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Reflections on the Reserve Bank of New Zealand's Monetary Policy Round

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The Reserve Bank of New Zealand occasionally asks external experts to attend monetary policy rounds, and seeks their observations as part of good practice peer review.

Dr Philip Turner was requested to attend the February 2017 monetary policy round, report on his assessment of the decision making process, and make recommendations where relevant.

This issue of the *Bulletin* presents Dr Turner's report back to the Bank.

Dr Turner is a former Deputy Head of the Monetary and Economic Department and a member of Senior Management of the Bank for International Settlements (BIS), where he worked from 1989 to 2016. Between 1976 and 1989 he held various positions, including head of division in the Economics Department at the OECD in Paris. In 1985–86, he was a visiting scholar at the Bank of Japan's Institute for Monetary and Economic Studies in Tokyo.

Dr Turner studied Economics at Churchill College, Cambridge, and earned his PhD from Harvard University. His fields of interest include monetary policy, international economics and central banking.

Author's introduction

I took part in the Reserve Bank of New Zealand's (RBNZ) forecast week and the Monetary Policy Committee (MPC) group discussions during 30 January-1 February 2017, with the further opportunity of listening to the Governor's press conference immediately following the announcement of the Official Cash Rate (OCR) decision and to the central bank's testimony in front of the Finance and Expenditure Select Committee (FEC) in Parliament. Especially useful were the many discussions I had with RBNZ economists, both before forecast week (notably at an RBNZ international conference on macro-prudential policy the previous week) and afterwards. During an earlier visit (February 2014), I had been asked to review the structural forecasting model (NZSIM, for New Zealand Structural Inflation Model) used by the Reserve Bank in its forecasting exercise.[1]

1 My main conclusons on that occasion were: (i) the use of a general equilibrium model can expose thinking that is partial or incomplete; (ii) the strategic choice to keep NZSIM small was vindicated by the use I saw made of it during the forecast round. This model was based on an intellectually coherent view of how monetary policy works in a small open economy; it was tractable in that forecasters know how to handle it and could prepare revisions rapidly during the MPC round; and MPC members understood its logic.

1 Policy Targets Agreement

The monetary policy mandate of the RBNZ is not a narrow one. The policy target is "to keep inflation between 1 percent and 3 percent on average over the medium term, with a focus on keeping future average inflation near the 2 percent target midpoint". Clause 4(b) adds further that "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*". I have italicised these words because they describe a mandate that is realistic about what monetary policy can achieve. This mandate would not have been fulfilled in recent years, given the large shocks to international prices, by trying to keep the year-on-year inflation rate in New Zealand at close to 2 percent. To have achieved this, interest rates would have had to move by more than they have in recent years, and this would have created the unnecessary instability in output and the exchange rate that the RBNZ is enjoined to avoid.

This mandate requires the comprehensive analysis of how the real economy works, the monitoring of financial developments which are key for monetary policy, awareness of changes over time in monetary transmission, and the willingness to revise policy judgements as events unfold.

2 Research agenda

This broad mandate seems to be well reflected in the several topics that are under active study at the RBNZ. I know from earlier contacts that economists are encouraged to present their papers at outside conferences, and that in international forums the RBNZ "punches well above its weight" given its small size. RBNZ senior officials and economists have also made excellent contributions to central bank meetings at the BIS, including those in Asia where the RBNZ is especially active.

One question of fundamental importance to the MPC is clearly on the agenda of the RBNZ: how will monetary policy work in 2020? That is, after all, the end-year of the current *Monetary Policy Statement* forecasts. The natural temptation of research economists is to rely too much on backward-looking models and not take enough account of the newer trends. I was therefore encouraged to read a couple of excellent memoranda for the MPC which analysed some new elements in macroeconomic developments. This helped to frame some key medium-term questions about what might be called the "new normal" for monetary policy[2].

Three aspects of such a "new normal" are worth further analysis. One is the lower natural or neutral rate of interest. The second is that aggregate demand has probably become more responsive to any change in interest rates. The third is how macro-prudential policies will affect monetary policy.

2 These memos were written by Rebecca Williams and have since been published as *Bulletin* articles: "Business cycle review: 2008 to present day" (Williams, 2017) and "Characterising the current economic expansion: 2009 to present day" (Williams, 2017).

RBNZ work estimating the decline in the neutral policy rate in New Zealand, as in most advanced economies, is important. How far will capital mobility create some convergence in neutral rates internationally? If a low natural rate were to worsen the trade-off between macroeconomic and financial stability, how should the central bank respond?

The second aspect is that impact on aggregate demand of a given increase in interest rates in the future may be larger than it has been in the past. One obvious element is higher household debt levels. The long rise in house prices in New Zealand also means that the household sector's financial assets/income ratio has increased. Both changes will alter the response of households to increases in interest rates. The size and structure of the financial industry is similarly changing. In countries where interest rates have been close to zero, interest rate risk exposures in the financial industry have risen. The fact that the policy rate has not been reduced to zero has perhaps limited such risks in New Zealand; but it is a question worth exploring. These questions are important because most macroeconomic models which inform monetary policy thinking ignore such slow-moving financial ratios.

The third aspect is how new macro-prudential instruments (such as the loan-to-value ratio for mortgages) will interact with monetary policy. The very practical flavour of the international workshop organised by the RBNZ at the end of 26-27 January 2017 stimulated thinking about this important question.

The questions about the "new normal" for monetary policy are already in the public debate (see the Communication section below). RBNZ economists should be encouraged to work further on them. I was impressed by how much so few economists already achieve, and wondered whether the RBNZ needs more to keep on top of the analysis of these major changes.

3 The MPC forecast round

Pre-meeting material

The written materials provided just ahead of the meetings covered comprehensively the many aspects that could be relevant for the central bank's broad mandate. Much thoughtful analysis and research had clearly gone into its preparation, and it was clearly presented. This rich material was well written, so much of it could be read in the day before the meetings began. The papers gave an outsider such as me a good up-to-date account of the New Zealand economy. It included a chart pack on macro-prudential indicators, which is very important given this new policy tool. The material also provided evidence that longer-term thinking (e.g. about the implications of high levels of immigration, the new normal for monetary policy) had not been crowded out by current developments.

This material helped to frame the discussions, and gave members enough information to ask pertinent questions of the presenters. There was one striking general characteristic of the all discussions during the MPC process. This was the efforts, reinforced at various stages of the policy round, to ensure that everybody, irrespective of rank, was encouraged to make relevant points.

Presentations

The opening presentations on five key issues were made mostly by the young economists who had prepared the analysis of these issues. They had clearly mastered their briefs, had worked hard to present their interesting analysis effectively, and were clearly not intimidated by presenting in front of the Governors.

This process, which takes advantage of the small size of the central bank, avoids a problem that affects many other institutions. This is that unpopular or unorthodox opinions can get filtered out by successive levels in the hierarchy, as it is only more senior staff who make the presentations to Governors. Much the same can happen when senior officials begin such meetings with a high-level "stage-setting". Sometimes this takes the form of asking staff, implicitly as often as explicitly, "What new can we say to support our policy view?" A number of recent accounts of processes in some major central banks even paint a picture of an over-dominant Governor (or senior official) dictating the agenda, sometimes to the point of creating major policy blind spots.

The open working-level culture is a credit to the RBNZ. Junior staff are given their voice. Views or arguments expressed by colleagues are challenged in a constructive and professional way. This is essential if the policy blind spots of a few individuals are to be avoided.

This spirit of courteous challenging of the analysis put forward by staff was, I felt, helped by the whole-hearted engagement of the external advisers. Given the internal character of the MPC, they are indispensable. One of them told me they were there to keep the Reserve Bank honest. They took the briefing material very seriously. One said that reading it carefully before the meeting was essential for him to formulate his arguments effectively. Their questions underlined to staff presenters the importance of communicating some complex analysis clearly in a non-technical way.

A particularly significant contribution of such advisers, with their up-to-date business perspectives (albeit coloured by their own sectors), is to inject a good dose of practicality into the discussions. An MPC is not a meeting between specialist economists. What happens elsewhere shows what a danger this can be. The published minutes of some MPC meetings of other central banks (and a number of discussions I had when at the BIS) show that some well-known economists sometimes take advantage of their external member status on the MPC to "push" hard their brand of economic analysis. Sometimes they pay too little attention to current economic developments. This can be fun in an academic context, but is not always conducive to a constructive assessment of practical policy options.

Preparation of the forecast

The forecast is cast in terms of a general equilibrium model, which serves to avoid the trap of partial thinking. The choice of a small central model with few key variables, supported frequently by supplementary or alternative analyses beyond that model, is a wise one. Debate is easier when the number of forecast variables is limited. It also allows revised forecasts to be quickly produced. And it is also well-suited for framing alternative scenarios.

Many other forecasting rounds use large, rather cumbersome models. The big disadvantage of large models is that those who have not been involved in the nitty gritty of model use and construction can find it more difficult to constructively engage. And the production of forecast output for scores of variables can distract from the key issues of the forecast. The processes in many central banks are longer, and generate much more paper, than that of the RBNZ. They have become much more resource-intensive in gathering more and more information than in the past. What needs keeping in mind is the key trade-off I noted during my years supervising the preparation of papers for meetings of central bankers at the BIS: the pressure is always to add more variables to surveillance exercises but there is a risk of distracting very busy policy-makers from the issues they need to face.

No forecast is good at identifying turning points. Reality almost always belies the projection of a smooth future. So it was good to see participants in the meeting approaching these (competent) forecasts with the necessary dose of scepticism. The questions raised (what imbalances could become more difficult? What exogenous shocks should be of concern?) were the right ones.

Key issues

Identifying a few key issues at the start, each subject to a more detailed presentation by the staff member responsible for the analysis, framed the discussion in a useful way. The topics were well-selected. The analyses undertaken used different research tools and showed a creditable awareness of recent research.

Looking in an unbiased way at what is actually happening in financial markets is essential in any macroeconomic forecasting exercise. I could see that this was an important element of the forecast round. The analysis of what global bond market developments meant for New Zealand interest rates - which I had found lacking in 2014 - was sophisticated. Indeed RBNZ economists have been doing well-regarded original research in this area. Box B of the *Monetary Policy Statement* introduced the term premium concept well, and I am sure this helped journalists and others understand this useful (if theoretical) concept. Such readiness to explain technical analysis makes the central bank more persuasive.

This focus was particularly relevant at the time of the February meeting given the large change in the yields on US Treasuries over the past few months. It is likely to remain so. Linking this development to the rise in New Zealand mortgage rates was very helpful, as was the underlying tightening this implied for financial conditions in New Zealand. Weighing the international implications of higher US yields was well done. If symptomatic of stronger expected US growth, this could be benign; but the fact that expected future short-term rates had not increased does not support this interpretation. Higher yields could weaken prospects in countries that are more important trading partners for New Zealand. More generally, international financial developments are crucial for New Zealand. Finally, I had the impression that there was fuller analysis of local financial markets (including their expectations of New Zealand monetary policy) than I remember from 2014. Careful market reviews can be an effective cross-check on macroeconomic analysis.

Another very welcome feature of the papers and the discussions was that the clear distinction between tradable and non-tradable inflation. Surprisingly, this is still often ignored by some major central banks. There was, however, one important question raised during the discussions that did not get a satisfactory answer: why was non-tradable inflation forecast to rise while labour costs were not. In theory, it could be explained by non-tradable cost elements other than wages (that is, rents, profits etc.) which respond to aggregate demand pressures in a different way than wages.

The model does not break down the different elements of non-tradable inflation. Rather, it derives its forecast of the non-tradable inflation rate from a suite of output gap and inflation expectations indicators. This may well be a wise modelling choice because it keeps the model simple. Nevertheless, alternative approaches should be examined because non-tradable inflation is so important. In principle, one cross-check would be to derive the wage forecast from a Phillips curve (using the unemployment rate and a measure of inflation expectations) and then add the non-wage elements of non-tradable inflation. In practice, lack of good and timely data on such non-wage elements might rule out such an approach. In any event, additional analysis of the labour market, and especially the implications of immigration, seems warranted. I saw several insightful RBNZ notes analysing this topic, and it was mentioned in the forecast meeting that there is now greater focus on labour market processes in preparing the projections. This is welcome.

What should go into a good analysis of the labour market? First, it should take a dynamic perspective. The usual static approach (assessing the balance between the supply and the demand for labour) has shortcomings. So the issue might be framed in a dynamic way: does increased migration mean that the elasticity of labour supply has risen? Even if part of the immigration proves temporary or seasonal, this would still mean that non-tradable inflation would not rise as much at cyclical peaks as it has in the past. A second requirement would be to examine how house price inflation (which immigration boosts) affects the price expectations variable that works best in the wage equation. Data on rents might also be telling: I was struck by the observation that marginal rents were rising at 8-10 percent, and wondered whether this was a good predictor of future average rents. If the house price/rent link to expected inflation is strong, then immigration would presumably tend to increase inflation, even if the effect on the elasticity of labour supply suggests the opposite.

Central banks nowadays routinely analyse alternative growth scenarios. Reporting in the *Monetary Policy Statement* two alternative scenarios, one implying higher growth and the other lower growth, and linking each to an alternative path for the OCR was shrewd. Of course, the shocks considered could be larger and there is an infinite number of other shocks. But this device was a good way of communicating that the central bank was not wedded to any specific interest rate path, a message some large central banks find hard to get across. Details of earlier scenarios the RBNZ had published over the past 18 months were included in the November 2016 *Statement* (and footnoted in the February 2017 *Statement*). This helps those who study the RBNZ's policy assessments, and is a good practice for transparency.

Canvassing views

It was very productive to get participants at the next stage (that is, after the key issues presentations had been discussed) to give their assessments. The design of the Harvest Risk Survey was good because it is concise. Distinguishing between the balance of risks and uncertainty is crucial: the balance of risks can change in a way that is positive for GDP growth (e.g., the upward revisions to *Consensus* forecasts for the world economy from late-2016) even when there has been a big increase in uncertainty (e.g. the election of a new Administration in the United States, event risk in Europe). Asking for responses about seven key elements was a good, specific way of bringing to light how the assessments had changed from the previous policy rounds. The two-page summary of this canvass was a good device for an inclusive process.

It is a good idea to get all MPC members to be explicit in their OCR advice. Asking for their distribution of appropriate OCR settings (rather than a single number) is a useful device for quantifying any bias around the central choice.

The publication of the future path of the OCR as a signalling device creates a challenge. On this occasion, the projection of virtually no change (just a ¼ point rise by March 2020) conveyed a plausible message. But it might be very difficult in other circumstances (e.g., if near-term growth is stronger than projected but global uncertainties deepen) when what is needed in the different sub-periods of the next two to three years differs.

4 Communication

I observed the *MPS* press conference and the RBNZ's testimony in front of the FEC in parliament. In both meetings, the questions were reasonable and relevant. Notable was the openness of the Governor and others in providing sensible and informative answers to questions about matters beyond the central bank's strict policy remit (e.g. the new US Administration, protectionism, China). This is a wise strategy. The alternative of dodging such questions (as being beyond the mandate) would leave the impression of a central bank that is too narrowly focused. It also irritates journalists who have to write a story. The message should be that the central bank is very open in assessing everything that can impact economic and financial prospects, doing so in a non-political way.

A similar reasoning applies to journalists' questions on the financial system, rather than on monetary policy strictly defined. One journalist asked "Have you done enough to make the financial system stronger?" Sometimes central bankers reply, "We will be exploring that question when we present our *Financial Stability Report*." The reply the journalist got (we can't fix the housing problem, the macro-prudential measures introduced have been very successful and the CEOs of banks now recognise that higher LVRs have given them stronger balance sheets) and the subsequent remarks on RBNZ's proposals to add debt-to-income ratios to the macroprudential toolkit were effective.

Further clarification on the forecast and other matters at the press conference by the Assistant Governor was valuable in underlining all the analysis that had gone into the policy decision. All in all, the journalists got a lot of information, explanations of the central bank's reasoning, indications of the inevitable uncertainties and so on.

Over the next few years, the "new normal" for monetary policy will provide a growing operational and communication challenge for central banks (mentioned above in the Research agenda section). Some flavour of this came up at the FEC: one member asked whether it was going to be more difficult to make the call to increase interest rates given high levels of debt. Higher levels of debt, increased stocks of financial assets and a bigger, more diversified financial system are likely to change how monetary policy works.

5 Conclusion

The main conclusion is that the monetary policy process at the Reserve Bank of New Zealand works well. This is hardly a surprise given the RBNZ's distinction as a pioneer in much of modern central banking (e.g. the inflation-targeting framework, the careful attention given to an accountability regime for the central bank that actually works) and given its high standing today among its central banking peers.

The whole forecast round has been engineered to bring to bear a full range of economic analyses and to ensure an open and comprehensive debate. I have tried to explain what I saw as the many elements of these efficient processes – the model, the identification of key issues, the open spirit of debate, getting participants to summarise their views and their advice in writing, the supplementary inputs of the external advisers and so on. The failures of some major central banks, especially before the Global Financial Crisis, only underline how important an open, enquiring and tolerant working culture is for the governance of a central bank.

In summary, I would identify two topics as priorities for further work. Both are on the radar screens of RBNZ economists. The first is what the changing labour market under heavy immigration means for non-tradable inflation. The second is what the "new normal" for monetary policy after years of very low interest rates means for future monetary policy. The impact of interest rate increases on the financial industry and on the real economy may be quite different than in the past.

A final remark, in conclusion. Results over the past few years speak for themselves. The RBNZ has helped steer its economy through several large external shocks. Because it has done so without becoming trapped at a zero policy rate and without multiplying the size of its balance sheet by buying domestic assets, it has retained more room to pursue, if needed, a more expansionary monetary policy than is available at present to many central banks of other advanced economies.