# CENTRAL BANK MONITORING – JUNE

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Monetary Department
Monetary Policy and Fiscal Analyses Division

CZECH NATIONAL BANK

## IN THIS ISSUE

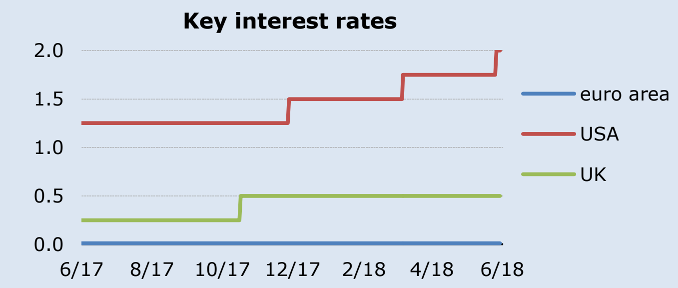
*Inflation has reached target levels in most of the economies we monitor, and economic growth is mostly slowing slightly from previous solid rates. Most countries are recording historically low unemployment rates and their previously negative output gaps are closing. Central banks' policy rates are still generally low, giving their economies a monetary policy stimulus. The Federal Reserve was the only central bank to raise rates. At the ECB and the Riksbank, a full exit from unconventional monetary policy instruments and related policy normalisation can be expected going forward.* Spotlight *focuses on the monetary policy of New Zealand, where the central bank is extending its mandate to a dual one this year and other changes to the RBNZ Act are in the pipeline. In our* Selected speech*, BoC Governor Stephen Poloz discusses the debt of Canadian households and its importance for monetary policy decisions.*

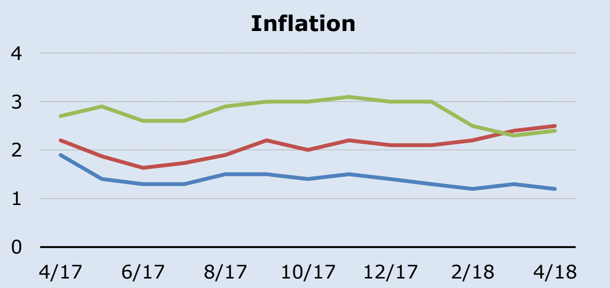
## 1. LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS

### Key central banks of the Euro-Atlantic area

| | Euro area (ECB) | USA (Fed) | United Kingdom (BoE) |
|---|---|---|---|
| **Inflation target** | <2%[1] | 2%[2] | 2% |
| **MP meetings (rate changes)** | 26 Apr (0.00)<br>14 Jun (0.00) | 20–21 Mar (+0.25)<br>1–2 May (0.00)<br>12–13 Jun (+0.25) | 22 Mar (0.00)<br>10 May (0.00) |
| **Current basic rate** | 0.00%; -0.40%[3] | 1.75–2.00% | 0.50% |
| **Latest inflation** | 1.9% (May 2018)[4] | 2.5% (Apr 2018) | 2.4% (Apr 2018) |
| **Expected MP meetings** | 26 Jul<br>13 Sep | 31 Jul–1 Aug | 21 Jun<br>2 Aug<br>13 Sep |
| **Other expected events** | 26 Jul: publication of Eurosystem staff projections | 18 Jul: publication of Beige Book | 2 Aug: publication of Inflation Report |
| **Expected rate movements[1]** | → | ↑ | → |

[1] ECB definition of price stability "below but close to 2%"; [2] January 2012 definition of inflation target; [3] deposit rate; [4] flash estimate; [5] meeting associated with summary of FOMC economic forecasts and press conference given by FOMC Chair; [6] direction of expected change in rates in next three months taken from Consensus Forecasts.




The **ECB** kept its policy rates unchanged and expects them to remain at their present levels until at least the end of 2019. It confirmed in June that the asset purchase programme will run at the current monthly pace of €30 billion at least until the end of September 2018. After that, subject to the current economic situation, the purchases will be reduced to €15 billion a month until the end of December 2018 and will then end. However, the reinvestment of principal payments from maturing securities will be maintained. The GDP growth outlook was reduced to 2.1% in 2018 (from 2.4% in March). The outlooks for 2019 and 2020 remain unchanged at 1.9% and 1.7% respectively. The inflation outlooks for 2018 and 2019 were revised up to 1.7% for both years (from 1.4% in March). The outlook for inflation in 2020 is still 1.7%.

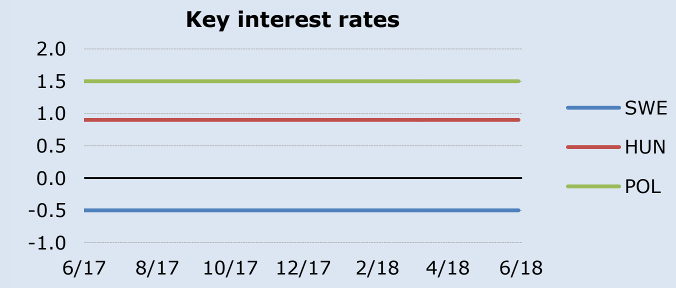
The **Fed** raised its key interest rate to 1.75%–2.00% in June, in line with market expectations. According to the median of the FOMC members' projections in June 2018, two more policy rate hikes of 0.25 pp to 2.4% can be expected this year. The median for 2019 is 3.1% and that for 2020 is 3.4%. The FOMC expects GDP to grow by 2.8% this year and 2.4% in 2019. The labour market remains strong, the unemployment rate outlook for the next three years is below 4% and the unemployment rate fell to 3.8% in May (the lowest level since April 2000). Inflation is expected to exceed 2% in the years ahead. The FOMC left out information about forward guidance from its accompanying statement and announced that press conferences would be held after each monetary meeting from January 2019.

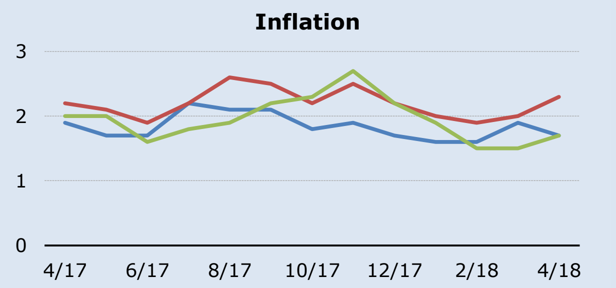
The **BoE** kept its key interest rate unchanged at 0.5% at its last two meetings. It also maintained the stock of government and corporate bond purchases at GBP 435 billion and GBP 10 billion respectively. Two MPC members nonetheless voted for a rate hike in May. Inflation is falling slowly towards the target and is expected to reach it in mid-2020 as the impact of the past depreciation of sterling on consumer prices gradually fades. The forecast assumes modest growth in rates over the next three years (three 0.25 pp increases). GDP will rise by 1.75% on average in the years ahead. Inflation is expected to average around 2%.

**Selected central banks of inflation-targeting EU countries**

| | Sweden (Riksbank) | Hungary (MNB) | Poland (NBP) |
|---|---|---|---|
| **Inflation target** | 2% | 3% | 2.5% |
| **MP meetings (rate changes)** | 25 Apr (0.00) | 27 Mar (0.00)<br>24 Apr (0.00)<br>22 May (0.00) | 10–11 Apr (0.00)<br>15–16 May (0.00)<br>5–6 Jun (0.00) |
| **Current basic rate** | -0.50%; -1.25%[2] | 0.9%; -0.15%[2] | 1.50% |
| **Latest inflation** | 1.7% (Apr 2018) | 2.3% (Apr 2018) | 1.7% (Apr 2018) |
| **Expected MP meetings** | 3 Jul<br>5 Sep | 19 Jun<br>24 Jul<br>21 Aug | 10–11 Jul<br>4–5 Sep |
| **Other expected events** | 3 Jul: publication of Monetary Policy Report | 19 Jun: publication of Inflation Report | Jul: publication of Inflation Report |
| **Expected rate movements[1]** | → | ↑ | ↑ |

[1] Direction of expected change in rates in next three months taken from Consensus Forecast survey; [2] deposit rate; [3] CPIF – consumer price index including fixed interest rate




The **Riksbank** left its key interest rate at -0.5% at its most recent meeting and now expects it to increase slightly later than it did previously: the rate is forecasted to return to a slightly positive level in early 2020. The Riksbank is continuing to reinvest redemptions and coupons in the market. Bond holdings amounted to just over SEK 320 billion in May. In its April forecast, the Riksbank slightly raised its CPI inflation outlook to 1.8% and its CPIF outlook to 1.9% for 2018 (by 0.1 pp in both cases). For 2019, it expects CPI inflation of 2.6% and CPIF inflation of 1.9%. It slightly lowered its GDP growth forecast for this year to 2.6% and expects 2.0% for next year.

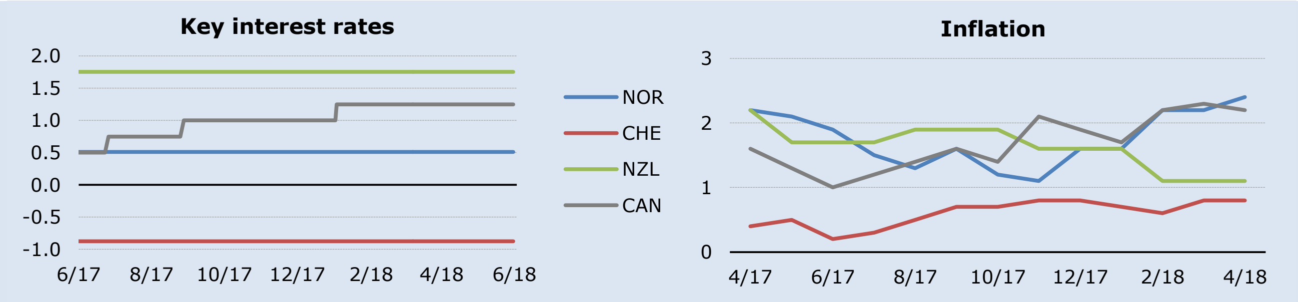
The **MNB** maintained its base rate at 0.9% and its deposit rate at -0.15%. It expects inflation to increase over the medium term due to growth in domestic demand and wages. The Hungarian economy maintained growth of 4.4% in Q1, mainly on the back of services and industry. Employment is at historical highs and unemployment is still falling. Lending to firms continues to grow at a solid pace of around 10%, partly due to the MNB's previous support programmes. Growth in loans to households (mostly mortgages) did not exceed 3%. The MNB has so far purchased mortgage bonds amounting to HUF 150 billion, roughly one-third of them on the primary market. It is also attempting to affect the long end of the yield curve through the IRS facility. These programmes have so far resulted in a sharp fall in the spread between yields on mortgage bonds and government bonds.

The **NBP** left its interest rate unchanged at 1.5% over the past three months. Annual economic growth slowed slightly to 5.1% in 2018 Q1 but remains strong, driven by consumer demand supported by rapid wage growth and consumer optimism. The NBP expects GDP growth of 4.2% this year, 3.8% in 2019 and 3.6% in 2020. Headline inflation slowed to 1.7%. Core inflation indicators remain low. Assuming a constant 3M WIBOR of 1.73%, the NBP expects inflation of 2.1% in 2018, 2.7% in 2019 and 3.0% in 2020.

## Other selected inflation-targeting countries

| | Norway (NB) | Switzerland (SNB) | New Zealand (RBNZ) | Canada (BoC) |
|---|---|---|---|---|
| **Inflation target** | 2%[5] | 0–2% | 2% | 2% |
| **MP meetings (rate changes)** | 15 Mar (0.00)<br>3 May (0.00) | 15 Mar (0.00) | 22 Mar (0.00)<br>10 May (0.00) | 18 Apr (0.00)<br>30 May (0.00) |
| **Current basic rate** | 0.50%<br>-0.50 reserve rate[1] | from -1.25<br>to -0.25%[2]; -0.75%[3] | 1.75% | 1.25% |
| **Latest inflation** | 2.4% (Apr2018) | 0.8% (Apr 2018) | 1.6% (2017 Q4) | 2.2% (Apr 2018) |
| **Expected MP meetings** | 21 Jun<br>16 Aug | 21 Jun | 28 Jun<br>9 Aug | 11 Jul<br>5 Sep |
| **Other expected events** | 21 Jun: publication of Monetary Policy Report | 27 Jun: publication of Quarterly Bulletin | 9 Aug: publication of Monetary Policy Statement | 11 Jul: publication of Monetary Policy Report |
| **Expected rate movements[1]** | → | → | → | ↑ |

[1] Only on reserves exceeding quota; [2] chart displays centre of band; [3] negative deposit rate on banks' account balances held at SNB, graded according to balance amounts; [4] direction of expected change in rates in next three months taken from Consensus Forecasts or, in the case of New Zealand, from RBNZ survey; [5] inflation target lowered from 2.5%.




The **NB** left its interest rate unchanged at 0.5% and expects it to be raised gradually after this summer. The Norwegian economy is continuing to grow and the negative output gap has almost closed. Inflation is below the 2% inflation target and will remain so during 2019. Registered unemployment is at 2.4%, while unemployment according to the Labour Force Survey is at 3.9%. The house price correction continued. Growth in loans to households is stable at 6% and growth in loans to non-financial corporations rose to 8%. Wage bargaining resulted in an agreement on wage growth in industry of 2.8%.

The **SNB** is maintaining the target range for its monetary policy rate (3M LIBOR) in negative territory (at between -1.25% and -0.25%). The rate on banks' account balances with the SNB also remains at -0.75%. The SNB continues to reserve the right to intervene in the foreign exchange market as necessary. It expects GDP growth of around 2% for 2018. The bank slightly lowered its inflation forecast for 2018 from 0.7% to 0.6% and expects 0.9% instead of 1.1% for 2019 and 1.9% for 2020.

The **RBNZ** left its official rate at 1.75%. Inflation stood at 1.1% in 2018 Q1, kept low by weaker import prices. It will rise to the 2% inflation target only gradually, reaching it in late 2020. Employment is at the peak of its sustainable levels (67.7%) and unemployment has declined to 4.4%. Economic growth reached 2.9% and the economy will expand at a rate of 3% according to the RBNZ forecast.

The **BoC** kept its key rate unchanged at 1.25% in both April and May. Inflation is slightly above the target and the economy is operating close to potential. According to the BoC's April outlook, the economy will grow at a lower rate this year than expected in the previous outlook, namely by 2.0% (as against 2.2%). In 2019, the growth will be 1.8% (as against 1.6% in the previous forecast). Inflation went up to 2.2% in April. In the period ahead, inflation will be modestly above 2%, owing mainly to the transitory impact of higher fuel prices.

## 2. NEWS OVER THE LAST THREE MONTHS

### New ECB overnight reference rate gets name

In May, the Governing Council of the ECB decided that the new ECB unsecured overnight interest rate, which will serve as a backstop reference rate, will be called ESTER (euro short-term rate). See the December 2017 CBM for more about the rate.

### BoE and ECB to form working group to study Brexit risks

The European Commission and the UK Treasury have asked the ECB and the Bank of England to form a working group on risk management in the area of financial services in the period around 30 March 2019, the day after the UK officially departs the EU. The group will be chaired by BoE Governor Mark Carney and ECB President Mario Draghi. The European Commission and the UK Treasury will attend as observers and other relevant authorities will be invited on an issue-specific basis. The group is expected to hold its first meeting before the summer.

### Sveriges Riksbank celebrates its 350th anniversary in style

To commemorate its 350th anniversary, the Riksbank is organising events for the general public all over the country this year. At the end of May it held an anniversary conference on "The role of central banks then, now and in the future". Among others, Fed Chairman Jerome Powell, BoE Governor Mark Carney and BIS General Manager Agustín Carstens, took the floor. The Riksbank also published a retrospective publication called "Sveriges Riksbank – a 350-year journey" describing important events in the history of the Riksbank. Cambridge University Press will publish a commemorative book titled "Sveriges Riksbank and the History of Central Banking" and PostNord is issuing anniversary stamps. A whole section of the Riksbank website is dedicated to the anniversary (see the March CBM for more details). In September, the Riksbank will organise an Open house at its head office in Stockholm.

### Central bank of Turkey and Turkish president at loggerheads

The Turkish central bank (CBRT) is trying to resist political pressure while saving the Turkish lira. Turkish President Erdogan wants to maintain economic growth before early presidential elections (24 June) and is promoting loose fiscal policy and low interest rates (as he is convinced that high interest rates cause inflation). He has therefore been pushing the CBRT not to raise interest rates. However, in a situation of an overheating economy, a falling lira and rising inflation (which exceeded 10% in 2018 Q1 and has been above the CBRT target of 5% for several years), the bank had to tighten monetary policy. At its 25 April meeting, the CBRT therefore raised its current interest rate (the late liquidity window, LLW) by 0.75 pp to 13.5%. The Turkish president responded by saying that interest rates are "the mother of all evil" and that if he wins the June election he will reduce the central bank's independence. The Turkish lira and government bonds responded by dropping sharply; the lira has weakened by more than 20% against the US dollar since the beginning of the year.

In defence of the Turkish lira and to keep inflation under control, the CBRT convened an extraordinary monetary policy meeting on 23 April, at which it raised its LLW rate by another 3 pp to 16.5% and confirmed it will continue to maintain a tight monetary policy. In a subsequent interview, the Turkish president did not comment on the rate hike and instead sought to calm the financial markets by stating that Turkey still follows global monetary policy principles and rules. A few days later (on 28 April), the CBRT announced a simplification of its monetary policy framework with effect from June. The currently unused one-week repo rate will become the bank's main monetary policy rate again and will be raised from 8% to 16.5%, while the overnight borrowing and lending rates will form a symmetrical b of ±1.5% around the repo rate. The Turkish lira responded by firming against the dollar; financial markets hope that the central bank's independence has increased again and that the bank will still pursue standard monetary policy. At its regular monetary policy meeting on 7 June, the CBRT further increased its one-week repo rate by 1.25 pp to 17.75%. In an effort to calm the markets, the

CBRT governor and the Turkish deputy prime minister met with investors in London at the end of May.

### US takes bank deregulation steps

At the end of May, the Federal Reserve Board approved a proposal to relax and simplify the 2013 Volcker rule, which bans big banks from engaging in speculative trading and investment. The proposed changes have to be approved by four other US federal regulatory institutions. The Volcker rule is part of the 2010 Dodd-Frank law, which was created to protect bank consumers by providing stronger supervision and regulation for banks and financial institutions after the 2008 financial crisis. The legal force of the Dodd-Frank law is reduced not only by the Fed's proposal, but also by a law approved by the US Congress a week before, aimed at helping small and medium-sized banks by relaxing the oversight and capital requirements applying to them.

### Other upcoming changes in Fed Board of Governors and FOMC

US President Donald Trump nominated Richard Clarida, a managing director at the PIMCO fund, and Michelle Bowman, a Kansas banking regulator, for two of the four remaining vacant seats in the seven-seat Board of Governors of the US Federal Reserve. Their nomination to the Board of Governors has to be confirmed by the US Senate. For previous nominations to the Board of Governors, see the December 2017 and September 2017 issues of CBM.

In June there will also be a change at the helm of the New York Fed, whose president traditionally serves as the vice-chairman of the FOMC and has a permanent vote on its decisions. The departing William Dudley will be succeeded by John Williams, currently President of the San Francisco Fed. Mark Gould, First Vice President of the San Francisco Fed, will serve as its interim president and will represent the San Francisco Fed on the FOMC.

### Kuroda continues to lead BoJ, bank drops time frame for hitting 2% inflation

In early April, the Japanese government reappointed Haruhiko Kuroda as the head of the Japanese central bank for a second five-year term. The BoJ's loose monetary policy can therefore be expected to continue. In its April Outlook for Economic Activity and Prices, the BoJ also dropped the time frame for hitting its 2% inflation target. The time frame has already been shifted six times since the launch of QE in 2013, undermining the BoJ's credibility. The January Outlook set the target for fiscal year 2019 (April 2019–March 2020).

### New governors of central banks of Finland and New Zealand

The Finnish parliamentary committee unanimously nominated Olli Rehn to the post of governor of the Bank of Finland (BoF) ahead of nine other candidates. His nomination was subsequently confirmed by the Finnish president. Rehn, who is the current deputy governor of the BoF, will start his seven-year term in July. He previously served as the Finnish minister of economic affairs and as the European commissioner for economic and monetary affairs and the euro.

At the end of March, on the unanimous recommendation of the RBNZ, the New Zealand finance minister appointed Adrian Orr as new Reserve Bank governor for a five-year term.

The incoming RBNZ governor and the finance minister also signed a new Policy Targets Agreement (PTA), adding employment outcomes alongside price stability as a dual mandate for the bank. For more about the history of the RBNZ and changes in its policy over the years, see *Spotlight* in this CBM.

### Norges Bank launches expert blog

Norges Bank this April launched the Bankplassen blog, an expert blog where contributors from Norges Bank can publish articles (mainly in Norwegian). The aim of the blog is to provide information in readable form about the numerous topical issues on which Norges Bank employees work and to encourage discussions with the general public. The Bank of England launched a similar blog (Bank Underground) in 2015 (see the September 2015 CBM).

**Bank of England launches new education initiative**

The BoE is involved in educating the public in economics and has created and published free materials designed to support the teaching of basic economics in schools. The "econoME" programme offers lesson plans, presentations, interactive activities and videos. As part of the BoE's educational strategy, "bank ambassadors" (BoE employees) will visit schools across the country to explain the BoE's role and inspire pupils to study economics. Senior managers and policy committee members will also visit selected schools to provide students with an insight into the bank's decision-making processes.

**Swiss voters reject sovereign money initiative in referendum**

A national referendum was held in Switzerland in June regarding (among other things) the proposed sovereign money concept (the Vollgeld Initiative), which would have banned private banks from creating money and given the central bank the exclusive power to do so. Swiss voters overwhelmingly rejected the proposal. The SNB acknowledged this outcome. In May, the SNB governor gave a speech at the University of St. Gallen to once more warn against the sovereign money concept, saying it would pose a danger to the stability of the financial system and confirming that the SNB, the Federal Council and Parliament firmly opposed the initiative. See the March CBM for more about the initiative.

## 3. SPOTLIGHT: NEW ZEALAND'S MONETARY POLICY – ALWAYS ON THE MOVE

*In 1989, New Zealand became the first country in the world to introduce inflation targeting as a monetary policy regime. Now, almost 30 years on, its government has decided it is time for another change. This article examines the change in the central bank's mandate and the government's interventions in the central bank's monetary policy.*

New Zealand is an island country covering an area just over 250,000 square kilometres, roughly the same as the UK, with a population of less than 5 million. Its closest neighbour is Australia about 2,000 km away. It is a constitutional monarchy with a parliamentary system of government.[1] It is a wealthy developed country and is about the 30th largest economy in the world as measured by GDP (PPP) per capita. It ranks 68th in the world based on the volume of GDP (PPP). Its economy is therefore small, yet open and strongly dependent on international trade: exports (and imports) account for around 30% of the country's GDP. It exports mainly agricultural products and is one of the five largest exporters of dairy products in the world; other export goods include oil, timber and paper products. Tourism and the film industry are also major sources of revenue. Its biggest import items are vehicles, machinery and equipment, oil and oil products. Australia, China, Japan, the USA and EU countries are New Zealand's largest trading partners.

### New Zealand's economy – from a British farm to a dynamic economy

Until the mid-20th century, most of New Zealand's exports went to the UK and its economy was strongly influenced by fluctuations in the British economy.[2] However, New Zealand had to seek new markets in the 1960s as the UK began to turn to European trading partners before joining the EU (1973). In 1966, New Zealand and Australia signed a free trade agreement (now known as Closer Economic Relations, CER). Since 1973, this has included a clause on the free movement of citizens. In 2008, New Zealand was the first advanced country to enter into a free trade agreement with China, and it is currently (together with Australia) negotiating a free trade deal with the EU.

In the 1970s and 1980s, New Zealand's economy recorded a period of high inflation, which the government tried to address by, among other things, freezing prices and wages. The next government decided in 1984 to abolish government regulation and to liberalise and diversify the economy. However, the radical transformation had harsh consequences: the economy slowed and unemployment increased. Inflation was brought under control in the early 1990s by a new inflation-targeting monetary policy system (see below). The government supported economic growth by, among other things, increasing the flexibility of the labour market (by amending some labour statutes and supporting immigration). From the end of the 1990s, New Zealand enjoyed a period of relatively stable growth and low inflation, and was even one of the fastest growing OECD economies at the start of the millennium. Nevertheless, the buoyant growth was accompanied by macroeconomic imbalances.[3] However, New Zealand managed to limit these imbalances through targeted economic measures and fiscal discipline.

Since 2011, New Zealand has seen stable economic growth (currently around 3% annually) with low unemployment (around 4.5%). This is due mainly to construction and high net migration amid loosened monetary policy and high external demand, especially from Asia. The stable growth is being aided by the government's commitment to maintain fiscal discipline. In recent years, the government has focused on reducing economic inequality.

[1] New Zealand became a British colony in 1841 and gained independence in 1947. Today it is part of the Commonwealth and its head of state is Queen Elizabeth II, represented by a governor-general.

[2] New Zealand sent as much as 70% of its total exports to the UK at the start of the 20th century; agricultural products, in particular wool, meat and milk, accounted for more than one-third of exports. Exports to the UK currently make up a mere 3% of exports.

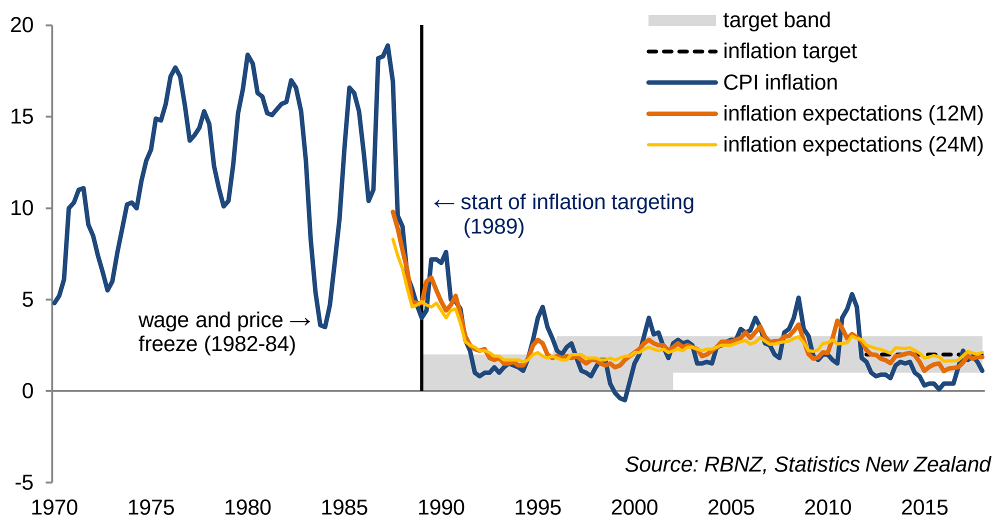
[3] The imbalances the country had to cope with included a relatively high current account deficit, high house price inflation, household indebtedness and excessive appreciation of its currency.

**The Reserve Bank of New Zealand – supervised independence**

The Reserve Bank of New Zealand (RBNZ) was established in 1934 as an institution independent of the government. It was tasked with maintaining the value of New Zealand's currency, and its objectives and responsibilities could be changed only by the parliament. However, this independence was soon changed by the government that took office in 1935, which, by gradually amending to the law, subjected the bank to government control to make it a tool of the government economic agenda. The bank could not formulate monetary policy on its own. Further amendments and a subsequent new 1964 law moved the management of the RBNZ from the parliament to the minister of finance and back, but the RBNZ never had real independence. It could thus influence monetary policy only by convincing the government and arguing its own economic views.

In the mid-1980s, after years of high inflation and concerned about possible further inflation pressures, the government and the RBNZ agreed that monetary policy should be focused on controlling inflation. Following a discussion among economic experts, initiated by the minister of finance, a new RBNZ Act was passed in 1989, which, by introducing inflation targeting, changed the nature of the bank's monetary policy and redefined the relationship between the central bank, the government and the parliament. The Act left responsibility for economic policy and the overall monetary policy stance with the government, but freed the RBNZ from dependence on short-term decisions of the government. The bank and the government (the governor and the minister of finance, specifically) now signed a Policy Targets Agreement (PTA) covering the entire duration of the governor's mandate.[4] The PTA makes the governor personally responsible for achieving the objectives and also revocable.[5]

Price stability, achieved through inflation targeting, became the statutory objective of RBNZ monetary policy. This made the RBNZ the first bank in the world to apply this regime officially. The new system was innovative in directly targeting inflation rather than the intermediate targets (such as money) used in other countries at the time. Its key features were the explicit announcement of an inflation target, operational independence of the central bank (i.e. the right to choose suitable instruments to achieve the target) and high monetary policy transparency. The RBNZ began to publish regular Monetary Policy Statements, intended primarily for the parliamentary committee responsible for supervising the central bank. The inflation target was set as a target band from the outset. The first PTA set a band of 0%–2%. The specification of a target worked for the public, and in just a few years inflation and inflation expectations were successfully anchored in the target band. In 1996, the band was widened to 0%–3% at the request of the government, but this change had no effect on inflation expectations.




*Source: RBNZ, Statistics New Zealand*

[4] A new PTA must be concluded and signed every time a RBNZ governor is appointed or re-appointed and is also signed when a new government is established. The government may also initiate amendments to the PTA. A total of 13 PTAs have been signed since 1990.

[5] The RBNZ's Board of Directors monitors the governor's work on behalf of the minister of finance and also proposes a new governor, who is appointed by the minister of finance.

In 1997, the RBNZ became the first central bank in the world to start publishing an interest rate forecast. The same year, a Monetary Conditions Index (MCI) was introduced to aid the implementation of monetary policy.[6] However, this seemed to foster unnecessary interest rate volatility due to a volatile exchange rate, and the Official Cash Rate (OCR) was introduced as the main monetary policy instrument in March 1999.[7]

The first review of the RBNZ's monetary policy was undertaken in 2000 at the request of the government. It found the bank's processes to be in line with the best international practices of the time and recommended (unsuccessfully) that a monetary policy committee be established and the governor's decision-making powers be transferred to it. In 2002, concerns that the existing inflation target (0%–3%) was restricting the country's growth too much led the government to change the target to 1%–3%, despite opposition from the RBNZ.

In 2004, at its own request, the bank obtained a mandate from the government to use foreign exchange interventions as an additional monetary policy instrument. The RBNZ made its first interventions in 2007. The bank underwent another review in 2007 due to government concerns that its monetary policy was fostering undesirable macroeconomic imbalances, in this case with no subsequent changes to the law or the PTA.

The global economic crisis proved that the inflation targeting regime could moderate excessive swings in inflation and anchor long-term inflation expectations in the target band. After the crisis, the 2012 PTA was amended to require the bank to take account of financial stability when setting monetary policy. The PTA also specified that future inflation should be kept near the mid-point of the target band. Since 2012, the RBNZ's target has been thus specified as inflation of 1%–3% with a target value of 2%.

**The current review and its results**

In November 2017, the New Zealand government decided to undertake an additional review of the RBNZ Act in order to modernise the monetary policy framework. The review was split into two phases, the first focusing on the conduct of monetary policy and the second on the bank's role in maintaining financial stability.

The conclusions of Phase 1 were announced together with the signing of a new PTA by the new RBNZ Governor Adrian Orr and the minister of finance at the end of March 2018. They include two significant changes in the conduct of monetary policy by the RBNZ: an extension of the RBNZ's mandate to a dual one including, in addition to price stability, support for maximum sustainable employment, and the introduction of a Monetary Policy Committee (MPC) responsible for formulating monetary policy. These changes are currently being incorporated into an amendment to the RBNZ Act due to take effect during 2018. The change to a dual mandate was reflected in the March PTA and the RBNZ is thus now going through a transition period before the amendment to the RBNZ Act takes effect.

***The first planned change – extending the mandate to a dual one***

Under the RBNZ's previous mandate, the bank's objective was to maintain price stability over the medium term. The new mandate will be extended to include supporting maximum sustainable employment. Monetary policy will thus continue to pursue the objective of maintaining price stability over the medium term (at the level specified in the PTA) and will simultaneously have the objective of supporting full employment, which, however, will not be quantified by any indicator. The US Federal Reserve and the Reserve Bank of Australia, for example, have a dual mandate comprising full employment in addition to an inflation target.

[6] The MCI was a weighted sum of the exchange rate and short-term interest rates. The weights reflected the medium-term effect of these variables on aggregate demand and hence on inflation. The index also identified likely future changes in monetary policy and their scale.
[7] The OCR is the RBNZ's overnight lending rate.

### *The second change – a Monetary Policy Committee*

The main current monetary policy decision-making principle at the RBNZ is the model of a sole decision maker, namely the governor. This principle is a product of the time when inflation targeting was adopted. Back then, public sector reforms usually involved installing managers with single decision-making power but with personal accountability for the functioning of their institutions. When making monetary policy decisions, however, the RBNZ governor always used an informal internal advisory committee. In 2013, it was formalised as a Governing Committee comprising the governor and a deputy governor and two assistant governors. However, the governor was the sole decision maker.

The proposed **Monetary Policy Committee** (MPC) will be collectively responsible for making monetary policy decisions. The five- to seven-member committee will be headed by the governor, who will be its sole spokesman. The MPC will be made up of internal and external members nominated by the RBNZ's Board of Directors and appointed by the minister of finance. A non-voting Treasury observer will also be on the MPC. His or her role will be to facilitate information flows between the RBNZ and the Treasury. Internal members (up to four) will be appointed for five years and external members (at least two) for four years, in both cases with an option of one extension of their mandate.

The MPC and the minister of finance will conclude a **Charter** about the detail of the MPC's practices. The Charter will, for example, stipulate how the MPC will publish its decisions and voting. Under the current proposal, the MPC will aim to reach decisions by consensus. However, if it fails to do so it will publish the balance of votes, with the governor having the casting vote in the event of a tie. The MPC will publish non-attributed meeting records that reflect differences of view where they exist.

### *The third change – setting the inflation target differently (the end of the PTA)*

The way in which the inflation target is set will also have to change after the MPC is established. Currently, the PTA is an agreement between the minister of finance and the governor, but such an agreement will not make sense after the MPC switches to collective responsibility. Inflation targets will thus be set solely by the minister of finance, but the minister's decision will need to take account of the non-binding public advice from the RBNZ and the Treasury. The option of requiring the minister to justify decisions before the parliament is also being considered in the proposed law.

### *Other changes – Phase 2 of the review*

Phase 2 of the review, which also includes a planned review of the current macroprudential framework and is generally focused on financial stability, should be completed in mid-2018. Proposals for possible changes will be announced after that.

## Conclusion: The RBNZ marches on under the baton of democratic government

In 1989, the Reserve Bank of New Zealand became the first central bank to introduce inflation targeting. At the same time, the RBNZ Act set forth the rules of a new monetary policy regime involving operational independence and high transparency. The RBNZ has repeatedly been highly rated for its transparency. In 2014, it ranked third behind the Riksbank and the CNB in this regard.[8] However, the same survey ranked it in a relatively low 70th place based on independence.[9] The RBNZ's low independence score reflects the fact that the New Zealand government has a historically strong position over the central bank and has always intervened in the country's monetary policy. New Zealand has the advantage that its government is

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[8] See Dincer and Eichengreen, "Central Bank Transparency and Independence: Updates and New Measures," *International Journal of Central Banking*, Vol. 10, No. 1: 189–259, March 2014.

[9] The rating reflects, for example, the independence of the governor, the possibility of dismissing the governor (or the entire monetary policy decision-making body), the independence of the bank in formulating monetary policy or its objectives, and intervention of the government in exchange rate policy formulation.

democratic and monetary policy decisions are taken in agreement or at least after discussion with the RBNZ or after review by external experts.

The question is to what extent monetary policy interventions, in the form of relatively frequent and not always regular changes in the inflation target or other monetary policy parameters, have the potential to undermine public faith in the monetary policy target. The bank itself concedes[10] that the number of changes to the PTA has been less than ideal, but it sees them as having been appropriate, as it believes that the changes have always formalised what the government and the bank have learned in the process of operating policy. Judging by inflation expectations, the public views the RBNZ as a credible institution despite these occasional monetary policy adjustments. As regards long-term credibility and stabilisation of the monetary policy regime, however, the approach adopted by the Bank of Canada (BoC) seems more appropriate: it has the standard power to change the inflation target, but does so only at regular five-year intervals, when it updates the inflation target in a joint statement with the government.

[10] For details, see RBNZ Assistant Governor John McDermott's April 2018 speech: *Inflation targeting in New Zealand: an experience in evolution*, https://www.rbnz.govt.nz/research-and-publications/speeches/2018/speech2018-04-12.

## 4. SELECTED SPEECH: CANADA'S ECONOMY AND HOUSEHOLD DEBT: HOW BIG IS THE PROBLEM?

*Stephen S. Poloz, Governor of the Bank of Canada (BoC), in his May speech at the Yellowknife Chamber of Commerce described the evolution of the debt held by Canadian households and its importance for monetary policy decision-making.*

The amount of debt held by Canadian households has been rising in recent years and has been a growing preoccupation for the BoC. According to Governor Poloz, the Bank's focus has been not only on the vulnerability of the financial system arising from elevated indebtedness, but also on the vulnerability of the economy to rising interest rates.

Over the past 20 years, the debt of Canadian households has risen roughly from 100% to 170% of disposable income. So far, it has not reached the levels observed in Sweden, Norway and Australia, but it has similar features: high rates of home ownership, well-developed mortgage markets and decades of steadily rising house prices. In the case of Canada, there have been factors working on both supply and demand to push prices up: on the supply side, for example, land-use constraints in many cities, and on the demand side demographics and a long period of low interest rates. Canadian households' strong desire for home ownership combined with rising house prices have naturally led to rising indebtedness.

The rise in Canadian household debt started in the late 1990s. At that time, the BoC had built some credibility around its inflation-targeting policy, reflected in low expected inflation and low interest rates. The global financial crisis in 2008 brought a dramatic turn as central banks, in an effort to encourage the economy, slashed interest rates and kept them at historically low levels for an extended period. The necessary fiscal and monetary actions helped prevent a fall into a deeper economic crisis, but they are financed with debt. While fiscal stimulus results in a build-up of government debt, monetary policy stimulus brings about a build-up in household debt. And excessive debt levels create a vulnerability, making the economy less resilient to shocks. This should be taken into account by monetary and fiscal policy-makers.

New mortgage regulations recently introduced in Canada are helping reduce the economy's vulnerability, but they apply only to new mortgages. The stock of household debt will persist. Therefore, a significant issue for the BoC is gauging how much more sensitive consumers, and the whole economy, have become to interest rate changes. This is particularly important right now because the economy will require higher interest rates to meet the BoC's inflation goals. Given current levels of household debt, the Bank expects that moves in its policy rate will have a stronger impact than before. But this is a significant uncertainty in both directions.

Since last July, the BoC has raised interest rates several times, but it is still too soon to know how strong an impact these moves will have given the length of the transmission of rates. However, the current policy rate is still well below the estimated neutral level and remains negative in real terms. In Poloz's opinion, the need for monetary stimulus is diminishing and interest rates will move higher. The question is how fast the BoC should – with all the risks the economy is facing, including those related to household debt – increase interest rates. While too quick an increase risks choking off growth and falling short of the inflation target, too slow a rise could result in a build-up of inflation pressures and an overshooting of the inflation target as well as a further rise in household debt and vulnerabilities.

It is obvious that getting the path of monetary policy right involves a lot of judgement. Bank staff have therefore developed an analytical note in which the risks associated with various hypothetical interest rate paths are calculated. It shows that by reducing financial vulnerabilities, macroprudential measures improve the trade-off policy-makers face in choosing when to adjust interest rates higher. Macroprudential policy thus allows monetary policy to deliver similar results for growth and inflation without exacerbating financial vulnerabilities.