Comments on first-round Reserve Bank MPC Remit review consultation

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1. In its recent document "Supporting New Zealand's economic stability" the Reserve Bank has sought comments on the forthcoming review of the MPC Remit. In this short paper I set out my response to some of the relevant issues, some raised in your document, but others not.

Process

2. The idea, now embedded in legislation, of a periodic review of the Remit, with public input, is welcome. The process appears to have been inspired by the Canadian model (an example one of your staff highlighted in a recent online consultation session I attended). However, in reading your document the contrast with the Canadian process is striking and stark, and not in the Reserve Bank of New Zealand's favour. As you will be aware, the Bank of Canada typically undertakes and publishes a lot of fresh research as part of their quinquennial review process[1]. By contrast, there is no new research reported in your consultation document, and more generally very little Reserve Bank formal research has been published in recent years.

3. Perhaps as disconcerting is that you are consulting on the future of the Remit but are offering no serious or sustained review of the experience of monetary policy (under the current Remit) over the last 2.5 turbulent years in particular. When I asked about this at the consultation session, I was advised that the Bank has such a review underway but that it was not able to commit to it being available before the next (and final) round of public consultation. As the Covid years have revealed that the Bank (a) was seriously underprepared (as regards negative interest rates), (b) has cost the taxpayer a fortune (current estimate about $8bn) when monetary policy should at worst not result in any losses to the taxpayer[2] (as it has not in all previous post-liberalisation decades) and (c) we have ended up with inflation (headline and core) well outside the target range, it seems curious to be launching a review of the Remit without first engaging in serious reflection and self-scrutiny about the handling of monetary policy under the current Remit. Perhaps such analysis would persuasively conclude that the formulation of the Remit did not really affect the poor outcomes (and my own stance is to be sympathetic to such a view), but not to have done the review (and opened it for scrutiny and challenge) seems to result in the cart being put before the horse. It also raises doubts about just how serious the Remit review, and particularly the consultation process, actually is.

4. Finally, on process matters, I note that this document is a Bank staff effort. It is one of the strange features of the new legislation that the MPC is responsible for the formulation and implementation of monetary policy, working to the policy targets set out in the Remit, but that staff (the internal majority on the MPC) provide the bulk of the advice to the Minister

[1] Toward 2021: Research - Bank of Canada

[2] Monopoly control over the supply/price of base money provides all the financial leverage a central bank needs, and only rank careless or undisciplined risk-taking should then be delivering financial losses from the conduct of monetary policy in a floating exchange rate system.

on the formulation of the Remit itself. I am aware that the legislation requires that the MPC be consulted before the Bank provides its final advice to the Minister, but that stage in the process seems to come only well after the public consultation phase. That might be less bothersome if we were aware of how the external MPC members themselves viewed the handling of monetary policy during the time the Committee has been in existence, but we have heard not a word from them. It simply isn't a satisfactory process, at least if the Review is intended as anything more than just a marketing exercise.

Substance

5. I have several changes I would like to see flowing from the current Remit review. I will address them in ascending order of significance.

6. The section headed "The Government's economic objective" should be removed from the Remit altogether. Text along these lines began creeping into Policy Targets Agreements a couple of decades ago, as a cheap piece of advertising for the government of the day and, in some sense, encouraging buy-in from the government of the day (in the days when Policy Targets Agreements were agreements between Governor and Minister rather than, as now (and sensibly) an instruction/mandate issued to the Bank by the Minister). The text adds no substantive value, nothing of the sort is envisaged in the legislation[3], and at the margin it distracts from the focus on what the Monetary Policy Committee can and can't do. Monetary policy can stabilise the price level or rate of inflation (or, more or less, any one nominal variable) and at times they can make some useful short-term stabilising difference to output and employment. They can make no sustained or useful difference to anything else, no matter how worthy the "anything else" might be in its own right. Moreover, the inclusion of the "government's economic objective" section, with its inevitable partisan tinges, continues to encourage a mentality that the Remit should be altered whenever there is a new government.

7. In a similar vein it would be preferable to remove the current section 2(3) of the Remit, which describes the current government's objectives regarding house prices. It is one thing to ask the Bank/MPC to assess and report on the impact of monetary policy choices on house prices (or tomato prices or any other relative price that takes the government's fancy) but a description of a government housing policy objective has no place in a monetary policy Remit. At best, monetary policy can influence aggregate nominal house prices. In principle, aggregate nominal house prices could be added to the objective set for monetary policy (although it would be deeply foolish to do so). But monetary policy cannot sensibly be expected to have any sustained or systematic impact on, for example, the mix between investor, first home and other purchasers. And including the text in the Remit - empty as it largely is - again risks distracting the focus of the Bank from what monetary policy can do and should be doing.

8. While staff may not consider this an issue that should be covered by the Remit review, the composition of the Monetary Policy Committee should affect the ability of the committee to run monetary policy to deliver on the mandate Parliament and the Minister have given them. It is extraordinary, and frankly shameful, that the Governor, the chair of the Board

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[3] Which does, however, now include a wider (but brief) purpose statement.

and the Minister got together to rule out as possible external MPC member anyone with current or likely future expertise in macroeconomics or monetary policy. That blackball was restated by the Minister of Finance earlier this year. I am not one of those who believes that an MPC should be stuffed full of academic monetary or macro economists, but I am not aware of any other country where that sort of background is treated as automatically disqualifying someone from appointment to a Monetary Policy Committee. The blackball is all the more troubling at present, when the internal executive members of the MPC are, to put it politely, light on the mix of experience and expertise that one would normally hope to see. A rather more expert set of external MPC members - each with a cast of mind disposed towards challenge, scrutiny, debate etc - would be more likely to act as a check on management, both around the Committee table, and in advice such as that on the future of the Remit.

9. The broad structure of the Remit (a CPI inflation focus, explicit focus on the midpoint, and recognition that there will be price shocks that should generally be "looked through" by monetary policy) seems appropriate. I would not favour material changes. As your document notes, there are real dangers in trying to be too prescriptive in a Remit type of document, and any apparent gains in accountability from being more prescriptive about the target would be unlikely to prove real or durable. I would prefer to focus on improving scrutiny and accountability via much greater transparency - both of relevant staff documents, and of the views, votes and analysis of individual MPC members (I will have some specific suggestions when, as you suggest, you invite comments on the MPC Charter).

10. A major gap in the consultation document was is that fixing the effective lower bound issue was not dealt with at all. The document appears to treat the lower bound as some state of nature constant that just has to be worked around, even as you complacently talk up the potency of alternative (non-OCR) tools - which have been of questionable efficacy and (observably) very high risk to the taxpayer. We were in many respects fortunate that the last downturn (in 2020) proved not to be primarily an adverse demand shock. But we know from New Zealand and overseas experience that in typical recessions (which 2020 was not) movements in policy rates of 500 basis points or more have often been required to do the macro-stabilisation job effectively. The Reserve Bank cut by 575 basis points in 2008/09 and even then struggled to get core inflation up to around the target midpoint.

11. Even if one was more convinced by the evidence for the effectiveness of QE than I am, not even the (undocumented) claims the Bank has made for effects of New Zealand's LSAP programme offer the prospect of reliable monetary stimulus to the extent of 500 basis points on the OCR[4]. And despite the current rise in nominal policy rates, we cannot count on the neutral rate having risen sustainably above the sorts of levels that seemed to prevail just prior to Covid (perhaps 1.5 to 2 per cent on the OCR in New Zealand). We remain very exposed in the next serious downturn, against a backdrop in which there may be less willingness to use fiscal policy, and at least some unease about the LSAP losses you have imposed on taxpayers in the last couple of years. A serious review would be focused on getting more (considerably more) conventional monetary policy leeway. Doing so is not technically challenging, but the issue is barely touched on in your document. Fixing the

[4] Especially given the way the New Zealand transmission mechanism works, in which any role for long-term government bond rates is much much smaller than in, for example, the United States.

lower bound issue properly would also increase confidence in the resilience of whatever inflation target is chosen for the future.

12. However, I think it is time for a more serious assessment of the case for a lower inflation target, perhaps a 0 to 2 per cent per annum target (as was in place from 1990 until 1996), centred a little above zero to allow for modest upside bias inherent in the construction of the CPI. It has always been a stretch to describe a target centred on 2 per cent annual inflation as "stability in the general level of prices": a 1 per cent midpoint would come much closer. And we know that inflation interacts with a nominal tax system in a way that produces undesirable and quite avoidable distortions. It was surprising, and perhaps revealing, that in your Table 6:1 the reduction or elimination of these distortions was not even shown as an advantage of a lower target midpoint[5].

13. While I would favour a lower inflation target, the Bank does not seem to have made an adequate case for what appears to be your favoured option, the status quo. In particular, you have not addressed at all - let alone presented any research insights - on why, given the effective lower bound, a target centred on 2 per cent made sense when we thought a neutral nominal OCR was perhaps 6 per cent (20 years ago) still makes sense now, when neutral is clearly currently so much lower. If you had dealt effectively with the lower bound issue, the question would not arise, but neither you nor your peers abroad have yet done so. But if you were to conclude that nothing further can usefully be done around the effective lower bound at present[6], then I think you need to look harder at the case for raising the inflation target (in the way that various prominent overseas economists have recommended). In designing instruments and targets, the next serious recession should always be presumed not to be far away.

14. To be clear, I favour fixing the lower bound issue (promptly - central banks have already had more than a decade or warning and have done little or nothing) and lowering the target (band and midpoint) a little. But simply counting on bond purchases or rhetorical handwaving (including so-called "forward guidance") to offset the limitations on the OCR that the effective lower bound imposes seems both cavalier and unwarranted. At very least, further analysis and research should be a priority as part of the current review.

[5] That said, I remain quite mystified what point you were making in your second advantage of a lower target ("Reduces out-of-sync price shifts")

[6] I cannot quite imagine how you could, but it is true that other central banks have done nothing so far.