Reserve Bank of New Zealand Board Submission to:
FEC Inquiry into the Future Monetary Policy Framework

18 July 2007

Executive Summary

This submission is made by the Board of Directors of the Reserve Bank of New Zealand. Our main conclusions on matters raised by the Terms of Reference for the Review are that:

- The current legislative framework for the conduct of monetary policy is sound.
- The current Policy Targets Agreement is appropriate in allowing the Bank to implement monetary policy flexibly in its pursuit of price stability.
- The Bank has set monetary policy in accordance with its obligations under the Reserve Bank of New Zealand Act and has met the medium term targets agreed with the Minister of Finance in the Policy Targets Agreements.
- In light of significant imbalances in the New Zealand economy, the Board supports the investigation of alternative instruments or structural policy changes that may (a) assist the Bank in achieving its monetary policy objectives; and (b) assist the transition to a more balanced economy.

1. The role of the Board of Directors

The Reserve Bank of New Zealand Act 1989 specifies that the Board of Directors of the Bank is responsible for keeping under constant review the performance of the Bank in discharging all its functions as the central bank of New Zealand. One particular focus is on the Bank's achievement of monetary policy targets agreed to between the Governor and the Minister in the Policy Targets Agreement (PTA). The Board assesses the consistency of the Bank's policy statements with its primary function and stated goals under the PTA. Under the Act, the Board prepares an annual report on the performance of the Bank. If, in the Board's judgment, the Governor of the Bank has failed to discharge the duties of the office satisfactorily, it may recommend to the Minister that the Governor be removed from office.[1]

2. Our approach to monitoring the Bank

Monetary policy is complex in that decisions are based on imprecise information, and policy affects future outcomes that are also influenced by external factors over which a central bank has little direct control. Problems that the Bank faces in setting monetary policy include:

- The Bank's interest rate instrument - the Official Cash Rate (OCR) - does not directly affect inflation, operating instead with variable lags through a number of transmission channels;
- Economies evolve continually, affecting the degree and nature of the influence of monetary policy on different economic sectors;
- The economic relationships are estimated with margins of error, and these margins themselves may change over time;
- Official data on the current state of the economy is only available with a significant lag and is subject to non-trivial revisions;

[1] The Act also enables the Board to provide advice to the Governor on any areas of the Bank's operations.

- Some of the most important variables for policy determination (such as the levels of output that are consistent over time with price stability) are unobserved and must be inferred from available data.

In light of these considerations, the Board's monitoring of the Bank's monetary policy decisions requires it to separate the effects of decisions on outcomes from the impact that good or bad fortune may have had on these outcomes. Good policy based on all relevant information can still deliver undesirable outcomes if unforeseen, adverse economic 'shocks' buffet the economy. Conversely, inappropriate policy that is countered by offsetting surprises as the economy evolves can yield outcomes that are consistent with the PTA. In monitoring the Bank, the Board therefore does not assess inflation outcomes in isolation; rather, the Board assesses whether the Bank has set policy appropriately in *pursuit* of its targets, given the prevailing economic environment and judgements of likely future economic developments.

3. The mechanics of monitoring the Bank

The Board uses a wide variety of information to undertake its evaluation and monitoring role. The practical arrangements for this monitoring have evolved over time, and have become more formal since the recommendations of the Independent Review of Monetary Policy by Professor Lars Svensson in 2001.

The Board generally meets each month and has access to the same papers and advice that inform the Bank's decisions and operations. At meetings that follow monetary policy decisions, these papers include summaries of recent developments in the macro-economy and in domestic and international financial markets, guidance on the near-term outlook for various sectors of the New Zealand economy, longer-term economic projections, as well as a précis of information from the Bank's business contacts and material on the views of markets and other commentators. A small subset of senior Bank staff provides the Governor with non-binding formal advice on changes to the OCR, and these are made available to the Board on a non-attributed basis. In addition, the OCR advice tendered by the Bank's two external monetary policy advisors who take part in the OCR advisory process (following the Svensson review of 2001) is made available to directors. Finally, *Monetary Policy Statements* published by the Bank are considered in detail at Board meetings, accompanied by a presentation from the Governor (and senior staff) on the rationale for the policy decision.

From time to time, various eminent academic economists and foreign central bankers have visited the Reserve Bank to observe the monetary policy decision-making process first hand. (The Appendix provides a partial list of such visitors.) The Board has access to these visitors' written reports and in some cases has met with them. The Board has also sought additional materials from Bank staff and, indirectly, from international monetary policy experts, on various aspects of monetary policy and its implementation. In general, the findings of these reports indicate that the Bank's processes are comparable with international best practice.

International organisations such as the IMF, the World Bank, the OECD and various credit ratings agencies periodically visit New Zealand to consult with the Reserve Bank, and with other government officials and private sector economists. The regular reviews that result from these visits include assessments of the recent performance of the New Zealand economy, forecasts over the medium-term, and detailed policy commentaries. Again, these reviews support the current legislative framework for monetary policy, and have generally reported favourably on actual policy decisions.

4. Monitoring policy in the current business cycle

The Board has continued to comprehensively examine the Bank's processes and policy decisions in the current cycle. The Policy Targets Agreements over the period have required the Bank to "keep future CPI inflation outcomes between one and three percent on average over the medium term". The PTAs have also required the Bank to set policy so as "to avoid unnecessary instability in output, interest rates and the exchange rate." Sometimes, there is tension between these objectives in the short term, but the Act and the PTAs make clear that price stability is the primary goal for monetary policy. In the current cycle, future inflation has on occasions risked rising above 3% p.a. The Bank has reconciled the tension in the policy objectives by interpreting the price stability obligation as a requirement for inflation to be comfortably within one and three percent over the second half of a three year forecasting horizon. The Board is satisfied that this interpretation is in keeping with the specification of the PTA.

In recent years, several noteworthy developments in the domestic economy and in international financial markets have made policy determination – and its evaluation – somewhat more complicated than is usual. On the domestic front, sustained strength in household consumption has been accompanied by high house price inflation and by sizeable negative rates of household saving (i.e., setting aside capital gains, household consumption has significantly exceeded household income). Some commercial activities have benefited from high prices for commodity exports while, for others, the exchange rate appreciation has been a major factor in rendering them uncompetitive.

Other important economic developments have included those related to oil prices, fiscal policy and migration. Imbalances have been manifest in many sectors of the economy: annual CPI inflation exceeded 3% for five quarters from September 2005 to September 2006, non-tradeables inflation has exceeded 3% consistently since June 2002, the deficit on the current account increased to levels widely considered unsustainable, and household debt levels rose to historical highs. Land prices have risen sharply, while significant regulatory and other pressures are apparent in the construction sector. The Board has been concerned with the development of these wider imbalances.

We are satisfied that the Bank has recognised the general nature of strengthening resource pressures, though, like other forecasters, it has been surprised by the magnitude and persistence of some of these pressures. In particular, oil prices rose much further than the Bank and others initially expected; more recently, the strength in dairy prices has been much greater than anyone (including those in the dairy industry) anticipated.

We consider it reasonable and appropriate that the Bank has chosen to 'look-through' the transitory components of these inflationary pressures. The Bank has endeavoured to set policy to ensure that the obligations of price stability and the avoidance of unnecessary volatility in ancillary variables have been met, as well as to ensure that expectations of future inflation have remained anchored within the target range.

We note that the Bank's forecasts have generally been more accurate than the private sector consensus both over the latest cycle and over prior periods. Importantly, this indicates that the Bank has used all the available information to inform policy decisions. In other words, 'surprises' to such variables as commodity prices and foreign exchange rates could not reasonably have been anticipated with the information then at hand.

5. Supplementary stabilisation instruments

As noted above, the sustained strength in housing and household consumption has proven to be a major influence on inflationary pressures in the current cycle. On several occasions over the past three years, the Bank has increased the OCR to dampen this strength. Throughout this period, New Zealand has maintained amongst the highest short-term interest rates in the OECD.

Despite higher levels of household debt, a variety of factors have combined to ensure that New Zealand households have been less affected by tighter monetary policy than in previous cycles. Some external commentators and analysts held views different to those of the Bank on the need for policy tightening in the early part of the cycle, and this dampened the effect of OCR increases on longer term interest rates. This effect, coupled with a sustained period of very low global interest rates and bouts of increased competitiveness between commercial banks, appears to have reduced the response of domestic interest rates to a given increase in the OCR. Households have tended to shift their mortgage borrowing to longer term fixed rates (2-5 years) and away from floating rates that more closely mirror the OCR. Overseas investors, through the so-called “carry trade”, have invested in New Zealand short-term financial instruments which have considerably higher yields than in most other countries, especially Japan. Tighter policy has therefore had a larger impact on the exchange rate and on the traded sector of the economy, than on effective mortgage rates, longer term interest rates and the non-traded sector.

The Board has long been cognizant of the fact that the Bank’s policy tightening has prompted a relatively slow response in effective mortgage interest rates in the current cycle. The Bank has devoted significant resources to examining this phenomenon and to understanding the related problem of the excessive share of highly-leveraged housing in New Zealanders' asset portfolios. In conjunction with the Treasury, the Bank launched a 'Supplementary Stabilisation Instruments' (SSI) project in November 2005, with the aim of assessing whether ancillary instruments with direct impact on the housing market could aid monetary policy in its task of quelling domestic inflation pressures. The Board supports the Bank’s examination of these ancillary instruments. The review proposed several plausible supplementary stabilisation instruments, and it is the Board's view that some of these warrant further consideration. We continue to encourage further work in this area.

With strong support from the Board, and also in conjunction with the Treasury, the Bank hosted several international experts at a 'Macro Policy Forum' in June 2006. These experts were given the remit of assessing the soundness of the legislative framework for ensuring stable, balanced growth. The broad conclusion of these experts was that New Zealand’s macro policy framework can be improved only at the margin, that monetary and fiscal policies have generally been set prudently, and that the imbalances of recent years can be attributed to the differential impact of various external developments on different sectors of the economy.

In accordance with these conclusions, monetary policy remains focused primarily on maintaining price stability, and the OCR remains the primary instrument for monetary policy. The Bank also has the discretion to intervene in foreign exchange markets to influence the value of the dollar should it be exceptionally and unjustifiably priced. The option of foreign exchange intervention is an additional tool but, at most, it is anticipated to reduce the cyclical amplitude of the exchange rate only at the margin. The Board has reviewed the Bank’s criteria for intervention and considers that these criteria are consistent with its mandate and that the Bank has a robust system for intervention decisions. The Board has also reviewed the Bank’s recently announced changes to its financing and management of New Zealand’s foreign currency reserves. We consider that the changes will result in the Bank having a more effective means of responding to foreign exchange crisis situations, and that the new approach is consistent with international best practice.

6. Conclusion

Extensive consultation supports the view that the current legislative framework for monetary policy is internationally well-regarded and that no change in the legislation, or in the current PTA, is warranted. We confirm our view that the Bank has met its obligations in respect of the legislation and the PTA.

The implementation of monetary policy, in the face of multiple influences on the New Zealand economy, is constrained by the limited range of instruments available to the Bank. We remain of the view that the New Zealand economy may benefit from additional policy instruments that could assist in balancing the economy at times of cyclical extremes. Close consideration of the pro’s and con’s of the range of supplementary stabilisation instruments discussed by the Bank and the Treasury in 2006 and subsequently is, we believe, warranted with a view to obtaining a more balanced and less volatile economy. A consensus-based approach to analysing these issues, as has occurred over the past twenty years with respect to monetary policy, is important to ensure sound and long-lasting policy outcomes.

Appendix: External observers of the RBNZ policy-setting process 1996-2007

Name	Designation	Organisation
Laurence Ball	Professor of Economics	Johns Hopkins University, USA
Charles Freedman	Deputy Governor	Bank of Canada
Donald Kohn	Vice Chairman	Board of Governors of the Federal Reserve, USA
Jon Nicolaisen	Deputy Executive Director	Norgesbank, Norway
Tiff Macklem	Deputy Governor	Bank of Canada
Andrew Rose	BT Rocca Professor of Economic Analysis and Policy	University of California, Berkley, USA
Lars Svensson	Professor of Economics *and* Deputy Governor	Princeton University, USA *and* Sveriges Riksbank, Sweden
David Stockton	Director of Research and Statistics	Board of Governors of the Federal Reserve, USA
Gordon Thiessen	Governor	Bank of Canada
Ted Truman	Former Director	Board of Governors of the Federal Reserve, USA
Sushil Wadhwani	MPC Member	Bank of England, UK
Kenneth West	Ragnar Frisch Professor of Economics	University of Wisconsin, USA
Michael Woodford	John Bates Clark Professor of Political Economy	Columbia University, USA
Simon van Norden	Associate Professor	HEC Montreal, Canada
Anders Vredin	Head of Research	Sveriges Riksbank, Sweden