

Changing thinking – Kiwis leading again

The New Zealand government is changing the rules on how the central bank manages monetary policy. From a macroeconomic angle, the change is not radical, but from a behavioural perspective, the signals sent are interesting



Looking at the behavioural signals

Two changes have been made to the mandate of the Reserve Bank of New Zealand in the way it manages monetary policy. It not only maintains price stability but also now includes support for employment. Also, previously the Governor alone was responsible to set policy, now there's a committee.

From a macroeconomic angle, neither change is radical. Many central banks such as the Federal Reserve, Norges Bank and the Reserve Bank of Australia already have dual mandates, and it is unusual for one person rather than a committee to set monetary policy. However, from a behavioural perspective, the signals are interesting.

[Read the Reserve Bank's announcement in full here](#)

Beyond macro

New Zealand led the world in establishing inflation targeting. A target of zero to two percent was set in 1990, broadened to between one and three percent in 1996. Governments in other

The signals are interesting

countries followed suit, often setting inflation targets to around two percent. It is interesting to [note](#) that the two percent target was not based on much extensive analysis, however, once this anchor figure of two percent had been set, others around the world adopted it.

Harvard economist, Dani Rodrik [tweeted](#) about the change in inflation targeting, noticing this was “interesting and important”.



Source: Dani Rodrik, Twitter

Rodrik [argues](#) that nowadays, the way economies are organised has led people to feel excluded from the making of policies that affect them. Changing to a dual mandate appears to recognise that solving one problem alone may no longer be acceptable if it means that other measures that affect people's welfare are harmed.

When inflation was persistently much higher, people could probably understand and accept that central bank targeting of inflation alone was acceptable, even if it meant a trade-off in other things they wanted, such as wage increases. With inflation now often below target levels, the compromises may be less acceptable.

Current and past conditions

Inflation in New Zealand was 1.6% in the year to December 2017, up from 1.3% a year earlier. The unemployment rate was 4.5% in December 2017, down from 5.3% a year earlier. The [RBNZ estimates](#) that unemployment is not putting pressure on prices because it calculates the Non-Accelerating Inflation Rate of Unemployment (NAIRU) to be between 4 and 5.5%.

It is often difficult to recognise change when you are in the middle of it

However, experienced local commentator, [Michael Reddell argues](#) that monetary policy was kept too tight over the last decade. The argument seems to be that keeping inflation below target was connected to unnecessarily high unemployment. It's not clear whether people find that trade-off acceptable, especially if made by an institution over which they have no influence. This sentiment echoes similar discussions in other countries.

Changing conditions

Anchoring the inflation target at two percent has been challenged before. In 2010, in the immediate aftermath of the global financial crisis, the then IMF chief economist [Olivier Blanchard and others argued](#) that inflation targets could be raised to four percent.

A key element was that the two percent target limited the ability of central banks to lower real interest rates below negative two percent because nominal rates could not easily fall below zero. A higher inflation target would allow an even greater fall in real rates, which was arguably appropriate at the time. Blanchard further noted the crisis had shown that “macroeconomic policy must have many targets”.

The move by the New Zealand government could be interpreted as a signal of change to the way economic policy is made. It could be a recognition of Blanchard's call to meet more than one target and to allow anchors to be reset when appropriate. It perhaps also plays into to Rodrik's call that greater attention is paid to the feelings of people who believe they cannot control their economic prospects.

It is often difficult to recognise change when you are in the middle of it. What has happened with the move by the NZ government could be the first of other changes in the way macro policy operates in the future.