making – a Committee Structure

16. To overcome the risk of relying too heavily on the qualities of a single person Svensson recommends that a formal 5 member internal committee be formed. The publication of named votes and non-attributed minutes is suggested as a means to provide individual accountability. An internal committee largely reflects current practice and would probably involve minimal transitional disruptions to policy making. Svensson's proposal is summarised in Table 2 as option B.

17. Two major issues arise with Svensson's proposal:
- 1) Members are appointed by the Board for their expertise in monetary policy but are also required to carry out a number of non-monetary policy tasks under the direction of the Chief Executive (the Governor). The complicated and unclear reporting lines may create some tensions around authority and responsibility, undermining the efficient and effective operation of the Bank.
 - 2) The Bank is not directly exposed to a greater diversity of views than currently when making its decisions. It is arguable that the risk of being captured by a single line of thought remains greater with an internal committee. The publication of minutes can only provide partial reassurance that external views are carefully considered.
18. Our view is that no decision-making option is without problems. The current process suffers from the weakness discussed by Svensson; other alternatives also have shortcomings. Around the world we can observe a range of decision-making structures each of which has strengths and weaknesses. In practice they all appear to work to produce low inflation.
19. We believe the clear and strong accountability of the present structure has considerable merit. The Governor is solely and clearly responsible for monetary policy performance and may be dismissed by the Minister in the event of inadequate performance. While the Minister's ability to dismiss a poorly performing Governor may be severely limited in practice, his ability to dismiss a poorly performing committee would be even more limited.
20. The formation of a decision-making committee would require extensive changes to the Reserve Bank Act. The statutory responsibility for price stability that currently rests with the Governor, and the statutory relationship between the Minister and the Governor, would need to be amended to give effect to the responsibilities of the Committee.
21. The issues raised above suggest that the potential benefits of forming a formal internal decision-making committee are likely to be small. However we do believe that there would be some benefit in broadening the Bank's exposure to external views.
22. Increased external input has the potential to increase the broad legitimacy of the Bank, may expose the Bank to a wider range of perspectives and information and may improve the Bank's capacity to incorporate feedback and learn from policy experience.

Exposure to External Views

23. In our earlier discussions with you, you asked us to provide you with options for including external advice into the Bank's decision-making process. Broadly there are two options for achieving this: either appointing external members to a statutory decision-making committee, similar to the Bank of England; or providing additional channels for including external views in the advice available to the Governor.

External membership of a decision-making committee

24. Appointing two part-time external experts to a five member committee is Svensson's second best option for a decision-making committee (it is summarised in Table 2 as option C). This committee structure has the additional advantage that external members may be more likely to challenge the views of the internal members and thus help guard against the risk that the Bank becomes insular in its views.

25. External members should be experts appointed by the Board to ensure they are independent from the Bank. They would be part-time and their duties would be limited to those related to their role as committee members.
26. External membership of a committee, in common with an internal committee, weakens and diffuses the accountability for monetary policy performance. In addition, external membership raises questions around New Zealand's ability to sustain a supply of high quality members without conflicts of interest. This is compounded by the relatively large time commitment (up to 40 days per annum) required. Overseas experience suggests that disputes over external members access to research resources may arise and there may be a temptation for members to "grandstand" that is, seek to raise their public profile by publishing dissenting views, with implications for the clarity of policy messages.

Incorporating external views into advice

27. An alternative to establishing a decision-making committee is to modify the current advisory process to more explicitly include external advice. One way that changes in the current process can be achieved is by developing a process similar to that used by the Reserve Bank of Australia. The most obvious differences are that under the proposed arrangement external members would be experts and would be advisors rather than decision-makers.
28. Under this arrangement Bank staff would provide a panel or committee of internal and external experts, including the Governor, with their views on the state of the economy and forecasts. This advice would be accompanied by detailed supporting documentation. The panel members would then provide their views on the appropriate stance of monetary policy to the Governor.
29. Providing for the involvement of internal and external panel members at the end of the forecasting process would not exclude them from becoming involved earlier in the process i.e. during the forecasting process. Should the external panel members choose to become involved in the forecasting process the benefits of this arrangement are likely to be greater.
30. This model probably represents the best compromise between maintaining the clear accountability of the Governor and integrating external advice into the process. It is summarised in Table 2 as option D.
31. This approach does not require legislation – it could be achieved through agreement with the Bank. Legislation would however ensure that any changes to the current process are lasting.

32. This approach has the same disadvantages as a decision-making committee and the additional disadvantage of allowing the Governor to dismiss or downplay the external views. The publication of minutes may mitigate the latter risk and ensure that the integrity of the process is maintained.
33. The Bank's submission to the review notes the wide range of external views that already informs the Bank's forecasting and decision-making process. Additional and more direct channels of external advice may usefully complement this existing advice.
34. Critical to the success of any process to incorporate external views is the requirement that external parties be expert and independent of the Minister and the Bank. We agree with Svensson that the operation of monetary policy is a highly technical activity. Non-experts may lack the capacity to participate in the high-level discussions required in efficient forward looking monetary policy and may therefore easily become dominated by experts. Appointments should be made by the Board to preserve the principle that while the Minister appoints the Governor, this is balanced by the Board's appointment of other key individuals in the decision-making process. We would recommend that any external parties brought into the process be experts in monetary policy, macroeconomics or financial economics.

Summary

35. The Treasury agrees with Svensson's conclusion that the current arrangement with a single decision-maker works well. We find his arguments for clarifying and strengthening the accountability and governance arrangements compelling and agree that they will be beneficial to the operation of monetary policy in New Zealand. However we have some reservations about his recommendations for removing all executives from the Board and for forming an internal decision-making committee.
36. Should you agree to adopt the Treasury's recommendations on changes to governance and accountability mechanisms, the Bank's public accountability will be significantly strengthened. We believe these changes will mitigate much of the risk that Svensson attaches to the current single decision-maker structure. To the extent that these changes enable alternative views to be more widely debated the benefits from further external involvement in the decision-making process are reduced.
37. You have asked us to consider whether there are likely to be benefits from increasing external input in decision-making. The Treasury considers that even after allowing for the changes above increased external input could have some benefits, although they could be small and there are some potential risks. The key choice is between a process that gives external members a decision-making role and a process that includes them in an advisory role. The value attached to maintaining strong and clear accountability for monetary policy decisions is a key determinant of this choice.
38. The Treasury favours the clear accountability of the present single-decision maker framework. Thus if you wish to include external views in the decision-making process we would recommend that they be involved in an advisory capacity. Regardless of your final decision we would favour external members being experts and minutes being published.

39. Including external input into the decision process raises a number of detailed implementation issues that are not addressed here. Should you wish to move in this direction we suggest that you direct the Treasury, in consultation with the Reserve Bank, to report to you on these issues by 4 May 2001.
40. Table 2 summarises the main options for changing the Bank's decision-making process. You may find the table useful for facilitating discussion at the meeting.

Annual Conference and FEC

41. In addition to the publication of an annual review by the Board Svensson recommends that:
 - The Bank contributes to funding an annual conference for the purpose of inviting experts to report on monetary policy; and
 - Parliament's Finance and Expenditure Committee (FEC) be encouraged to make greater use of experts when conducting thorough and detailed hearings of the Bank.
42. We agree that these proposals would contribute to increased public accountability of the Bank and help to ensure that monetary policy remains consistent with the best international practice of flexible inflation targeting. The Treasury supports both proposals. We note that they may have fiscal costs for the Crown. These costs will be identified more fully in the subsequent Cabinet paper.
43. There are a number of ways these proposals could be implemented. For example the proposed annual conference could be held in conjunction with the New Zealand Association of Economists annual conference.
44. An annual conference may however be too frequent to provide sufficiently high quality analysis to ensure good value for money. We believe that a conference every two years would be more appropriate.
45. Greater expertise can be made available to FEC through a number of channels. They may contract directly with external experts or indirectly by asking the Audit Office or some other agency to provide expertise. You have asked FEC to provide their views on this recommendation.

Policy Targets Agreement

46. Svensson recommends that the inflation target in the PTA be amended to 12 monthly increases in the CPI of 1.5% over the medium term. He recommends that this change be made at the beginning of a new term of Governor (August 2003).
47. We support this amendment and agree that it would provide a better anchor for inflation expectations. To the degree that inflation expectations are lowered there may be some benefits from making the change immediately. However the Bank already targets 1.5% inflation over the medium term so the gains are unlikely to be large and there does not appear to be any pressing need to make the change immediately.
48. We suggest you seek the Bank's agreement to this proposal.

Data Issues

49. Svensson recommends that CPI data and industrial production statistics be produced on a monthly basis. We agree with the view of the 1997 CPI Revision Advisory

Committee that there are higher priority issues to be addressed by Statistics New Zealand.

50. We note that the primary user of this data, the Reserve Bank, also accords the development of other statistics a higher priority.

Monetary and Fiscal Policy Coordination and Prudential Supervision

51. Svensson believes that the transparent medium term framework within which both monetary and fiscal policy decisions take place allows for full coordination between the two policy arms. He notes that the gains from any more explicit coordination between fiscal and monetary policy are likely to be small and may be overwhelmed by the negative consequences of reducing the operational independence of monetary policy.
52. We agree with Svensson's view that the current system works well and need not be changed.
53. Svensson recommends that the Bank report on the state of the financial system in a regular publication twice a year. He notes that the Bank already does so to some extent through an annual article in the Reserve Bank Bulletin. We agree that raising the visibility and transparency of prudential policy should help protect against problems in the financial system.
54. We understand the Bank supports this recommendation, although they have not decided whether it should be a standalone publication.
55. You may wish to discuss with the Bank their timeline for reaching a decision on publication details.

Other Issues for the Bank

56. Svensson makes a number of other recommendations for the Bank to agree to. The recommendations are for the Bank to:
- Make technical improvements to their Forecasting and Policy System;
 - Report and discuss alternative measures of inflation expectations; and
 - Consider alternative ways of conveying the inherent uncertainty in projections.
57. We agree that there is some value in progressing these recommendations, however we note that there may be some cost implications, particularly with enlarging the Bank's surveys of inflation expectations.

58. We understand that the Bank intends to progress these recommendations but has yet to determine how and when they will be implemented. We suggest that you discuss these issues with the Bank and ask them to discuss with the Treasury a timeline for implementation and any cost implications for inclusion in the Cabinet paper.

Fiscal Implications

59. A number of the proposals above will require the Reserve Bank or some other agency to incur additional costs. While we do not consider any of the costs will be large further work is required to better quantify the costs and determine whether any additional funding is required. Should the Bank seek additional funding an amendment to the Banks five year funding agreement would be necessary.
60. Should you agree to any of the recommendations in this paper we suggest that costings, and a process for addressing them, be included in the Cabinet paper.

Process

61. You have previously announced your intention for the Government's view to be announced by the end of May. This will require you to seek the approval of the Cabinet Finance, Infrastructure and Environment (FIN) Committee in early May, so that any outstanding issues can be addressed and put to Cabinet by the end of May.
62. We suggest that you invite the Treasury, in consultation with the Reserve Bank, to draft the Cabinet paper by 4 May 2001.
63. The Prime Minister's Department and the State Services Commissioner also have an interest in changes to governance, decision-making and accountability and will be consulted in the preparation of this paper.
64. You have indicated that you wish to send a copy of this paper to the Hon Bill English. A copy is attached.

Table 1 Svensson’s Recommendations

Svensson’s recommendations	Comment	Treasury recommendation	Agreed yes/no
Governance			
The Board of Directors should only consist of non-executive directors	<p>The Board’s primary role is to monitor the Bank’s monetary policy, financial and general performance. This recommendation seeks to increase the Board’s independence.</p> <p>Information flows may be reduced if all the executives leave the Board but the Board’s incentives to seek external information may be increased.</p> <p>Minor legislative amendments are required</p>	Support Svensson recommendation but retain the Governor on the Board	yes/no
To ensure sufficient independence of the Board, the chair of the Board should be selected by the non-executive directors among themselves and not by the Treasurer.	<p>The chairperson’s independence ensures accountability is unbiased.</p> <p>Minor legislative amendments are required.</p>	Support	yes/no
The Board of Directors should publish an annual report with an evaluation of the Bank’s monetary policy. This report could be separate or part of the Bank’s <i>Annual Report</i> . The Board may appoint a panel of experts for its assistance.	<p>Raises the visibility of the Board and strengthens accountability.</p> <p>The requirement to report may be enshrined in legislation.</p> <p>May have fiscal cost.</p>	<p>Support</p> <p>Support inclusion in legislation</p>	<p>yes/no</p> <p>yes/no</p>

Table 1 contd

Svensson's recommendations	Comment	Treasury recommendation	Agreed yes/no
<i>Policy Targets Agreement</i>			
Section 2b (of the PTA) should be modified to read "...the policy target shall be 12-monthly increases in the CPI of 1.5% over the medium term"	We agree that a point target provides a clearer anchor for inflation expectations.	Support	yes/no
Any change to the PTA should be made at the beginning of a new term for the Governor	We agree that there is no need to make this change until 2003.	Support	yes/no
Data Issues			
Statistics New Zealand should collect monthly data on the Consumer Price Index and industrial production	In our view there are higher priority areas for improving statistics.	Do not support	yes/no

Table 1 contd – Svensson’s recommendations relating to the Bank’s internal operations

Svensson’s recommendation	Bank’s response	Treasury comment
<p>The Reserve Bank may want to consider some further developments of its Forecasting and Policy System (FPS). Alternative interest rate reaction functions and alternative interest rate paths could be used and presented systematically to the MPC to provide a larger menu of policy choices for discussion and consideration.</p>	<p>The Bank hopes to adopt this recommendation as the capability of their model is improved.</p> <p>However they do not see this as a priority. The Bank’s priorities are to diversify their approaches to analysis and forecasting to avoid the dangers in having a single view of the economy.</p>	<p>Svensson notes that the adoption of this recommendation would probably not make a material difference to policy outcomes.</p> <p>You may wish to ask the Bank when they would be in a position to progress this recommendation.</p> <p>You may also wish to ask the Bank for more details on how it intends to diversify its approaches to analysis and forecasting.</p>
<p>The Reserve Bank could consider reporting and discussing alternative measures of inflation expectations for the medium and long-term credibility of the monetary policy regime.</p>	<p>The Bank agrees this is sensible</p>	<p>Inflation expectations are an important input into inflation forecasts and assessments of the credibility of monetary policy.</p> <p>Svensson suggests that the data might be commissioned at arm’s length from the Bank, such as by Statistics New Zealand.</p> <p>We agree that this proposal has merit, but note that there could be cost implications.</p> <p>You may wish to ask the Bank to provide the Treasury with costings of this proposal and a timeline for implementation for inclusion in the May FIN paper.</p>
<p>The Reserve Bank should summarise its information about the financial system, including a number of macro-prudential indicators of financial stability in a regular report.</p>	<p>The Bank sees this proposal as having some merit. They intend to evaluate the costs and benefits of publication through the Bulletin as compared to a stand-alone publication.</p>	<p>You may wish to ask the Bank to provide the Treasury with the outcome of this analysis and a timeline for implementation for inclusion in the May FIN paper.</p>
<p>The Reserve Bank should consider alternative ways of conveying the inherent uncertainty in projections while maintaining transparency.</p>	<p>The Bank agrees that the rounding method is unsophisticated and is looking at alternative ways of presenting data.</p> <p>The methods suggested by Svensson, and used overseas, do not translate readily to New Zealand.</p>	<p>We agree that it would be preferable to convey forecast uncertainty by some other means.</p> <p>You may wish to ask the Bank what priority they accord to looking at alternatives and whether they have a timeframe for change.</p>

Table 2: Decision-making options

Options	Proposed Structure	Benefits/Risks
Option A: <i>Single decision-maker with stronger accountability</i>	<p>The Board is made more independent through the exclusion of the Deputy Governors. The Board publishes an annual review and evaluation of monetary policy. A 2 yearly conference is held. More thorough FEC scrutiny Stronger accountability may be a part of other options below.</p>	<ul style="list-style-type: none"> • Strengthens the accountability of the Governor • Evaluation of the Bank occurs after the event and does not change the decision process • Board may not seek external views in its annual review • Conference may fail to attract high quality participation
Option B: <i>Internal decision making committee (Svensson's proposal)</i>	<ul style="list-style-type: none"> • 5 member internal committee, appointed by the Board, except the Governor who is appointed by the Minister. • five year overlapping terms • named votes and non-attributed minutes • Governor remains solely responsible for all Bank functions other than monetary policy 	<ul style="list-style-type: none"> • Reduces exposure to single person risk • Accountability is more diffuse • Tension between management relationships and "independence" of committee members • Does not increase exposure to external views • Raises transparency through the publication of minutes and votes • Formalises current practice. • Legislation is required
Option C: <i>External Committee (includes internal and external members)</i>	<ul style="list-style-type: none"> • 5 member committee; three internal, two external, otherwise similar to committee above. • external appointees are experts • external appointees are part-time 	<ul style="list-style-type: none"> • Increases exposure to external views • Reduces exposure to single person risk • Accountability is more diffuse • Limited pool of available experts without conflicts of interest • Potential for conflicts of interest and "grandstanding" leading to a loss of clarity in communication • Raises transparency through the publication of minutes and votes • Legislation is required
Option D: <i>External advice model</i>	<p>Bank staff presents a panel (some internal and 2 external members) with their views on the state of the economy and forecasts. This advice is accompanied by detailed supporting documentation.</p> <p>The panel members advise the Governor on the OCR decision. Panel members may also be involved in forecasting process.</p> <p>This is similar to the process used by Reserve Bank of Australia to reach decisions.</p>	<ul style="list-style-type: none"> • Requires some change to existing processes • Increases exposure to external views • Limited pool of available experts without conflicts of interest • External experts can choose to become more involved • Potential for conflicts of interest and "grandstanding" leading to a loss of clarity in communication • Raises transparency through the publication of minutes • External advice may be ineffective