Submission to the Finance and Expenditure Committee

on

Reserve Bank of New Zealand Bill

by Michael Reddell

Thank you for the opportunity to submit on the Reserve Bank of New Zealand Bill.

I worked at the Reserve Bank for many years (1983-2015) including a couple of decades on the Governor's OCR Advisory Group, many years on the key internal financial stability and regulatory committees, and three years as Head of Financial Markets. I have written extensively about Reserve Bank reform issues, in recent years mostly on my blog www.croakingcassandra.com.

Notwithstanding the government's (unfortunate) decision to keep all the current functions of the Reserve Bank in a single institution, there are some worthwhile reforms in this bill. In particular, I strongly welcome the fact that this bill, if passed, will complete the removal of the single decisionmaker conception from New Zealand's central banking legislation. The first step in that direction was taken with the establishment by statute of the Monetary Policy Committee. The 1989 model was quite out of line both with the models used in other central banks and financial regulatory agencies and with those used in other New Zealand policy-setting agencies (including the Cabinet itself). I also welcome the formal role being given to The Treasury in monitoring the Reserve Bank and supporting the Minister in his/her role of holding the Bank to account.

In this submission I wish to focus on two areas that I see as problematic and quite likely to lead to problems in coming years:

- The quite different governance models proposed for two important and complex, policy functions housed in the same institution,
- The key role the new Board will play in appointing the Governor and MPC members.

Governance models

The Bank has two prime functions.

The first is the conduct of monetary policy, which is primarily the responsibility of the Monetary Policy Committee (MPC). The MPC operates under a Remit set by the Minister, outlining more specifically the goals for monetary policy. The Governor chairs the MPC, and although the remaining members (three internal, three external) are appointed by the Minister on the recommendation of the Board, the Governor himself has a great deal of say in those appointments, especially those of the internal members, whom the Governor appoints, remunerates, and allocates resources to (in respect of their line management functions). That influence will be further strengthened under this bill because (rightly) the Deputy Governor will no longer be a statutory role.

The second main function is financial supervision and regulation, oversight of the financial system as a whole and prudential regulation of banks, deposit-takers, and insurance companies. The Bank has extensive discretionary policymaking powers, especially as regards banks (the largest, by far, financial institutions in New Zealand). This discretion exists not just as regards the application of clear policy to a specific institution's circumstances, but as regards policy itself (notable recent examples in New Zealand have been around loan to value limits, and bank capital requirements).

This bill provides for a new Financial Policy Remit. There is probably some merit in this innovation, although only time will tell (since we have not seen what such a Remit will look like or operate). However, members should not be deceived by the use of the term of "Remit" for both monetary policy and financial regulatory functions. The monetary policy remit is more or less binding on the MPC, clearly setting out a fairly widely-agreed target that is not too dissimilar to targets in a range of other advanced countries. By contrast, section 201 makes clear that the financial policy remit is to be no more than the identification of things the Minister considers it desirable for the Bank to have regard to. In other words, a huge amount of discretionary policymaking power is to be left with the Bank, in areas where there is no generally agreed right or wrong approach and thus little effective basis for holding the Bank to account for its exercise of those powers. In the literature, notably for example former Bank of England Deputy Governor Sir Paul Tucker's book *Unelected Power*, this lack of clarity (an unavoidable lack given our current state of knowledge) would be an argument for putting **less** policy-setting power in the hands of unelected officials, leaving contested policy choices to the Minister of Finance, working with expert advice from (in this case) The Treasury and the Reserve Bank.

What is striking, however, is the quite different governance model chosen for the Bank's financial regulatory functions. The powers of the Bank in this (and most other) areas will, in future, be vested in the Bank's Board, and neither the Governor nor any other staff will be members of the Board. There may be some merits in a governance model of that sort for some sorts of agencies. In many Crown entities the chief executive is simply an employee of the Board. That is, as I understand it, the situation at the Financial Markets Authority (albeit an agency that does not have extensive policymaking, as distinct from implementation, powers). But it seems strangely anomalous to have two quite different governance models for two different, both prominent and complex, policy functions operating in the same institution. And if there was a case for giving the chief executive (and fulltime experts) a stronger role in one or other of these functions, one might suppose it would be in the financial regulatory and policy side, where there is much greater ambiguity and uncertainty.

It also seems anomalous that the monetary policy provisions have been written to make clear that the Governor is the key figure, including the prime public representative. By contrast, for financial regulatory matters there will be a separate chair of a Board the Governor is not even a member of, and the Governor is at most an adviser to, and spokesman for, the Board. While it is not unknown to have monetary policy and financial regulation done by different committees in the same institution (eg the UK) I'm not aware of any country that has chosen to create such gaping differences in the roles/powers of the Governor across those functions. In one - the smaller (although more prominent) side of the Bank in future - he will be "kingpin"; in the other the Governor will have a diminished role that will only become clear with time.

Perhaps it might be a more pardonable outcome if the model has grown like topsy over a long period of times, but the two stages to the institutional reform of the Reserve Bank of New Zealand have been done as part of one process and by a single Minister of Finance. It is not too late to step back and introduce greater alignment across the governance models used for the Bank's two main functions. Or to reserve more of the financial regulatory policymaking power to the Minister of Finance.

Appointment of Governor and MPC members

Since 1989 the Governor has been appointed by the Minister of Finance, who may only appoint someone recommended by the Bank's Board. That in itself is a highly unusual model internationally. It is much more normal for the Minister of Finance (or the executive collectively) to be able appoint his/her own preferred candidate as Governor (that is, for example, the model in Australia, the UK, and – subject to Senate confirmation - in the US). Much the same model – Minister can appoint only people recommended by the Board - was adopted for the other members of the Monetary Policy Committee in the 2018 amendments.

Whatever the possible merits of that model under the 1989 Act, the situation will be quite different under the provisions of this bill as drafted. Under the 1989 model, the Board itself had few decision-making powers, none on any policy or operational matters, and its role was explicitly primarily about holding the Governor to account, and one of its key functions was the recommendation of the appointment of the Governor. Whatever considerations influenced successive ministers in making Board appointments over the years, it was clear the Board had much the same (monitoring and accountability) responsibilities across all the functions the Bank/Governor were responsible for. That remained more or less so under the 2018 amendments, in respect of the other MPC members.

But under this bill, the primary functions of the Board will in future be the conduct of the affairs of the Bank, other than those of the Monetary Policy Committee. By far the largest of those functions will be financial system oversight and financial institution regulation and supervision (together with associated financial functions such as physical currency, payments systems, and the wholesale securities settlement system). It seems likely that the bulk of the people appointed to the Board will be people with skills and background in and around financial institutions, and perhaps some people with a regulatory/corporate background. That may be quite appropriate for the financial regulatory/oversight functions. But macroeconomics and monetary policy is a quite different sort of role and requires a quite different set of skills, and it isn't obvious that we (or future Ministers) can count on future Boards to have any real expertise in these matters, or any great interest (given that they will be busy doing the stuff the Board has prime responsibility for). And when it comes to the appointment of the Governor in particular, isn't there a serious risk that the Board will be more likely to emphasise skill sets relevant to their functions, those they see the Governor in each week/month, and not the skills necessary for the effective conduct of monetary policy? And even if the Board members are well-motivated around monetary policy, what expertise or ability to judge are they likely to bring to the appointment/recommendation decisions.

I would strongly urge that these provisions be reviewed and amended. In the Bill, Board members are to be appointed by the Minister but he/she will be required to consult with other political parties before making those appointments. Why not, then, adopt, the same model for the appointment of the Governor and the appointment of other MPC members? Doing that would not only make clear that monetary policy is not some secondary function, but would ensure that the Minister (a) has discretion to appoint people he/she is comfortable with (important since only the Minister has electoral accountability), (b) can draw on advice from The Treasury, the government's key adviser on economic policy matters, and (c) adds a layer of reassurance (consultation with other parties) that still keeps tolerably low the risk of raw cronies being appointed to these important roles. An alternative model to political party consultation - one I would prefer, and one used in the UK - is to provide for FEC itself to hold hearings on people being appointed to these before people can take up their appointments. FEC would not have a formal power of veto, but the requirement for public scrutiny and the scope for hard questions also acts as an effective check in helping ensure that good quality candidates are consistently appointed.

4 February 2021