

New government, new monetary policy framework

The new Labour-New Zealand First coalition Government has indicated it would review the Reserve Bank Act, with consideration of “full employment” to be added to the central bank’s inflation target when setting monetary policy. Monetary policy has been extraordinarily loose in the major economies in the wake of the Global Financial Crisis (GFC). Despite that, growth and inflation in the major economies have been slow to pick up. In contrast, asset prices have surged, and household debt levels have expanded rapidly. This divergence between subdued general consumer price inflation and accelerating asset price inflation has raised questions about whether the current monetary policy framework, both abroad and here in New Zealand, is fit for purpose.

Change is on the cards

The new Labour-New Zealand First coalition Government has put the spotlight on the Reserve Bank of New Zealand (RBNZ), with the announcement that the Reserve Bank Act will be reviewed and reformed. The review provides a welcome opportunity to make sure New Zealand’s monetary policy framework is fit for purpose. The RBNZ is hamstrung under the current framework’s focus on CPI inflation – economic activity and employment growth is solid and asset price inflation is strong, but interest rates cannot increase since consumer price index (CPI) inflation is low largely because of positive supply shocks.

Changes likely to be considered include the addition of an employment target to the central bank’s inflation target, and a move away from a single decision maker system. However, the addition of an employment target has the potential to result in conflicting signals about which way the official cash rate (OCR) should go. We think alternative targets should also be considered in the review, such as nominal GDP growth. New Zealand First has also highlighted the currency as an alternative target for the RBNZ, similar to the exchange rate-centred monetary policy framework used by Singapore. Targeting the currency would effectively be ceding control of monetary policy to the economy of the currency to which the home currency is pegged to.

Inflation targeting worked well when bringing inflation down was the main goal ...

The RBNZ was the first central bank to introduce inflation targeting in 1990. Since then, other major central banks including the Bank of Canada (BoC), Bank of England (BoE), European Central Bank (ECB), Bank of Japan (BoJ) and the US Federal Reserve (the Fed) have adopted inflation targets as part of setting monetary policy.

While these central banks have largely been successful in bringing inflation down, they have found it much harder to bring inflation *up*, particularly in the wake of the Global Financial Crisis (GFC). And although some central banks have included other targets such as unemployment when setting monetary policy, monetary policy was effectively still focused on inflation.

For example, the Fed had indicated in 2012 it would raise interest rates when the US unemployment rate fell below 6.5 percent, but only did so when the unemployment rate fell below 5 percent because there were no signs of inflation emerging, despite solid employment growth.

... but economies also face supply shocks that push growth up and inflation down

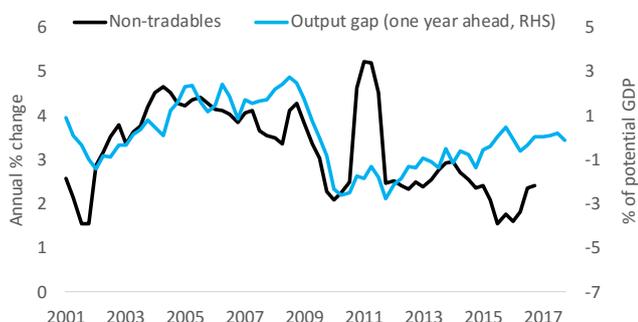
The current focus on inflation presents a problem for central banks, including the RBNZ, at a time when inflation has remained persistently low despite extraordinarily loose monetary policy.

Tradable deflation from a high exchange rate and weak global inflation has been a key influence behind low CPI inflation in New Zealand. And domestic inflation pressures have also been lower than what the robust growth rate in New Zealand in recent years would suggest.

The divergence between non-tradable inflation and the output gap since 2014 (see Figure 1) suggests underlying inflation is not picking up to the extent implied by the rise in capacity pressures in the New Zealand economy. This reflects a variety of structural changes to the economy, including technological changes which allow more to be produced for less (particularly oil, an input into many other industries) and increased globalisation.

Figure 1 Underlying inflation weaker than capacity pressures suggest

Non-tradable CPI and output gap



Source: Statistics NZ, RBNZ, NZIER

The RBNZ has relatively little room to move under existing arrangements

Inflation targeting in New Zealand has also seen interest rates fall to historically low levels.

The current Policy Targets Agreement (PTA)¹ between the Reserve Bank Governor and Minister of Finance requires monetary policy to be carried out “with a goal of maintaining a stable general level of prices”.

Although the PTA requires the RBNZ to monitor a range of price indices, including asset prices, the price stability target is defined as the All Groups Consumer Price Index (CPI), as published by Statistics New Zealand. The PTA specifies the RBNZ is required to maintain CPI between 1 and 3 percent on average over the medium term “with a focus on keeping future average inflation near the 2 percent target midpoint”.

Section 4b of the PTA asks the RBNZ to “seek to avoid unnecessary instability in output, interest rates and the exchange rate.” which means that it already requires the RBNZ to consider employment and the exchange rate when setting monetary policy. The RBNZ can look through temporary factors such as sharp changes in commodity prices or major government policy changes. This means that additional targets from the review is unlikely to do anything more than slightly lift the decision-making weight given to employment and currency explicitly.

The RBNZ cut the Official Cash Rate (OCR) sharply over 2008 and 2009 in the wake of the GFC. However, inflation

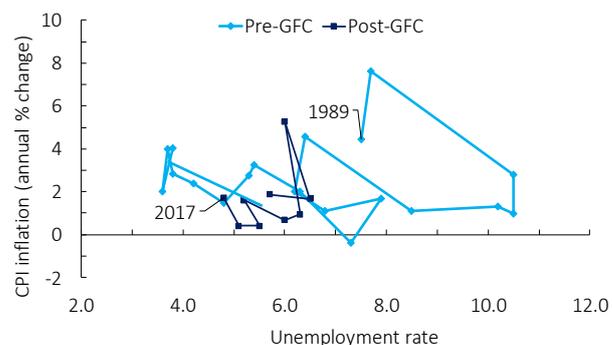
has been subdued, particularly in recent years. Since annual CPI edged below the Reserve Bank’s 1 to 3 percent inflation target band in June 2012, annual CPI has undershot the target band in 13 of the past 21 quarters.

Traditional relationships such as that between lower unemployment and higher inflation no longer hold in New Zealand after the GFC, with inflation remaining low despite reduced unemployment (Figure 2).²

This suggests to us that the planned review of New Zealand’s monetary policy framework should not be confined to simply incorporating employment and any other targets into the existing PTA.

Figure 2 Phillips Curve relationship broken down in New Zealand post-GFC

Annual % change in CPI and unemployment rate



Source: OECD, NZIER

There is no monetary policy framework that dominates in all cases

A key challenge for those implementing monetary policy is how to deal with positive supply shocks that simultaneously boost growth and employment (suggesting higher interest rates) while suppressing prices (suggesting lower rates).

Using only monetary policy to affect dual outcomes simultaneously is difficult. Adopting additional targets such as full employment introduces the risk of the central bank losing focus in its setting of monetary policy, given the potential for conflicting signals.

For example, the drop in the New Zealand unemployment rate since 2015 would suggest perhaps interest rates should have been higher, despite inflation remaining very

¹ <http://rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Policy%20targets%20agreements/2017pta.pdf>

² It has been a similar story in many of the major economies, with the traditional relationship between unemployment and inflation breaking down following the GFC (see Figure 4). Inflation has largely remained unresponsive to lower unemployment.

The Federal Reserve’s estimate of the Non-Accelerating Inflation Rate of Unemployment (NAIRU) has been falling over the years, meaning it sees a greater reduction in unemployment is required to have the same increase on inflation. Hence despite the fall in US unemployment the Federal Reserve still sees continued slack in the US labour market (see <https://www.federalreserve.gov/monetarypolicy/fomcminutes20170614.htm>).

subdued over this period. Conversely, it is unclear how monetary policy should respond to any increase in unemployment which was accompanied by rising inflation.

The Reserve Bank of Australia targets other objectives in its monetary policy, including the stability of its currency, full employment and economic prosperity in Australia. However, price stability is explicitly stated as the focus of its monetary policy framework.

But nominal GDP targeting has real advantages

Targeting nominal income growth is sometimes advocated as a monetary policy regime but has no adopters. We recommend nominal GDP targeting also be considered in the review of the Reserve Bank Act, as it considers both inflation and growth outcomes, as well as the relationship between these two variables. Nominal GDP targeting would overcome the drawbacks of monetary policy being loosened in response to positive supply shocks which reduce inflation but boost growth.

For example, setting a nominal GDP target of 4 percent annual growth would mean that interest rates would be lifted should annual nominal GDP growth be projected to be above 4 percent over the medium term. This would overcome the issue of positive supply shocks which increase output but reduce inflation, which under inflation targeting would mean interest rates be cut. Conversely, negative supply shocks which decrease output but increase inflation may mean lower interest rates should annual nominal GDP growth be projected to be below 4 percent over the medium term. Under inflation targeting, the increase in inflation from the negative supply shock would mean a recommendation of higher interest rates.

Nominal income targeting fulfils the requirements of a good monetary policy regime in having a clear, transparent target which the central bank can use to manage expectations of households and firms on the future path of interest rates, and helping to stabilise the economy by responding quickly to shocks.³ By addressing both supply and demand shocks to the economy, nominal GDP targeting should deliver a better mix of inflation and GDP growth for the economy. It would also reduce the distortions that arise from monetary policy being loosened purely in response to low CPI inflation, when asset prices are increasing strongly and GDP growth is robust.

No central bank explicitly use nominal GDP as a primary target. The RBNZ in 2011 rejected the use of nominal

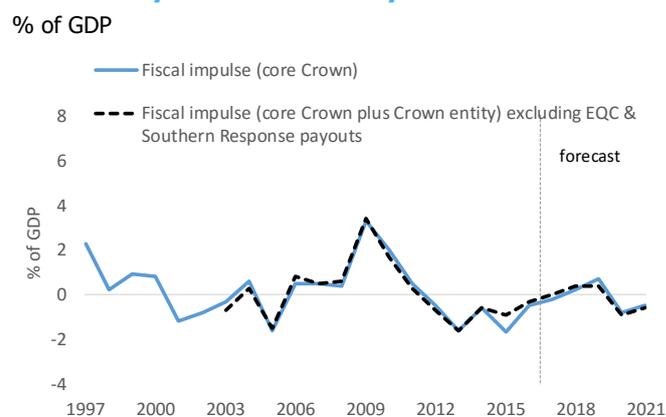
income targeting, noting such a target was complex as GDP was subject to large revisions which made the setting of monetary policy difficult to communicate.⁴

Monetary policy needs mates

The other key element of effective monetary policy setting is that it requires the support of fiscal policy. The reliance on monetary policy as the only lever to lift inflation in recent years has contributed to distortions in the economy, with the effect of very low interest rates manifesting itself in very high asset prices. It is not realistic to expect monetary policy can be used to address all the economy's problems.

Fiscal policy is projected in the Pre-Election Economic and Fiscal Update (PREFU) to be expansionary over the next few years. With Government expenditure expected to stimulate the economy over the next few years, this should take some of the pressure off the RBNZ to boost CPI inflation.

Figure 3 Fiscal policy expected to be stimulatory in the next few years



Source: Treasury, NZIER

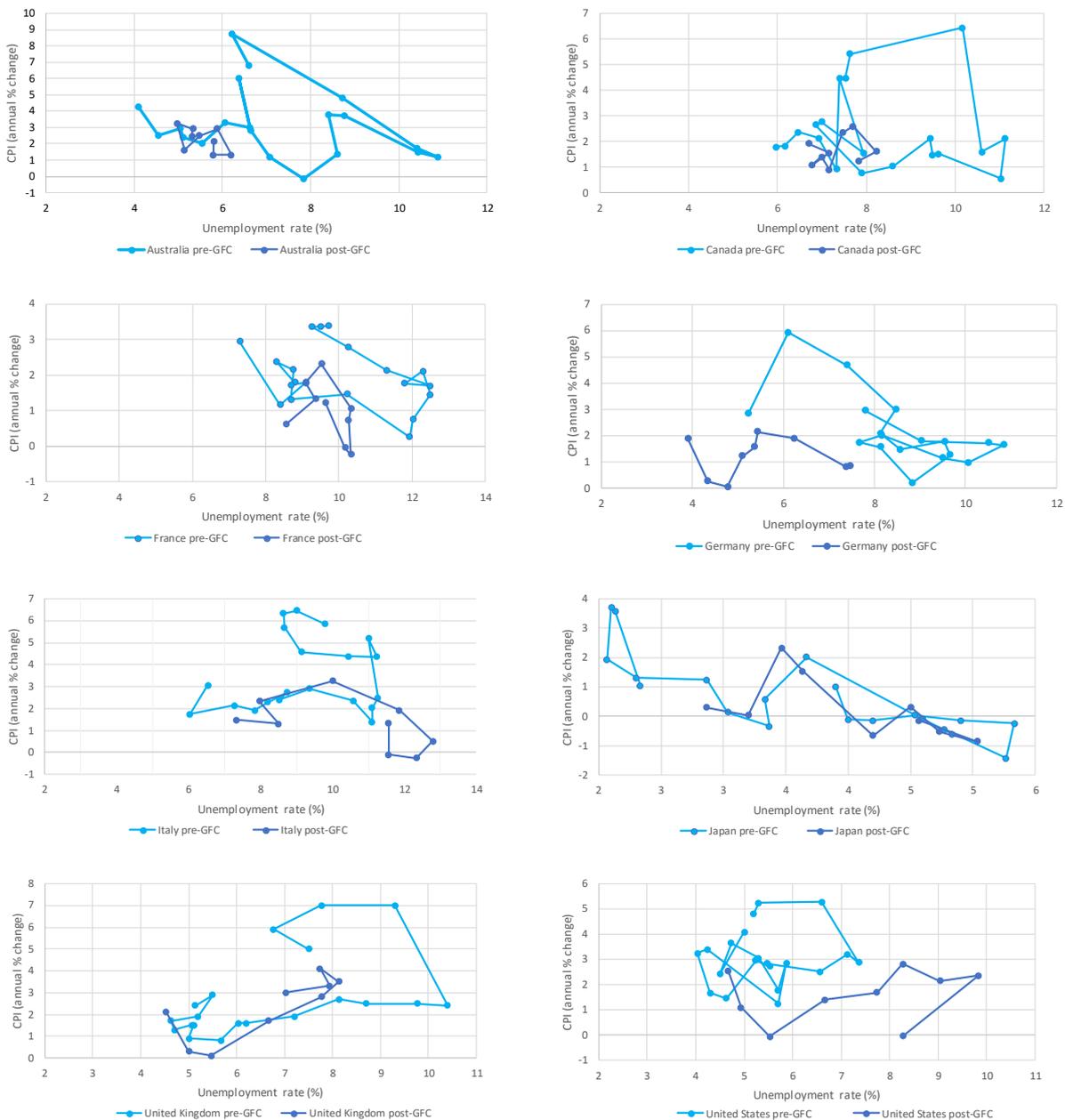
The review of the Reserve Bank Act provides a welcome opportunity to assess the appropriateness of New Zealand's monetary policy framework. This should include consideration of alternative targets beyond just the addition of employment to the RBNZ's inflation target. We recommend revisiting nominal GDP targeting as an alternative to inflation targeting. Consideration of a comprehensive set of alternative targets will ensure the monetary policy framework is fit for the post-GFC environment.

³ See our previous discussion of nominal income targeting "Time to reassess inflation targeting" https://nzier.org.nz/static/media/filer_public/6d/90/6d90212a-1829-478b-adb7-4a5f9d8e0b59/nzier_insight_57_reassess_inflation_targeting.pdf

⁴ See "NZ's experience with changing its inflation target and the impact on inflation expectations" (Lewis & McDermott) for empirical analysis and overview of literature of inflation targeting <http://www.tandfonline.com/doi/full/10.1080/00779954.2016.1191529>

Figure 4 Global breakdown in the relationship between unemployment and inflation – Phillips Curve relationship less evident in many major economies

Annual % change in CPI and unemployment rate



Source: OECD, NZIER

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