Submission by

GROWING PROSPERITY AND POTENTIAL

to the

Finance and Expenditure Select Committee

on the

Reserve Bank of New Zealand (Monetary Policy) Amendment Bill

September 2018

SUBMISSION BY BUSINESSNZ[1] ON THE RESERVE BANK OF NEW ZEALAND (MONETARY POLICY) AMENDMENT BILL

1.0 INTRODUCTION

1.1 BusinessNZ welcomes the opportunity to submit on the Reserve Bank of New Zealand (Monetary Policy) Amendment Bill (the "Bill").

1.2 The Bill has two main objectives, namely, to:

1. Amend current monetary policy objectives to require consideration of maximum sustainable employment alongside price stability in monetary policy decision making; and
2. Institute a monetary policy committee (MPC) to make decisions on monetary policy.

1.3 BusinessNZ has been a strong advocate over many years of the 1989 Reserve Bank Act's overriding objective of price stability and independent decision-making, with responsibility for monetary policy decisions resting with the Governor of the Reserve Bank.

1.4 Notwithstanding the above, we are reasonably comfortable with proposals to move towards a monetary policy committee (MPC), although some of our members may have specific comments on the MPC which BusinessNZ would commend to the Select Committee. There are some risks in moving towards a committee structure.

1.5 This submission focuses principally on the proposed dual mandate (i.e. objective 1, outlined above).

1.6 A number of reviews of the Reserve Bank Act, including the latest Independent Expert Advisory Panel to the Minister of Finance (March 2018), have found that the Reserve Bank has served NZ well over the years. Indeed, a number of papers have upheld the independence of the Reserve Bank and its clear focus on price stability as being in line with world best practice.

1.7 Over the last 3-3 decades, New Zealand has been upheld around the world as having developed world class fiscal and monetary policy settings. These include the Reserve Bank Act's independent monetary policy and the country's

[1] Background information on BusinessNZ is included as Appendix 1.

fiscal policy, as espoused by the Fiscal Responsibility Act (now superseded by the Public Finance Act). Successive governments have, over the years, largely endorsed both these essential pillars of NZ's economic policy, with only minor tweaks here and there.

1.8 BusinessNZ is concerned the addition of a "maximum sustainable employment" objective alongside the price stability objective has the potential to muddy the waters with regard to what monetary policy can actually achieve. Employment outcomes are the result of many factors; beyond the very short-term, monetary policy settings are unlikely to impact materially on employment.

1.8 This submission is in two sections. Section 1 is a general discussion of monetary policy. Section 2 provides specific comments on, and recommended amendments to, the proposed Bill.

RECOMMENDATIONS

BusinessNZ **recommends** that:

the Bill not proceed.

Notwithstanding the above recommendation, if the Bill proceeds then:

BusinessNZ **recommends** that:

Clause 4:

The wording of new section (1A)(a) be amended to read: "The economic objective is to achieve and maintain stability in the general level of prices over the medium-term, while supporting maximum sustainable employment", and new paragraph (b) be deleted.

BusinessNZ **recommends** that:

Clause 8:

New section 10 (Remit for MPC) be amended by omitting the current operational objectives and having the MPC remit address the policy targets set out in section 9 of the 1989 Act, including that targets are to be agreed between the Minister and the MPC.

2.0 SECTION 1: GENERAL DISCUSSION ON MONETARY POLICY

2.1 The question of whether New Zealand's monetary policy, with and its focus on achieving and maintaining price stability, is appropriate or not has been raised numerous times and indeed has been the focus of various reports over the years.

2.2 The last two decades have seen a number of reviews and discussion papers on monetary policy as specifically related to New Zealand.

2.3 Some key reviews were:

- *Independent Review of the Operation of Monetary Policy in NZ: Report to the Minister of Finance* (The Svensson Report - February 2001)
- *Testing stabilisation policy limits in a small open economy:* the proceedings from a macroeconomic policy forum (Reserve Bank of NZ, October 2006).
- *Inquiry into the future monetary policy framework* (Report of the Finance and Expenditure Committee, September 2008)

Independent Review of the Operation of Monetary Policy in NZ: Report to the Minister of Finance (February 2001)

2.4 In May 2000, the Minister of Finance invited Lars Svensson, an international expert on monetary policy from the Institute for International Economic Studies, Stockholm University, to review the operation of monetary policy in New Zealand. Terms of Reference were provided.

2.5 The Svensson report (February 2001) found with regard to the operational framework and management of monetary policy in pursuit of New Zealand's inflation target that *"….monetary policy in New Zealand is currently entirely consistent with the best international practice of flexible inflation targeting, with a medium-term inflation target that avoids unnecessary variability in output, interest rates and the exchange rate."*

Testing stabilisation policy limits in a small open economy: the proceedings from a macroeconomic policy forum (Reserve Bank of NZ, October 2006).

2.6 In early 2006, at the request of the Reserve Bank and the Treasury, four international academic experts and practitioners in macro-economic policy visited New Zealand. Their brief was to examine the country's macro-economic policy framework critically and consider whether alternative, possibly non-conventional, policy tools might be used to provide a smoother ride for the externally exposed sectors of the economy over the business cycle.

2.7 The report stated that:

"The overall conclusion that emerged is that the essential elements of New Zealand's macroeconomic policy framework are still fundamentally sound and remain appropriate. Furthermore, some fluctuations in the current account and some volatility in the exchange-rate and other relative prices are to be expected and are an important part of the process of adjustment to changing international and domestic events. Nevertheless, several suggestions to improve the way structural, fiscal and monetary policies interacted and impacted on the economy were raised and debated…"

In other words, although there was debate about possible changes that might be made, ultimately there was general agreement about the soundness of New Zealand's monetary policy.

Inquiry into the future monetary policy framework (Report of the Finance and Expenditure Committee, September 2008)

2.8 In 2007, the Finance and Expenditure Committee conducted an inquiry into New Zealand's future monetary policy framework.

2.9 The Committee's terms of reference covered a range of areas including, amongst others: the causes of inflationary pressures, the effectiveness of current monetary policy in controlling inflation, the interaction of monetary policy and fiscal policy, and productivity issues.

2.10 The report was presented to the House of Representatives in September 2008 and made a number of findings:

- The importance of maintaining price stability as a vital component of a healthy and well performing economy
- Acknowledgement that New Zealand's monetary policy approach, emphasising central bank independence and inflation targeting, is standard among small, open, and developed economies
- Acknowledgement that at times of strong inflation pressures, the cost of maintaining price stability is often borne disproportionately by the export sector
- Acknowledgement that a range of economic factors and resource constraints has contributed to recent inflationary pressures and the speed with which monetary policy has affected inflation outcomes
- Acknowledgement that factors other than monetary policy – such as sustained improvement in trend productivity – play a key role in lessening the adjustments required to maintain low inflation over the medium term

- That the evidence at the present time was not sufficiently compelling to support the pursuit of supplementary stabilisation instruments such as a mortgage interest rate levy, an interest-linked savings scheme, and other taxes that might complement interest rates in managing inflation.

2.11 In summary, none of the above reports found fundamental problems associated with NZ's monetary policy framework, although as mentioned above, some did recommend minor tweaks here and there.

2.12 The current Bill is informed by the Independent Expert Advisory Panel Report to the Minister of Finance (March 2018) while the Bill's explanatory provides possible rationales for the two main objectives.

2.13 BusinessNZ has been a strong advocate for the Reserve Bank Act 1989 and its overriding objective of price stability and independent decision-making with responsibility for monetary policy decisions resting with the Governor of the Reserve Bank. However, we are reasonably comfortable with proposals to move towards a monetary policy committee (MPC).

2.14 As noted in our introductory statement, BusinessNZ remains concerned the introduction of a "maximum sustainable employment", objective alongside price stability objectives, has the potential to muddy the waters as to what monetary policy can actually achieve. Employment outcomes are the result of many factors, and beyond the very short-term, monetary policy settings are unlikely to materially impact on employment.

2.15 The Expert Advisory Panel Report to the Minister of Finance (May 2018) appears at least to acknowledge this fact by stating that:

"Monetary policy is not, however, a primary determinant of the level of full employment, which is largely determined by structural factors such as the level of skills in an economy, the tax system, and labour and product market regulations (para 8, p.10).

2.16 The proposed Bill has been sold to the public on the basis that it does not involve fundamental changes to the Act and/or that a number of other countries have multiple objectives in the setting of monetary policy.

2.17 This begs the question if the Bill's changes will have a strictly limited impact on monetary policy settings why are they needed? Alternatively, if they have significant implications for the setting of monetary policy in NZ, their intended and unintended effects need to be analysed to determine whether they will have any net benefits. More fundamentally, the basic question is: what is it about the current model that is "broke"?

2.18 The current environment, where inflation has been low for a considerable period and unemployment is low (certainly by historical standards), might see the Bill's changes having minimal effect. The danger is how will the MPC react if conditions change significantly.

2.19 For example, if inflationary pressures rise and unemployment increases significantly (commonly termed stagflation), how should the MPC act to ensure businesses and households have a reasonable degree of certainty in what the Reserve Bank is trying to achieve?

2.20 The definition of ""maximum sustainable employment" is also likely to be the subject of vigorous debate. For example, while frictional, cyclical, and structural unemployment are generally reasonably well understood in economic circles, the non-accelerating inflation rate of unemployment (NAIRU) is still subject to significant debate about what "full employment" actually means. Without rigorous definitions of the different types of unemployment and more particularly, of what is meant by "maximum sustainable employment", the MPC's task will inevitably be a moveable feast.

2.21 Moreover, replacing the Policy Targets Agreement (PTA) between the Minister and the Governor of the Reserve Bank with a "remit" could mean greater uncertainty as to how monetary policy decisions are made. The current focus on price stability (keeping annual CPI inflation between 1-3 percent) with the ability of the Reserve Bank to look through short-term impacts on inflation is clear. The Bill gives the Minister a much stronger role in determining operational objectives (see below our specific comments on the Bill).

2.22 The proposed model's associated risks, at a time when the economy is untested, leaves New Zealand vulnerable. And the current system is not broken, as the reviews above indicate.

2.23 The Bill can largely be seen as a solution looking for a problem.

BusinessNZ **recommends** that:

the Bill not proceed.

3.0 SECTION 2: <u>SPECIFIC COMMENTS ON THE BILL</u>

3.1 Notwithstanding the above recommendation, if the Bill proceeds, BusinessNZ advises certain amendments.

3.2 This section could address a number of issues, including how the MPC will be established and will operate, but BusinessNZ's comments focus specifically on the proposal to provide the bank with a dual mandate of price stability and employment objectives.

Part 1
Main amendments

Clause 4: Section 1A amended (Purpose) – p4

3.3 Clause 4 of the Bill, replacing current section 1A with new sections 1 and (1A), changes the purpose of the Reserve Bank of New Zealand Act. The current section 1A(1) reads as follows:

(1) The purpose of this Act is to provide for the Reserve Bank of New Zealand, as the central bank, to be responsible for -
- *(a) formulating and implementing monetary policy designed to promote stability in the general level of prices, while recognising the Crown's right to determine economic policy; and*
- *(b) promoting the maintenance of a sound and efficient financial system; and*
- *(c) carrying out other functions, and exercising powers, specified in this Act.*

3.4 Section 1(A)(1) is to be replaced by the following:

(1) The purpose of this Act is to promote the prosperity and well-being of New Zealanders, and contribute to a sustainable and productive economy, by providing for the Reserve Bank of New Zealand, as the central bank, to be responsible for -
- *(a) formulating and implementing monetary policy directed by the economic objectives set out in subsection (1A), while recognising the Crown's right to determine economic policy; and*
- *(b) promoting the maintenance of a sound and efficient financial system; and*
- *(c) issuing bank notes and coins in New Zealand to meet the needs of the public*

> (d) *carrying out other functions, and exercising powers, specified in this Act.*

A further section (1A)(a) and (b) provides:

> *(1A) The economic objectives are –*
> *(a) achieving and maintaining stability in the general level of prices over the medium term; and*
> *(b) supporting maximum sustainable employment*

3.5 As previously discussed, BusinessNZ has concerns with the dual mandate provided for in new section (1A). This is particularly so as the "(a) and (b)" construction appears to give the two mandates equal weighting despite the Bill's Explanatory Note correctly explaining the limitations of monetary policy for maximising employment. As well, analysis in the Independent Expert Advisory Panel's report to the Minister of Finance on Phase 1 of the Review suggests the overriding focus should remain on price stability BUT with concern over supporting maximum sustainable employment objectives.

3.6 The Independent Expert Panel Report recommended monetary policy be directed towards the monetary policy objectives of "*achieving and maintaining stability in the general level of prices over the medium term, while supporting maximum sustainable employment*."[2]

3.7 If employment is to be included as a monetary policy objective, BusinessNZ would be more comfortable endorsing the Independent Expert Advisory Panel's recommended wording over that of the Bill which implies an equal weighting of the two objectives.

BusinessNZ **recommends** that:

Clause 4:

The wording of new section (1A)(a) be amended to read: "The economic objective is to achieve and maintain stability in the general level of prices over the medium-term, while supporting maximum sustainable employment", and new paragraph (b) deleted.

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[2] *Independent Expert Advisory Panel for Phase 1 of the Review of the Reserve Bank Act*, March 2018 (p.6)

Clause 8: Remit for MPC (p.6)

3.8 New section 10 would establish the "remit" for the MPC. The remit replaces the PTA used since the 1989 Act came into effect. The rationale for the change is that the use of a PTA is not appropriate when monetary policy decision-making is to be made by a committee rather than an individual (the Governor) although BusinessNZ is not convinced that the latter change is necessary.

3.9 Notwithstanding the above, if the Bill simply translated the 1989 Act's wording for policy targets (set out in section 9) into the remit's provisions BusinessNZ would not be unduly concerned. However, the Bill's wording is quite different from the Act's section 9, giving the Minister a much stronger role in determining operational objectives. New section 10(3) will enable the Minister to "specify or provide for the operational objectives **in any way that the Minister thinks fit**" and the Minister will be able to specify or provide for:

(a) a target or targets for an economic objective;
(b) a framework for weighting the economic objectives;
(c) defining any matters in connection with an economic objective; and
(d) a requirement for the MPC to have regard to one or more matters in connection with seeking to achieve an economic objective.

3.10 What will happen if both inflation and unemployment are rising and the Minister decides, for political reasons, the Reserve Bank should emphasise employment maximisation over price stability (as outlined earlier) or if stagflation becomes a reality? We could see the Reserve Bank pressed to undertake overly loose monetary policy thereby driving up inflation. A knee-jerk reaction could then follow aggressively combatting high inflation if the Minister decides price stability should now be the higher priority. Rather than creating stable and well-understood monetary policy positions, the Minister of Finance's new power could (a) undermine the independence of the Reserve Bank and (b), arguably more importantly, result in the boom-bust cycles which, ironically, led to the 1989 Act's introduction.

BusinessNZ **recommends** that:

Clause 8:

New section 10 (Remit for MPC) be amended by omitting the current operational objectives and having the MPC remit address the policy targets set out in section 9 of the 1989 Act, including that targets are to be agreed between the Minister and the MPC.

Appendix One - Background information on BusinessNZ

BusinessNZ

GROWING PROSPERITY AND POTENTIAL

BusinessNZ is New Zealand's largest business advocacy body, representing:

- Regional business groups EMA, Business Central, Canterbury Employers' Chamber of Commerce, and Employers Otago Southland
- Major Companies Group of New Zealand's largest businesses
- Gold Group of medium sized businesses
- Affiliated Industries Group of national industry associations
- ExportNZ representing New Zealand exporting enterprises
- ManufacturingNZ representing New Zealand manufacturing enterprises
- Sustainable Business Council of enterprises leading sustainable business practice
- BusinessNZ Energy Council of enterprises leading sustainable energy production and use
- Buy NZ Made representing producers, retailers and consumers of New Zealand-made goods

BusinessNZ is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.
In addition to advocacy and services for enterprise, BusinessNZ contributes to Government, tripartite working parties and international bodies including the International Labour Organisation (ILO), the International Organisation of Employers (IOE) and the Business and Industry Advisory Council (BIAC) to the Organisation for Economic Cooperation and Development (OECD).