Submission by

BusinessNZ

GROWING PROSPERITY AND POTENTIAL

to the

Reserve Bank of New Zealand (RBNZ)

on

Supporting New Zealand's Economic Stability

A public consultation on the five-year review of the Remit that guides monetary policy decisions

July 2022

SUBMISSION BY BUSINESSNZ[1] TO THE RESERVE BANK OF NEW ZEALAND ON SUPPORTING NEW ZEALAND'S ECONOMIC STABILITY: A PUBLIC CONSULTATION ON THE FIVE-YEAR REVIEW OF THE REMIT THAT GUIDES MONETARY POLICY DECISIONS

1.0 BACKGROUND

1.1 BusinessNZ welcomes the opportunity to submit on Supporting New Zealand's Economic Stability – A public consultation on the five-year review of the *Remit that* guides monetary policy decisions *("the Consultation Document").*

1.2 BusinessNZ notes that the purpose of the Consultation Document is to get feedback on the *Remit* for monetary policy given the Remit guides the Monetary Policy Committee's (MPC) decision-making on monetary policy and Official Cash Rate (OCR) adjustments.

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

1.4 Notwithstanding the above, the Government decided to introduce a dual mandate, including also, "maximum sustainable employment" (adopted in 2019) despite opposition from a number of parties, including BusinessNZ.

1.5 BusinessNZ in its submission on the Reserve Bank of NZ (Monetary Policy Amendment Bill (September 2018) Bill outlined its concerns about a dual mandate, stating:

> *"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.*

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

The Expert Advisory Panel Report to the Minister of Finance (May 2018) appears at least to acknowledge monetary policy's limitations when it states: *"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).*

BusinessNZ further stated:

> *"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.*
>
> *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?*
>
> *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."*

1.6 BusinessNZ's response to the dual mandate is set out above as many of the issues raised in its September 2018 submission are now coming home to roost. More importantly, the Reserve Bank's role is likely to be even more compromised if the other factors currently proposed are included in the Remit (housing, distributional outcomes, and climate change).

1.7 This in no way implies housing and climate change are not fundamentally major issues affecting NZ and beyond, rather the question is whether the Reserve Bank, with its monetary policy focus, can do anything meaningful about them.

1.8 The obvious danger is that, with so many balls in the air, the Bank will no longer concentrate on monetary policy's prime purpose of ensuring relatively stable price levels over time – and that, unfortunately could reduce New Zealanders' confidence in the independence and predictability of the Bank's monetary policy settings.

1.9 In this respect, BusinessNZ most strongly supports the statement on p.6 of the Consultation document:

> *"The MPC currently takes into account a range of factors other than price stability and MSE through the current Remit. Requiring the MPC to have regard to housing, distributional outcomes or climate change would have uncertain benefits, and could make it more difficult to achieve price stability and support MSE."*

1.10 It is noted that on page 6 the Consultation Document states explicitly that": ***"This review is about the MPC Remit. While we welcome feedback on other relevant matters, we cannot make any changes as part of this Remit review related to:***

> ***the two legislated economic objectives of the MPC of price stability and maximum sustainable employment, which are specified in the Act rather than the Remit."***

2.0 QUESTIONS (P.3 OF THE CONSUTLATION DOCUMENT)

2.1 Given the Consultation Document's clear statement (above) and for the purposes of brevity, the remainder of this submission responds to the twelve questions set out on page 3 of the Document.

Q1. Do you have any comments on our design principles for the *Remit* review or the description of global practice? Are there any other principles that you think would be important for the *Remit* review?

Response

2.2 BusinessNZ is reasonably comfortable with the five design principles outlined in the Consultation Document namely, legitimacy, credibility, achievability, flexibility, clarity and transparency. Notwithstanding, it is noted that at times there will be trade-offs over which of these should take precedence. For example, a flexible approach to economic objectives might not necessarily be consistent with the ability to easily monitor performance against the Remit.

2.3 In this respect, the greater the number of objectives and requirements a Remit places on the Reserve Bank, the more likely will it become increasingly difficult to achieve the Reserve Bank's primary objective of delivering on price stability.

Q2. The current *Remit* sets a target to "keep future annual inflation between 1 and 3 percent over the medium term, with a focus on keeping inflation near the 2 percent midpoint." Do you think this target is about right? If not, what do you suggest that the target range be changed to, and why?

Response

2.4 BusinessNZ generally supports setting the annual inflation rate at between 1 and 3 percent over the medium term, with a focus on staying near the 2 percent midpoint, as in the current Remit.

2.5 A 1 to 3 percent inflation provision has worked reasonably well over recent years and is now generally well understood. It is important for the Reserve Bank to retain credibility by showing it can deliver on price stability within a reasonable timeframe (the medium term).

2.6 In a useful speech delivered to the Reserve Bank of Australia conference on central bank frameworks (12 April 2018), its authors[2] outlined the evolution of monetary policy, particularly since the introduction of the Reserve Bank Act in 1989.

2.7 The paper made the particularly important point that monetary policy's core purpose is to ensure the monetary policy framework established the Reserve Bank's credibility as able to bring inflation down and keep it down. This was particularly important as prior to the Reserve Bank Act 1989, NZ had a very poor track record of price stability, notably in the 1970s and 1980s.

2.8 The paper also outlined in some detail the rationale for the initial 1990 price stability target of 0-2, the subsequent changes in 1996 to 0-3 percent and 1-3 percent in 2002 with a further change in 2012, retaining the 1-3 percent target but with a focus on the 2 percent midpoint.

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[2] *Inflation targeting in New Zealand: an experience in evolution – A speech delivered to the Reserve Bank of Australia conference on central bank frameworks,* Sydney, 12 April 2018, Dr John McDermott, Assistant Governor and Rebecca Williams, Economic Advisor

2.9 These reasons for these changes are not repeated here, suffice to say they reflected changing circumstances, and particularly the need to ensure the Reserve Bank could meet its price stability objective and hence maintain public confidence.

2.10 However, the paper stated in conclusion: *New Zealand's experience with inflation targeting has been one of evolution. The Reserve Bank Act (1989) provided the supports that enabled us to establish credibility in our intent to meet our objective of price stability. As we lowered inflation, and anchored expectations within the target range, we could implement an increasingly flexible approach to monetary policy that has been reflected in successive PTAs. This flexible approach means that we have long had regard to the real economy, including employment."* [3]

2.11 Putting aside for a moment the current global pandemic and high rates of global inflation, over recent years global competition and innovation have enabled the development of better products and services at lower cost. Consequently, the old argument that as demand ratchets up, prices will rise does not now necessarily hold as good as it did in the past. Prices over a wide range of products and services are dropping, both in real and nominal terms, a significant shift away from the traditional assumption that generalised inflation is here to stay. Moreover, consumers have much more choice about where they can source their products, including the fact that on-line shopping has become a very fast and efficient method of obtaining goods and services.

2.12 This would suggest that (putting aside current world events) inflation is currently rising but is likely to return to the very low levels that existed pre-2021/22 over the medium term. Therefore, the current approach (1-3 percent over the medium term with a focus on keeping inflation near the 2 percent mid-point) is still highly appropriate.

2.13 At the present time, any changes to the Remit's price stability objective would send a very dangerous signal to markets (particularly given that for a range a circumstances, some domestic and some international inflation is currently well above the Reserve Bank's target range).

Q3. The *Remit* states that inflation should be measured using the All-Groups Consumer Price Index as published by Statistics New Zealand". What are your views of this measurement approach, and whether alternatives should be considered?

[3] Ibid, p.14

Response

2.14 The CPI is a widely understood concept having been utilised by many businesses and individuals over the years as a sound measure of consumer prices. It is respected and has a long history which should not be tampered with without very good reason.

Q4. Do you have any thoughts on how maximum sustainable employment could be measured reliably, or whether the *Remit* should include reference to the benefits of high employment?

Response

2.15 BusinessNZ expressed its concerns (as indicated above), when the Government contemplated giving the Reserve Bank a dual mandate (price stability and maximum sustainable employment).

2.16 Those concerns notwithstanding, we would again refer to the very helpful comments in the paper previously mentioned noting the sheer impossibility of defining maximum sustainable employment. Focusing on one labour market indicator does not, for example, provide a full picture given underlying employment trends are influenced by a range of factors such as the population's age and skills, the efficiency to which jobs are matched to available work and the nature of employment-related legislation.

> *"Focusing too narrowly on one indicator, such as the unemployment rate, can be misleading. For example, a fall in the unemployment rate could be the result of an increased demand for labour – typically reflecting a strong economy – or the result of people dropping out of the labour force altogether because they are unable to find a job and have become discouraged. These different causes have very different implications for how the labour market is evolving and would therefore have very different implications for monetary policy. Specifying a numerical target for inflation but leaving the employment target as a qualitative objective is consistent with the practice here in Australia and in the United States too. The RBNZ will continue to consider a wide range of labour market indicators when formulating policy, although we will communicate our assessment of, and outlook for, the labour market in more detail than we have in the past. And just as with inflation, our understanding of the labour market can always be improved as we are faced with new data, new developments, and as new research methods become available.*

That said, there are widely recognised limits to what monetary policy can do over the long run. We have some influence over the degree to which the unemployment rate, as just one example, deviates from its underlying trend. But ultimately, that underlying trend is determined by factors outside of our influence that rely, instead, upon the age and skills of the population, the efficiency with which jobs are matched to available workers, and the nature of employment regulation."[4]

Q5. Do you think the *Remit* gives the monetary Policy Committee the right level of guidance to achieve the price stability objective? What changes, if any, should the Reserve Bank focus on?

Response

2.17 BusinessNZ has always been of the view that having multiple (and potentially at times conflicting) objectives of price stability and maximum sustainable employment (however defined) was always going to be problematic. This is likely to be increasingly the case given the potential for rising inflation and lower levels of economic and employment growth.

2.18 When the dual mandate was introduced in 2019, NZ had very low inflation and basically full employment which meant there was little pressure on the Reserve Bank to change the OCR given the relative stability of output and prices.

2.19 Now that pressure is on the Reserve Bank to deliver on price stability (with inflation currently well outside the target range), and to consider "equally" maintaining maximum sustainable employment, it is going to be difficult to know which of the two takes precedence (as outlined above).

2.20 BusinessNZ would like a clear and unambiguous statement with the Remit indicating that achieving and maintaining price stability is the best way the Reserve Bank can support maximum sustainable employment. Nevertheless, it is debatable that this can be achieved under the current framework where there is an explicit requirement to maintain price stability AND maximum sustainable employment. Without a change to the Reserve Bank Act 1989 removing the explicit sustainable employment objective, Remits are likely to remain unclear as to what will take precedence when push comes to shove. In this respect, uncertainty is likely to continue, not helpful for the Bank's public credibility.

[4] Ibid, p.14

Q6. Do you think the *Remit* should include guidance on the weight of the inflation and employment objectives? What changes, if any, should the Reserve Bank focus on?

<u>Response</u>

2.21 Ideally, the emphasis should be on maintaining price stability given price stability maintenance is clearly required of the Bank.

With the Consultation Document stating that any changes to the principal Reserve Bank Act 1989 are effectively off the table, it would be preferable to give greater weight to price stability than to maximum sustainable employment.

2.22 While a compromise (given the constraints mentioned above), it is noted that 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*."[5]

2.23 Despite obvious weaknesses, BusinessNZ would be more comfortable endorsing the Independent Expert Advisory Panel's recommended wording for the Remit rather than the current wording which implies an equal weighting of the two objectives (price stability and maximum sustainable employment).

Q7. Should the *Remit* be changed to aid the MPC's response to future economic downturns? If changes should be made, what options should we focus on?

<u>Response</u>

2.24 It can be argued that the Reserve Bank already has adequate tools for dealing with any potential downturns while continuing to place an overriding emphasis on maintaining price stability.

Q8. Do you have any comments about the current additional considerations included in the *Remit?*

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

Response

2.25 The role of the Reserve Bank is likely to be even more compromised if there is an attempt to include in the Remit the other cited factors (housing, distributional outcomes, and climate change).

2.26 As previously stated, this doesn't imply that housing and climate change are not fundamentally major issues affecting NZ and beyond, but the question is whether, given its monetary policy focus, there is anything meaningful, other than by focusing on monetary policy, the Reserve Bank can do about them.

2.27 BusinessNZ in its latest BusinessNZ Planning Forecast (June 2022) states the danger of adding all sorts of new priorities and considerations:

> *"…the danger from the Reserve Bank having so many balls in the air is that it will no longer concentrate on the prime purpose of monetary policy which is to ensure a relatively stable price level over time. This would be unfortunate and could reduce New Zealanders' confidence in the independence and predictability of the Bank's monetary policy settings. Doing its principal job (maintaining price stability) is probably asking enough of the Reserve Bank. Even then, the Reserve Bank needs mates to help it perform its functions at least in regard to overall costs to the economy. This implies developing sound fiscal and regulatory policies."*

Q9. Do you have any comments about the relevance of house price sustainability for monetary policy?

Response

2.28 It is important that any tools developed are appropriate for dealing with any perceived risks associated with the financial system.

2.29 Yes, runaway housing inflation is obviously an issue that should concern the Reserve Bank, but what, if anything, the Reserve Bank can do about it is another question. Housing affordability has very much to do with overburdensome land supply planning, lack of financial options for funding new infrastructure, and a broad range of regulatory requirements regarding what, and how, something, should be built apart from meeting reasonable building standards and not adversely affecting others in the community.

2.30 As stated above, monetary policy needs mates. In this respect fiscal policy and more particularly regulatory policy have, until recently, been key drivers behind the massive increase in house prices. This is not largely linked to monetary policy settings although to be fair, the Reserve Bank's "no regrets" policy over the past couple of years, resulting in extremely low interest rates, would have contributed to some, but certainly not all, house price rises.

Q10. Do you have any comments on the relevance of distributional effects for monetary policy?

Response

2.31 Arguably the best contribution monetary policy can make to distributional effects is to ensure relative stability in the level of prices over time.

2.32 Extremely loose monetary policy over the past couple of years contributed to significant rises in asset prices which have affected the distribution of wealth between the "haves" and the "have nots". This reinforces the need to focus on the principal objective of price stability as the best contribution monetary policy can make to economic and social well-being.

2.33 To be absolutely clear, there is no role for the Reserve Bank as a contributor to distributional outcomes. It is for central government, through the tax system and social policy initiatives, to target specifically those in need.

Q11. Do you have any comments on the relevance of climate change for monetary policy?

Response

2.34 The Reserve Bank has gone from very much assuming climate change issues have little to do with the overall stability of NZ's financial system, to making significant submissions in respect to climate change. It is difficult to see how the Reserve Bank can act on these issues over which it has little, or no, control. The Reserve Bank has at least come out in the consultation document stating that *"It is not clear that monetary policy can influence climate change or its economic impacts."*

2.35 Notwithstanding the above, NZ potentially faces significant risks from climate change, and on this issue, it is noted the Government recently released papers looking at possible National Adaptation Plans (NAP). NAPs would be used in the future should it prove necessary to address the need for a managed retreat due to potential sea level rises.

2.36 It is acknowledged that early consideration of policies relating to a possible managed retreat from sea encroachment is important, but it is also important, both for regulators and affected property owners, that such policies are based on better data and provide better guidance than they do at present. Responding to the Ministry for the Environment's (MfE) draft NAP for climate change, BusinessNZ, in its recent submission, indicated the need for more data on risk levels. A technical working group should consider, for example, what an appropriate threshold for requiring people to move in response to climate change would be, how to ensure compensation for removal, or for restrictions on land use, and how to incentivise households and businesses to make good, long-term decisions on development (current or future) in risk areas.

2.37 Managed retreat is a very complex issue and with its significant implications for property rights, needs to be carefully thought through.

2.38 The real risk for households, banks and ultimately the Reserve Bank is how regulatory changes would impact on asset prices and potentially housing cost, availability and supply since this could heighten financial risks.

2.39 While the Reserve Bank cannot directly influence house prices over the longer term, it needs to keep a watchful eye on government regulations which potentially could cause asset bubbles or bursts. However, these are largely beyond the control of the Reserve Bank.

Q12. Are there any other issues that the Reserve Bank should consider for inclusion in the additional considerations of the *Remit?*

Response

2.40 No.

Appendix One - Background information on BusinessNZ

BusinessNZ
GROWING PROSPERITY AND POTENTIAL

The BusinessNZ Network is New Zealand's largest business organisation, representing:

- Business groups EMA, Business Central, Canterbury Employers' Chamber of Commerce, and Business South
- BusinessNZ policy and advocacy services
- 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

The BusinessNZ Network 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.

The BusinessNZ Network contributes to Government, tripartite working parties and international bodies including the International Labour Organisation (ILO), the International Organisation of Employers (IOE) and Business at OECD (BIAC).

BusinessNZ Network