Comments on second round of Reserve Bank MPC remit review consultation

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1. These comments should be read together with my submission on the first round consultation document (which you will have, but which is also available here [comments-on-first-round-mpc-remit-review.pdf (wordpress.com)]). My comments are organised broadly in the order of the issues raised and questions posed in your paper.

2. I strongly support the retention of inflation targeting (and prime focus on CPI-based measures) as the basis for the formulation and implementation of monetary policy. There are arguments for a different targeting basis (whether nominal GDP or nominal wages) but the transitional costs would be substantial and any practical gains likely to be minimal in most circumstances. There are also arguments in some quarters for models which provide more discretion to the Reserve Bank and MPC, but since the quid pro quo for more discretion is, almost inevitably, less effective accountability and the last couple of years have provided a good example of how little effective accountability there often is in the current system I would strongly oppose any such shift. Citizens cannot assume that officials will consistently and capably act in the public interest, and the extent of the delegated authority already provided to the Bank, and the damage it can do (and has done recently) highlights the importance of keeping accountability in focus (without pushing towards mechanical approaches which prioritise accountability over substance).

3. Consistent with the emphasis in the previous paragraph I support

    a. Retaining the current width of the target band,
    b. Retaining both the explicit midpoint focus and the explicit target range (they serve two different purposes),
    c. Retaining the "medium term" horizon, although perhaps with the addition of a specific requirement on the MPC to outline from time to time how it sees the "medium term" in practice (e.g. it might state that it expects to forecast that inflation 2 years ahead will routinely be very close to the target midpoint, and adjust policy to underpin such forecasts).

4. Consistent with past submissions, including at the time the legislation was going through Parliament, I see the fundamental purpose of active discretionary monetary policy as being to do what it can to stabilise output and unemployment (the latter in particular), subject to keeping core inflation in check. However, given that this review is working within the confines of the current act, and given the public and political pressures and sensitivities that have arisen through the last couple of years, there could be merit in clarifying in the Remit that medium price stability is the overriding goal and constraint, and that any trade-offs between the two limbs are only short-term in nature.

5. I do not favour the retention of a 2 per cent target midpoint, although would prefer the status quo to any suggestion of raising the target. My comments on this point in my submission as part of the first round of consultation stand. There is no credible way that a

target centred on debasing the value of the currency by 2 per cent per annum can be considered as price stability (such a rate of inflation over the 33 years of New Zealand inflation targeting would have almost halved the value of the currency) and there is no good reason why we should settle for such targeted changes in one of society's principal measures (we don't do for example with weights or lengths or temperatures). The main obstacle to a lower target, something centred on "true zero", appears to be the failure of central banks, including the RBNZ to deal effectively with the near-zero current effective lower bound on nominal interest rates, a bound that itself only exists now because of the choices of central banks and their political masters, against a backdrop of steadily improving payments technologies.

6. Central banks' revealed reluctance to do anything about removing, or greatly alleviating the binding nature of, the effective lower bound, is puzzling, and the Reserve Bank of New Zealand has made no satisfactory case. Even if - as you appear to - one were to be persuaded of the merits of instruments like the LSAP or FLP, few serious observers regard such tools as fully effective substitutes for the ability to adjust the policy rate directly (including because policy rate changes do not expose taxpayers to the huge fiscal risks programmes like the LSAP entailed). Moreover, there is a danger now of fighting the last war - focusing on the recent outbreak of high core inflation - and not to focus sufficiently on the risks around the next demand-led recession which will tax monetary policy capacity in a way that Covid did not.

7. In practical terms, I would favour an explicit statement in the next Remit that it is expected that the target will be reduced to 0-2 per cent inflation over the next few years and explicitly requiring the Bank and the MPC to take steps (including recommending any necessary supporting legislative fixes) to ensure that the effective lower bound was removed or greatly alleviated by the end of 2024.

8. Finally on this topic, I was disconcerted to read paragraph 51 of the consultation document, in which it is suggested that there is some substantive economic merit in having a very similar inflation target to that in other countries. Such claims recall half-baked arguments about focusing on the inflation rates of our "trading partners" that were being made when inflation targeting was first being developed in New Zealand, and have no apparent macroeconomic merit. The arguments in that paragraph seem particularly threadbare, and there is no serious case to be made that aiming at an inflation rate the same of those of some other countries - and note that New Zealand's has always been below that in the economy we have the tightest links to, Australia – will assist in achieving price stability (especially when the current inflation target itself is barely consistent with medium-term price stability).

9. In terms of the "additional considerations" for the Remit, I

    a. Agree that the clause relating to house price sustainability should be removed (and should never have been inserted),
    b. Would favour the complete removal of the financial system provision (it never having been clear that here or in the Act it had any real substance that aided decision-making or accountability, and

c. Favour the complete removal of the "unnecessary instability" clause. It does relatively little harm, but muddies the water and as you will be well aware over 24 years now it has never been clear to anyone (in the Bank or holding it to account) what the words really meant and what policy implications, if any, they should have.

10. I am fairly strongly opposed to the removal of the "transitory effects" clause, and if anything would favour a return to a somewhat more expansive, if inevitably illustrative approach, of the sort adopted in many successive Policy Targets Agreements. Removing the clause will unbalance the document, and weaken the MPC's hand in conducting policy as it should. A clause of this sort is an important balance to the (inevitably somewhat imprecise) "medium term" phrasing of the primary objective itself.

11. Contrary to the consultation document's proposal, I consider that it would be highly desirable to include some explicit material in the Remit regarding the governance of alternative instruments, and particularly those (unlike say the FLP) that expose taxpayers to considerable financial risk. The Remit is the central document for monetary policy targeting and around which accountability is supposed to focus, but it and its predecessors have a structure designed for an era in which short-term policy rate adjustments (or, pre-99, counterpart quantities) were the primary, and low risk, instruments. As the material in the document notes - and it is one of the flaws in the new legislative model - there are anomalies in which the MPC and the Board both have responsibilities in this area, but that is not an adequate reason to simply ignore the issues in the Remit document (especially as the Board itself is subject to much weaker accountability and transparency provisions than the MPC). I do not have a specific formulation to suggest, but would lean towards a model that required the MPC to outline in a timely and full way the risk analysis undertaken before alternative instruments were deployed and a requirement to report regularly and routinely on the extent of the financial risks and any financial gains/losses.

12. I do not favour (but also do not feel particularly strongly about) text on monetary and fiscal policy coordination, for various reasons including those you outline in the document.

13. I have written extensively on issues around the MPC composition, charter, and communications, and do not propose to repeat all that material at vast length here. However, in brief:

14. You ask whether I have views on "the decision-making model the Charter should be based on, or wider changes the MPC could make to improve its decision-making". The short answer is yes. The key change that should be made is to move away from the current Governor-dominated system, which has proved particularly problematic when the first Governor under the new system is both a very strong personality but also one without evident leading expertise in monetary policy or matters macroeconomic. In general, with such a heavy focus now on the Bank's prudential regulatory responsibilities (and with a Board more focused there) there is no guarantee that any future Governor will be primarily an expert in matters directly relevant to monetary policy.

15. Within the confines of the current legislation (which should be amended) a significant first step would be to remove the current policy barring anyone from consideration as an external MPC who has ongoing or likely future research or analytical focus on monetary

policy and macroeconomic issues. This has proved particularly problematic as the quality of the internal MPC members has deteriorated - and thus we have one senior figure with no subject expertise or background at all – but would be a serious flaw in the system (and unknown in any other central bank now) even with a very strong bench of internals. The current restriction biases appointments towards people at or very near retirement, and while many such people may be quite able, they are not the only ones likely to be able to bring expertise or insight to the MPC process. Moreover, such people may be more likely to be willing to simply go along with management, since the MPC appointment may well be their last significant role.

16. Perhaps as importantly, there should be a shift to a model in which each MPC member is required to register a vote on each monetary policy decision, and where that vote (and a summary of reasons for it) is published as part of the minutes. At present, it is impossible for any outsider to have any basis for confidence that external MPC members are adding any value at all, and there is no accountability for those individuals (especially as the externals are outnumbered by management MPC members, all of whom work for the Governor). We have come through a period of the worst monetary policy failure in decades and it appears that no MPC member ever thought there were sufficient problems to put on record a dissenting view. In any functioning group of able and energetic people that simply should not have been possible, and suggests that one or both of the following has happened: a poor quality of people have been appointed, and/or the people appointed have not felt the necessity of or freedom to marking out distinctive positions and adequately identifying emerging risks/threats.

17. The current system has put a strong emphasis on the idea that MPC members should form a consensus view. Monetary policy decisions - characterised by a huge amount of inevitable uncertainty at the best of times, revisited frequently - are not ones that naturally cry out for consensual decision-making. Instead, with respect for one another at an individual level, what we need is evidence of clear contest of ideas, and a ready openness to the possibility of being wrong, all combined with some serious accountability.

18. As your document notes, the current Charter allows non-executive MPC members to make speeches etc. In fact, of course, there have been none, and we (and Parliament's FEC) have hardly ever heard from any of the external MPC members (and have heard almost as little on monetary policy issues from some of the internals). The rare occasions when external MPC members have been heard from - e.g. the recent questions Peter Harris answered – have not been to the credit of the institution or the individuals concerned. Better outcomes could no doubt be achieved within the current Charter wording, but a superior route would be to amend the Charter to explicitly articulate an expectation that MPC members (internal and external) will be giving serious on-the-record speeches and interviews, and that they will be encouraged to lay out and articulate the thinking, analysis, and evidence they are each using to shape their views. The contest of ideas, and serious scrutiny of the arguments MPC members are making, should lift both the quality of the MPC's own deliberations (including making it less Governor dominated) and outside confidence in the systems and processes (reducing risks of groupthink and free-riding). It is a system that works well in the US and UK, even if it is no guarantee of better policy outcomes. (Consistent with this sort of expectation I would favour making available to external MPC members a small amount of independent research assistance).