NZCTU
Te Kauae Kaimahi

Submission to the RESERVE BANK OF NEW ZEALAND on the:

Monetary Policy Committee Remit Review

Submitted by the New Zealand Council of Trade Unions Te Kauae Kaimahi
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This submission is made on behalf of the 31 unions affiliated to the New Zealand Council of Trade Unions Te Kauae Kaimahi (CTU). With over 340,000 union members, the CTU is one of the largest democratic organisations in New Zealand.

The CTU acknowledges Te Tiriti o Waitangi as the founding document of Aotearoa New Zealand and formally acknowledges this through Te Rūnanga o Ngā Kaimahi Māori o Aotearoa (Te Rūnanga), the Māori arm of Te Kauae Kaimahi (CTU), which represents approximately 60,000 Māori workers.

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1. Summary of Recommendations

The CTU:

1.1. Recommends that full employment should be a central macroeconomic policy goal in New Zealand.

1.2. Supports the retention of a flexible inflation-targeting framework.

1.3. Supports a balance between the two primary objectives – price stability and maximum sustainable employment – and notes that the current Remit, and the MPC's operationalisation of the Remit, is biased towards the price stability objective.

1.4. Opposes the suggestion that the primary objectives of the Remit should be hierarchically ordered – requiring the MPC to consider supporting maximum sustainable employment *subject to* meeting the price stability objective.

1.5. Supports the retention of an undefined medium term as the target horizon for the price stability objective, and notes that the RBNZ should do more to "look through" the current inflationary pressures and that higher-frequency data on inflation would assist with this.

1.6. Supports the continuance of a range and mid-point for the RBNZ's inflation target.

1.7. Recommends a moderately higher range and mid-point is adopted for the RBNZ's inflation target, the benefits of which outweigh the costs.

1.8. Supports retaining the clause related to avoiding unnecessary instability in output, interest rates, and the exchange rate.

1.9. Recommends maintaining a clause that the MPC must discount the transitory component of an event's impact on inflation.

1.10. Opposes removing the preamble paragraphs in the Remit that set out the Government's economic objectives and the ways in which monetary policy can contribute to realising the Government's economic objectives.

2. Introduction

2.1. The CTU welcomes the opportunity to submit on the Monetary Policy Committee Remit Review (the Review). The CTU supports a macroeconomic policy framework that places the wellbeing of New Zealanders at its centre. The Reserve Bank of New Zealand (RBNZ) can play an important role here by helping to achieve price stability, full employment, and a sound financial system.

2.2. The CTU's view is that a central objective of macroeconomic policy should be the promotion of full employment – defined as a situation in which every person in New Zealand who is willing and able to work can obtain legal employment.[1] A fully employed society has been a long-standing goal of progressive economic policy and is a foundation of the UN's Universal Declaration of Human Rights and Sustainable Development Goals.[2]

2.3. At the time of writing, New Zealand's headline unemployment rate sits at 3.3 percent. By recent historical standards, this is a record low. Between the 1950s and the late 1970s, the unemployment rate in New Zealand was consistently below 2 percent, although this was achieved in a very different economic environment to that of today. During the restructuring of the 1980s and 1990s – which included the passing of the Reserve Bank of New Zealand Act 1989 and the development of inflation targeting – unemployment rose sharply, peaking at 10.9 percent in 1991. Over the following two decades headline unemployment slowly trended back down, reaching a low of 3.4 percent just before the onset of the 2008 financial crisis. In the wake of that crisis, unemployment almost doubled, reaching a peak of 6.7 percent in 2012. Unemployment then slowly declined over the next eight years, reaching a pre-pandemic low of 4 percent in 2019.[3] Today's rate of unemployment is therefore the lowest we have seen since the early 1980s.

2.4. The CTU's view is that policymakers should seek to preserve the current low rate of unemployment, which is an important economic and social achievement. Indeed,

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[1] There will always be a degree of "frictional" unemployment in a market economy, as people look for new work in response to business closures, technological change, and economic restructuring, among other things. A small amount of frictional unemployment need not be a problem so long as there is a robust social-welfare system and active labour market policies that are available to support workers through that period. Unemployment becomes problematic when people are unable to find work within a reasonable timeframe.

[2] Full employment was a central pillar of macroeconomic policy in New Zealand during the post-war decades. By contrast, the central pillars of macroeconomic policy since the early 1990s have been (1) price stability and (2) fiscal balance: D. Rose, "Fiscal History, Fiscal Policy", *IGPS Working Paper 19/03* (2019). For greater clarity, we note that New Zealand should strive for full employment in *decent work* – i.e., work that has a lasting positive impact on the worker, the employer, and the wider community, affords good pay and conditions, and in which both employers and employees are treated with respect and dignity. We recognise that ensuring the availability of work of a particular standard is primarily the responsibility of elected Government, unions, business, and other civil society actors, not the central bank.

[3] Rose, "Fiscal History, Fiscal Policy", pp. 14–16.

our view is that more could and should be done to drive the rate of unemployment lower over time. New Zealand should aim to consistently have one of the lowest rates of unemployment in the developed world.

2.5. The CTU recognises that maintaining stability in the general level of prices is also an important objective for macroeconomic policy, because sustained periods of high inflation can have negative economic consequences that undermine wellbeing and social stability, including the availability of employment. We also recognise that the RBNZ is constrained in its ability to support a full-employment goal, and that the primary levers through which this can be achieved are fiscal and structural. Nevertheless, our view is that the RBNZ can still make an important contribution towards supporting full employment in this country. At minimum, the RBNZ's policy framework and implementation should be consistent with such an objective.

2.6. With these points in mind, this submission focuses on how the MPC Remit can better support high levels of employment in New Zealand without unduly undermining the maintenance of price stability over the medium term. In section 3, we respond to questions raised in the consultation document regarding the monetary policy framework and the primary objectives. In section 4, we respond to selected questions raised about the calibration of the primary objectives and additional considerations for the Remit.

3. The Monetary Policy Framework and Design of the Primary Objectives

3.1. This section responds to all six questions raised in chapters 2 and 3 of the consultation document.

The monetary policy framework

3.2. The CTU supports the retention of a flexible inflation-targeting framework.

3.3. There is a voluminous literature on the debate over "rules versus discretion" in monetary policy. Without trudging through the details of this debate here, we note simply that a prescriptive, rules-based framework is an *inappropriate basis* for monetary policy – and for macroeconomic policy in general.

3.4. Rules may be an appropriate basis for policymaking if one is dealing with a stable system to which all relevant information is accessible and whose future state can

be accurately forecast. The opposite is true of market economies, which are *dynamically unstable* and are characterised by *imperfect information* and *fundamental uncertainty*. In this context, policymakers need a degree of latitude if they are to make optimal decisions – i.e., “when the facts change”, policymakers need to have a reasonable degree of freedom to calibrate their response accordingly. A flexible inflation-targeting framework provides policymakers some latitude in setting monetary policy; it also helps policymakers to support high employment and avoid causing unnecessary economic instability in the pursuit of their mandates.

Weighting of the primary objectives – “credibility versus flexibility”

3.5. The RBNZ currently has a “dual mandate”. It is required “to formulate monetary policy with the goals of [1] maintaining a stable general level of prices over the medium term and [2] supporting maximum sustainable employment” (MSE). The consultation document raises concerns that the RBNZ’s “credibility” as an inflation manager – i.e., its *commitment to* low inflation and its *ability to deliver* low inflation – may have been undermined by the adoption of the MSE objective and/or a lack of guidance regarding how trade-offs between the two primary objectives should be managed. The CTU’s view is that this is not a realistic concern, for three reasons.

3.6. First, there is scant empirical evidence that the RBNZ’s credibility as an inflation manager has been undermined over this period. Long-term inflation expectations are often taken as a proxy measure for a central bank’s credibility as an inflation manager. According to the surveys cited in the *Monetary Policy Statements*, both 5-year and 10-year inflation expectations have hardly budged since the MSE objective was introduced in early 2019. Both remain well within the RBNZ’s 1–3 percent inflation target and near to the 2 percent midpoint. We return to this issue in more detail below; the point made here is simply that these measures in no way suggest the RBNZ’s credibility as an inflation manager has been undermined by the adoption of the dual mandate or a lack of clear guidance regarding trade-offs.

3.7. Second, “maximum sustainable employment” is a very different concept to that of “full employment”. As the RBNZ’s operational definition reads, MSE is “The highest utilisation of labour resources that can be maintained without generating an acceleration in inflation”. By contrast, full employment can be defined as a situation in which every person in New Zealand who is willing and able to work can obtain legal employment. By definition, MSE is a *conditional* term, while full employment is an *unconditional* term. The conditionality of MSE is further evidenced by the fact

that the current Remit outlines a specific numerical target for the price stability objective: to "keep future annual inflation between 1 and 3 percent over the medium term, with a focus on keeping future inflation near the 2 percent midpoint". By contrast, there is no numerical target for the MSE objective, which, as the Remit notes, "is largely determined by non-monetary factors that affect the structure and dynamics of the labour market and is not directly measurable".

3.8. Third, the asymmetry of the two primary objectives is evidenced by the RBNZ's recent response to above-target consumer-price inflation. Since October 2021, the RBNZ has aggressively tightened monetary policy. It was one of the first advanced economy central banks to raise rates;[4] to date, it has also raised rates higher than most other advanced economy central banks (Figure 1), even though New Zealand has recorded lower rates of inflation than most other advanced economies over this period (Figure 2). On its current forecasts, the RBNZ expects that it will raise the OCR to a peak of 5.5 percent. The bank forecasts that this will send New Zealand into a shallow but reasonably lengthy recession in 2023 and early 2024 and will drive unemployment up to 5.7 percent by early 2025.[5] In other words, the RBNZ is actively seeking to drive economic output down and unemployment up in order to lower inflation.

3.9. In short, there is little reason to think that the RBNZ's credibility as an inflation manager has been undermined by the adoption of the "dual mandate" or the lack of a clear position on how trade-offs should be made between the two primary objectives. As such, there is no compelling reason why the flexibility afforded the RBNZ by the current Remit should be curtailed in any way.

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[4] Only the Norwegian central bank raised rates earlier, by two weeks.

[5] Other recent forecasts are not quite as pessimistic, but still see unemployment rising significantly. The Treasury forecasts that unemployment will peak at 5.5 percent in 2024; and NZIER's consensus forecast is that it will peak at 5.1 percent in 2025/26. The Treasury, *Half Year Economic and Fiscal Update* (December 2022); NZIER, *Consensus Forecasts* (December 2022).

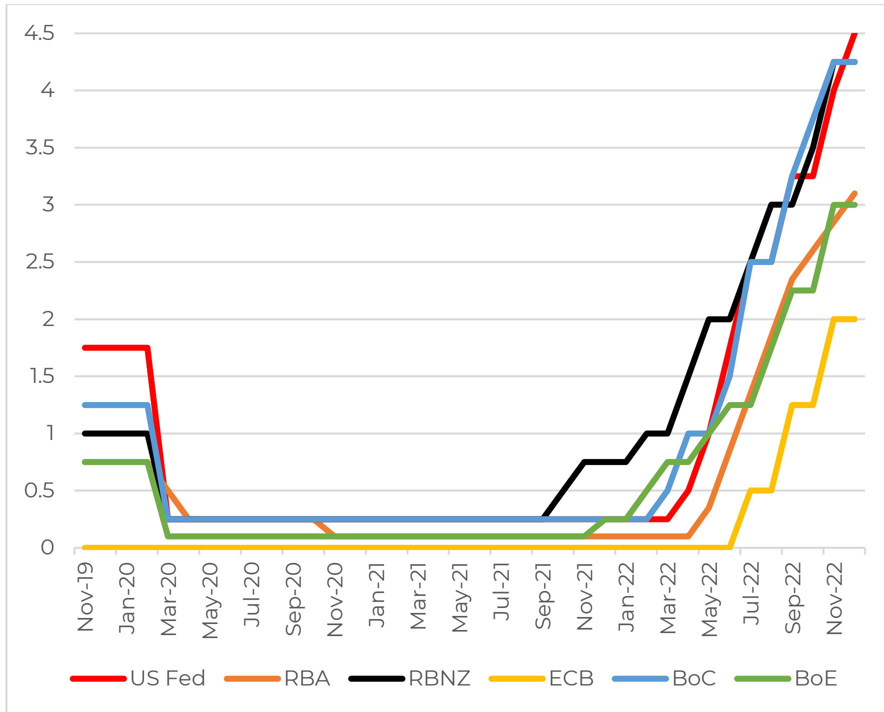

Figure 1: Central bank policy rates, 2020–2022.

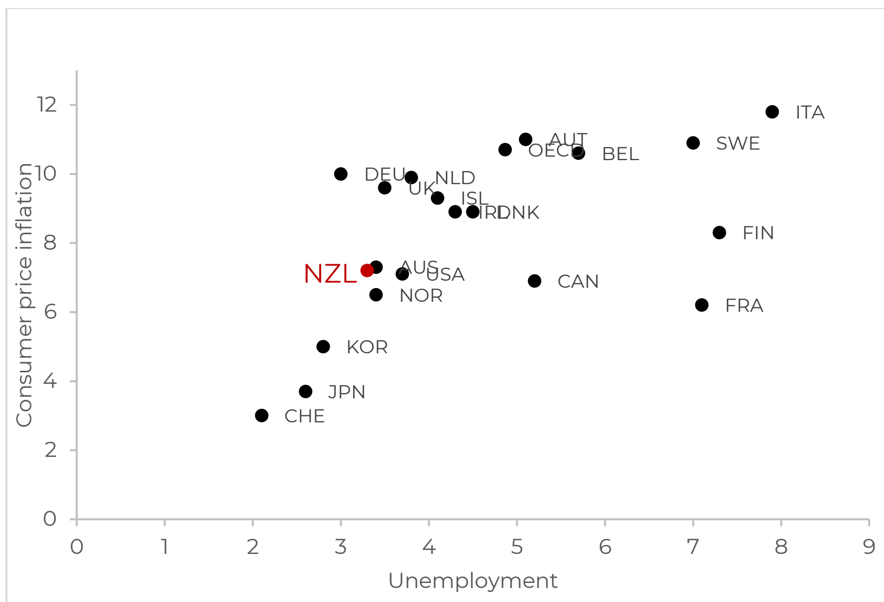

Figure 2: Advanced economies misery index, December 2022 (OECD data).

Hierarchical ordering of the primary objectives

3.10. The CTU strongly opposes the suggestion that the primary objectives of the Remit should be hierarchically ordered – requiring the MPC to consider supporting MSE *subject to* meeting the price-stability objective. Further emphasising the primacy of the price-stability objective would only reinforce the RBNZ's current price-stability bias. It would also undermine the recent progress that has been made in

bringing an employment objective back onto the agenda of macroeconomic policy in New Zealand.

3.11. As discussed above, there is little evidence to suggest that the RBNZ's credibility as an inflation manager may have been undermined by the adoption of the MSE objective and/or a lack of guidance regarding how trade-offs between the two primary objectives should be managed. Indeed, the question can be reversed: is the current Remit – and its operationalisation by the MPC – excessively concerned with keeping consumer-price inflation between 1–3 percent, and does this come at the expense of supporting MSE?

3.12. Inflation in New Zealand has primarily been driven by exogenous shocks caused by the COVID-19 pandemic and the war in Ukraine. Globally, demand rotated away from services and into goods during 2020 and 2021, putting enormous pressure on supply chains; this was compounded by shipping jams and port lockdowns, among other idiosyncratic issues. In this context, energy, food, and commodity prices began to rise in price in late 2021 and then further in response to the Russian invasion of Ukraine in early 2022. This imported inflation still accounts for around half of total CPI in New Zealand, and the rising costs of imported goods has been a significant factor driving up the costs of domestic goods and services.

3.13. The RBNZ is unable to do anything about these international price shocks. The relevant domestic question is whether these price shocks have given rise to a self-sustaining inflationary dynamic in New Zealand. Here, two main justifications have been drawn upon by the RBNZ to support its rapid monetary tightening: (1) the threat of a "wage–price spiral" developing; and (2) the risk that inflation expectations are becoming "unanchored". Empirically, neither justification is well supported.

3.14. The first argument is that rising wage demands are evidence of an evolving wage–price spiral, suggesting that employment is "above its maximum sustainable level". The upshot is that unemployment needs to increase so as to generate some "slack" in the labour market, which will help to moderate wage demands.

3.14.1. This, of course, is not a distributionally neutral response. At the time of writing, around 100,000 people are unemployed in New Zealand and another 180,000 are underutilised. If the unemployment rate peaks at 5.7 percent in early 2025, then monetary policy tightening will have pitched roughly 70,000 *more* New Zealanders into involuntary unemployment, and more again into underemployment. These job losses will not be experienced evenly across

demographics. History suggests those who are at the highest risk of losing their job as the economy cools are Māori, Pasifika, the young, and the low-paid (it would be difficult to find a group in the workforce that is less able to influence the setting of prices and wages). Thus, the current policy response asks some workers (predominantly the most vulnerable workers) in New Zealand to "take one for the team".

3.14.2. Regardless of these distributional issues, it should be noted that there is scant evidence that a wage–price spiral is on the cards for New Zealand. Real wage growth continues to lag inflation in New Zealand and inflation continues to be driven primarily by international factors that are beyond the RBNZ's control. New Zealand is not alone in this situation. As the ILO's recent *Global Wage Report* details, there is currently "no evidence of a wage–price spiral either in high-income countries or in middle- and low-income ones".[6] And as research from the IMF has found, only in rare cases have historical episodes of rising inflation and low unemployment combined with rising nominal wages and falling real wages – the precise dynamic we are currently experiencing in New Zealand – resulted in wage–price spirals.[7] In short, wage–price spirals are rare economic phenomena and the evidence thus far does not suggest we are on the cusp of one emerging in New Zealand. The threat of a wage–price spiral is therefore not a credible basis for rapid monetary policy tightening aimed at driving unemployment up.

3.15. The second argument is that inflation expectations are showing signs of becoming unanchored, which may be a sign that either the central bank's credibility as an inflation manager is at risk, or that high inflation is becoming self-sustaining, or both.

3.15.1. The question of inflation expectations is a vexed one. The dominant view in the modern literature on central banking and monetary policy is that inflation expectations are an important driver of observed inflation. This argument boils down to the idea that expectations about future inflation determine price-setting behaviour in the present. If price-setters expect that inflation will be high in the future, then they will be more inclined to raise prices in the present. It is argued that a central bank is capable of "anchoring" inflation expectations at a low level if it is widely perceived as a credible inflation manager – i.e., that it will intervene forcefully to keep inflation low. The dominant view is that

[6] ILO, *Global Wage Report* (2022).
[7] IMF, *World Economic Outlook* (October 2022).

credibility has been "won" through the institutions of central bank independence and inflation targeting over the past 30 years or so. The emergence of a low-inflation economic environment across the advanced economies from the 1990s has been taken as evidence that inflation can be anchored by a credible central bank. Today, central banks are set on "winning back" or "protecting" their hard-earned credibility by stamping out the current inflation, even if this comes at the cost of higher unemployment and lower growth.

3.15.2. This is certainly a neat narrative; however, it is not at all clear that it is correct. While research confirms that the period of independent, inflation-targeting central banks has been one of low inflation,[8] this correlation does not amount to causation. Other research points to the salience of institutional and structural dynamics such as globalisation, the declining power of organised labour, and relative geopolitical (and therefore energy-price) stability over this same period.[9] Indeed, despite the existence of quite different central bank mandates and institutional structures across the advanced economies over the past three decades, low and stable inflation has been a *common* experience across the developed world. This suggests that these structural factors have been salient. This is not to entirely invalidate the conventional narrative; but it does suggest it is not a particularly robust basis for policy decisions.

3.15.3. Nevertheless, if we set the above points to one side and assume that inflation expectations and central bank credibility *do* matter a great deal, then the literature is clear that it is *long-term* inflation expectations that are the relevant metric. While short-term inflation expectations may quite reasonably adjust up or down in response to economic shocks, the theory is that long-run inflation expectations should remain anchored near the central bank's inflation target if it is viewed as a credible inflation manager.

3.15.4. Notably, long-term inflation expectations in New Zealand have remained *flat* over the past five years – which is the period in which the MSE objective was introduced (see Figure 3). Although 1-year inflation expectations have shot up

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[8] E.g., A. Cukierman, "Central Bank Independence and Monetary Policymaking Institutions – Past, Present and Future", *European Journal of Political Economy* 24, no. 4 (2008).

[9] E.g., BIS, *Annual Economic Report, June 2021* (2021); H-F. Hung and D. Thompson, "Money Supply, Class Power, and Inflation: Monetarism Reassessed", *American Sociological Review* 81, no. 3 (2016); A. Stansbury and L. Summers, "The Declining Workers Power Hypothesis: An Explanation for the Recent Evolution of the American Economy", *Brookings Papers on Economic Activity* (Spring 2020); D. Ratner and J. Sim, "Who Killed the Phillips Curve? A Murder Mystery", *Federal Reserve Board, Finance and Economics Discussion Series* (2022).

as the inflationary shock of 2021 and 2022 has unfolded, they now appear to have peaked, remaining stable over the last three quarters of 2022. Meanwhile, 2-year inflation expectations have remained reasonably close to the RBNZ's target range (the 2022 peak being 3.6 percent). More significantly, 5-year inflation expectations have risen by only 0.3 percent and 10-year expectations have hardly budged. As of the latest MPS, 5-year expectations are at 2.4 percent and 10-year expectations are at 2.2 percent, both well within the target range of 1–3 percent and close to the mid-point of 2 percent. Currently, neither measure is appreciably higher than the pre-pandemic norm; and neither measure has risen appreciably higher than the pre-pandemic norm throughout the last five years. This suggests two things: (1) the adoption of the dual mandate has had no effect on the inflation-fighting credibility of the RBNZ (indeed, short-term inflation expectations actually fell after the introduction of the dual mandate in early 2019); and (2) the RBNZ's fears that inflation expectations are becoming unanchored are not well grounded in evidence and are therefore not a compelling justification for continued OCR hikes.

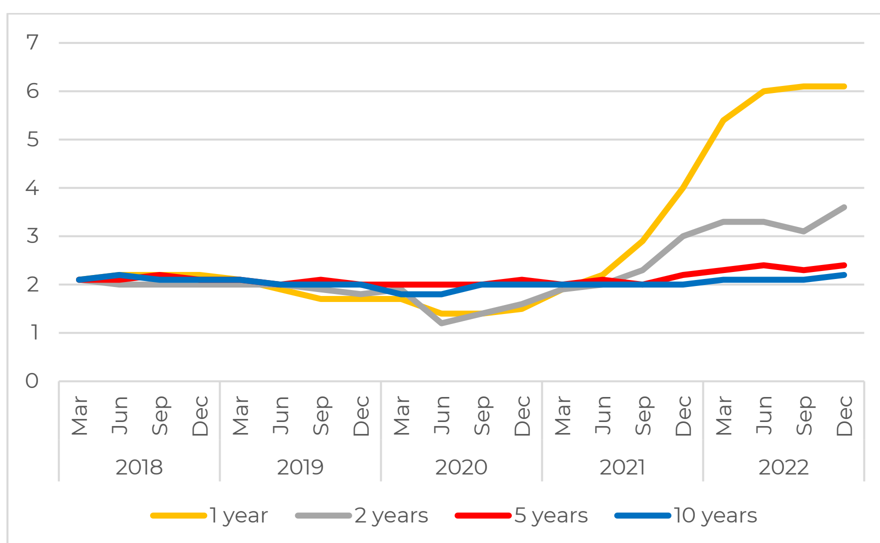

Figure 3: Inflation expectations in New Zealand, 2018–2022 (RBNZ data).

3.16. It is reasonable to be concerned about inflation pressures becoming embedded, as the evidence suggests that transitions from low-inflation regimes to high-inflation regimes are self-sustaining.[10] However, there is a need for monetary policy decision-makers to be more circumspect in the present conjuncture. The evidence does not suggest that inflation is becoming self-sustaining, either through wage pressures or through the drift of inflation expectations. Further, there is a material risk that

[10] BIS, *Annual Economic Report, June 2022* (2022).

the RBNZ is on course for an "overcorrection" with its tightening cycle. This would cause unnecessary economic harm and would undermine the wellbeing of both individual New Zealanders and the country as whole.[11]

3.17. In sum, although some monetary policy tightening was warranted from 2021 (and, in retrospect, the Large Scale Asset Purchase programme and the Funding for Lending programme could have been ended earlier), our view is that the tightening trajectory that the RBNZ has set itself on is excessive, and that this stems from its price-stability bias.[12] The RBNZ could be doing more to "look through" the current inflationary pressures and preserve New Zealand's low rate of unemployment, which is an important policy success.

3.18. We therefore strongly oppose the suggestion that the primary objectives of the Remit should be hierarchically ordered – requiring the MPC to consider supporting maximum sustainable employment *subject to* meeting the price stability objective. Further emphasising the primacy of the price-stability objective would only reinforce the current price-stability bias and undermine the recent progress that has been made in bringing an employment objective back onto the agenda of macroeconomic policy in New Zealand.

The "medium term"

3.19. The CTU supports the retention of an undefined medium term as the target horizon for the price stability objective. However, we note that the RBNZ should do more to "look through" inflation that is generated by transitory shocks, such as the post-COVID inflation; this should be strongly encouraged in the Remit. When responding to inflationary pressures, a patient, medium-term approach is needed to ensure not only that economic volatility is minimised, but also that the negative employment effects of rising interest rates are minimised.

3.20. Although monetary policy is a very blunt instrument, it can be a useful tool to deploy when inflation is driven primarily by excess *aggregate* demand. However, it is too blunt an instrument to deal effectively with inflation that is driven primarily

[11] As the RBNZ is aware, changes to the OCR take between 12–24 months to be fully felt in the wider New Zealand economy. Because around 90 percent of New Zealand mortgages are on fixed-term rates, changes to the OCR are not widely felt until most mortgage holders have had to refix. The majority of mortgages are due for refixing over the next 12 months and refixing at far higher rates will likely have a significant negative impact on aggregate demand. In short, the full effects of the last 12 months of OCR hikes are yet to be felt. The risk of overcorrection is compounded by the fact that imported inflation pressures are easing and global economic growth is widely forecast to be sluggish in 2023, which should act to further drag down inflation.

[12] We note that the Reserve Bank of Australia has embarked on a more cautious series of rate hikes over the past year. Although inflation is running at 7.3 percent in Australia at the time of writing, the RBA has only raised rates by 300 basis points thus far, from 0.10 percent to 3.10 percent.

by, for example, sectoral shocks that constrain supply or shift demand patterns from one sector to another – which is a fair description of the post-COVID inflationary dynamic.[13] In these circumstances, fiscal and structural policies are far more effective and do not have the same adverse side effects as monetary policy. Indeed, one of the side effects of restrictive monetary policy is that it undermines future productive capacity, thereby potentially *intensifying* inflationary pressures over the long run. In these contexts, the RBNZ needs to have more flexibility to "look through" periods of inflationary adjustment. In turn, government needs to be prepared to lend the RBNZ a hand by using fiscal and structural policy to build out New Zealand's productive capacity in a way that enhances our resilience to future inflationary shocks.

3.21. If a more specific timeframe for what constitutes the "medium term" were to be adopted it should be *no shorter than two years*, as this is the estimated time that it takes for the effects of monetary policy decisions to be fully felt in the wider economy.

3.22. A further point to be made here is that New Zealand lacks high-frequency data on consumer-price inflation. StatsNZ only publishes this data on a quarterly basis, meaning that the MPC's monetary policy decisions are based on excessively backward-looking data. This increases the likelihood of monetary policy being set pro-cyclically, both when inflation is rising and when it is falling. Publishing monthly consumer-price inflation data and using this higher-frequency data to inform MPC decisions should result in better monetary policy decisions.

The target range for inflation

3.23. The CTU supports the continuance of a range and mid-point, as it provides a desirable level of flexibility and helps to minimise unnecessary instability in output, interest rates, and the exchange rate.

3.24. The CTU supports maintaining the current range of plus or minus 1 percentage point. However, as discussed in the next section, we suggest that a higher inflation target may provide significant benefits at little cost and should therefore be seriously explored.

[13] J. Stiglitz and I. Regmi, "The Causes of and Responses to Today's Inflation", *Roosevelt Institute Report* (December 2022); I. Weber et al., "Inflation in Times of Overlapping Emergencies: Systemically Significant Prices from an Input–Output Perspective", *University of Massachusetts Amherst, Economics Department Working Paper* (2022).

4. Calibration of the Primary Objectives

4.1. This section responds to selected questions raised in chapters 4, 5, and 6 of the consultation document.

The level of the inflation target

4.2. The CTU recommends that a moderately higher range and mid-point for the RBNZ's inflation target may provide significant benefits while imposing minimal costs.

4.3. "Price stability" is a relative term and an inflation target is ultimately an arbitrary number. However, an optimal inflation target is one that enables at least three things to be true at once. First, the target needs to be high enough to provide a buffer against hitting the effective lower bound (ELB) and to allow for the necessary price adjustments that enable resource reallocation across the economy. (For this reason, having a zero-inflation target is economically harmful and the CTU would strongly oppose lowering either the range or the mid-point from its present levels.) Second, the target needs to be low enough to help stabilise inflation expectations over time; ideally, inflation should be something that firms and households do not think all that much about. This, again, is relative – what is considered unacceptably high inflation differs across time and place. Third, it needs to be a target range that the central bank can reliably hit over time, without causing unnecessary instability in output, interest rates, and the exchange rate – and without, we would add, undermining the country's employment goals. If the central bank cannot reliably hit its inflation target without causing unnecessary economic instability, then its credibility as an inflation manager will be undermined, as will the country's economic welfare.

4.4. With these points in mind, we recommend that a range of 2–4 percent with a 3 percent mid-point would offer significant benefits and impose minimal costs. A target around this level or slightly higher has received widespread support from economists in recent years.[14] There are two main reasons why a moderately higher inflation target would be beneficial.

[14] E.g., O. Blanchard et al, "Rethinking Macroeconomic Policy", *IMF Staff Position Note 10/03* (2010); L. Ball, "The Case for a Long-Run Inflation Target of Four Percent", *IMF Working Paper 14/92* (2014); J. Gagnon and C. Collins, "The Case for Raising the Inflation Target is Stronger than You Think", *Peterson Institute for International Economics* (2022).

4.5. First, as many economists have argued over the past decade, a slightly higher inflation target would provide central banks with more room to conduct counter-cyclical policy without running into the ELB.

4.5.1. As the Bank for International Settlements notes, "monetary policy loses traction when nominal interest rates are very low. [...] The more limited traction of monetary policy at low levels of inflation means that bigger moves in the policy instrument are needed to produce the same inflationary effect, with larger side effects for the real economy".[15] Many central banks have been faced with this problem since the 2008 financial crisis. In response, they have resorted to sub-optimal "alternative" monetary policy tools, especially large-scale asset purchases (quantitative easing/QE), which help the central bank to meet its inflation target but can also undermine financial stability and contribute to wealth inequality.[16]

4.5.2. A higher inflation target should help to lift the average level of the nominal interest rate, meaning that the RBNZ has more room to cut rates to stimulate economic activity in a downturn, or in response to an unexpected shock, before it runs into the ELB. This should help to keep unemployment lower on average and to avoid having to resort to sub-optimal policy tools.

4.6. Second, it is likely that we are entering a period of structurally higher inflation – or at least of more frequent inflationary price shocks. In this context, a higher inflation target will assist central bank credibility by making it easier for the central bank to both meet its inflation target and support high employment without causing unnecessary economic instability.

4.6.1. As discussed in section 3, the evidence is mixed regarding exactly what has underpinned the low-inflation regime of the past three decades. However, based on the wider literature, it is reasonable to argue that the low-inflation regime was underpinned by the combination of four key factors: (1) globalisation, which opened up new sources of supply and put downward pressure on wages; (2) the decline of organised labour and the flexibilization of labour markets, which also put downward pressure on wages; (3) relative geopolitical stability, which helped to keep energy and other commodity prices low; and (4) the combination of inflation-targeting central banks and

[15] BIS, *Annual Economic Report, June 2022*, p. 60.
[16] D. Gabor, "Revolution Without Revolutionaries: Interrogating the Return of Monetary Financing", *Transformative Responses to the Crisis, Finanzwende, Heinrich-Böll-Foundation* (2021); J. Montecino and G. Epstein, "Did Quantitative Easing Increase Income Inequality?" *Institute for New Economic Thinking Working Paper 28* (2015).

fiscal policy focused on returning balanced government accounts. To this list, we should also add a fifth factor that contributed to low inflation: a stable and relatively predictable global climate.

4.6.2. As even a casual observer would note, points 1 and 2 no longer hold to the same extent that they did throughout the 1990s and the first two decades of the 2000s. Globalisation has come under immense stress politically and great power conflict is back. These developments should be expected to put significant pressure on supply chains in the future and to make inflationary price shocks more common. The acceleration of climate change and the need to ramp up emissions-reduction policies that require significant fiscal investment and resource reallocation further increases the likelihood that inflationary shocks will become more common in the future. Finally, it is now widely recognised that the policy mix of inflation targeting and fiscal balance, while helpful in keeping inflation low, has contributed to higher levels of unemployment, rising inequality, and chronic underinvestment in infrastructure over the past three decades. This is not socially sustainable and suggests that increased fiscal expenditure is necessary over the coming decade.

4.6.3. In this context, a higher inflation target will reduce the risk that the RBNZ will consistently overshoot its inflation target and will therefore aid the RBNZ's credibility. It will also enable better monetary and fiscal policy coordination in the context of the higher fiscal expenditure that is needed to address New Zealand's infrastructure deficit and green transition needs, among other things. Finally, by making it less likely that the RBNZ will be in a situation where it faces a "trade-off" between inflation and unemployment, a moderately higher inflation target will also assist the RBNZ in meeting its employment objective.

4.7. Over the past three decades, advanced economy central banks have adopted very low inflation targets in the range of 1–3 percent per annum. The basis for these low targets has been the argument that low inflation is key to enabling strong and stable economic development. It should be noted, however, that this is not well supported by the empirical evidence, which suggests that inflation only imposes significant economic costs when it rises to double digits.[17] Indeed, recent research finds that high-income economies have historically achieved *stronger* real GDP

[17] J. Kirshner, "The Political Economy of Low Inflation", *Journal of Economic Surveys* 15, no. 1 (2001); L. Ball, "The Case for a Long-Run Inflation Target of Four Percent", *IMF Working Paper 14/92* (2014).

growth when inflation runs significantly higher than the 1–3 percent range.[18] It should also be noted that the RBNZ's consultation document does not discuss in any depth what the negative welfare effects of a moderately higher inflation target would be.[19]

4.8. By contrast, it is likely that a moderately higher range and mid-point would help the RBNZ to avoid the problem of the ELB, better support high employment, and assist its credibility in a changing economic system (not to mention a changing climate). Thus, the benefits of a moderately higher inflation target appear to substantially outweigh the costs.

Additional clauses

4.9. The CTU supports retaining the clause related to avoiding unnecessary instability in output, interest rates, and the exchange rate. We also recommend including employment in this list. The RBNZ should always seek to ensure that monetary policy is implemented in a way that minimises economic instability.

4.10. The CTU recommends maintaining a clause that the MPC must discount the transitory component of an event's impact on inflation; however, this could be reworded and included in the primary objective, as suggested in the consultation document. As discussed above, the RBNZ should be doing more to "look through" the current inflationary pressures. Maintaining the above clause is important in helping to encourage such an approach in the future.

Monetary and fiscal policy coordination

4.11. The CTU does not support removing the paragraph that sets out the Government's economic objectives. Nor does the CTU support removing the paragraph that sets out the way in which monetary policy can contribute to realising the Government's economic objectives.

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[18] R. Pollin and H. Bouazza, "Considerations on Inflation, Economic Growth and the 2 Percent Inflation Target", *PERI Working Paper* (2022). As the authors note, in high-income economies "the evidence suggests that they are paying a significant penalty in terms of foregone GDP growth when policymakers set an inflation target at 2 percent as the central goal of macroeconomic policy" (p. 22).
[19] The consultation document does raise the issue of a "transition risk", whereby the RBNZ's credibility as an inflation manager is negatively impacted if the public perceives that the inflation "goalposts" are being shifted. This is not an unreasonable concern, and we would suggest that shifting the target range and midpoint upwards should only happen after the current inflationary shock has abated, and inflation has shifted down close to, or within, the current range of 1–3 percent. More generally, though, a shift upwards by 1 percent or slightly more would not be a dramatic change to monetary policy in New Zealand. The New Zealand public has coped perfectly well with the previous three major changes to the numerical target since the passing of the Reserve Bank Act. In 1996, the inflation target was shifted from 0–2 percent to 0–3 percent. In 2002 it was shifted from 0–3 percent to 1–3 percent on average over the medium term. And in 2012 the 2-percent midpoint was introduced.

4.12. The consultation document suggests that removing these paragraphs may "enhance the perception of central bank independence". However, it is difficult to see how either of these paragraphs materially undermine central bank independence in the first place – and the consultation document does not elaborate on this issue further. It should be recalled that central bank independence means *operational* independence – i.e., independence in determining how to achieve the objectives laid out for the RBNZ in the relevant legal texts. As such, there is no contradiction between (a) the Government providing guidance on how the RBNZ can support the Government's economic objectives and (b) the central bank's ongoing operational independence in the pursuit of the monetary policy objectives it has been delegated. Indeed, in a democratic society it is both inappropriate and potentially destabilising for a central bank to pursue – intentionally or not – objectives that run contrary to those of elected government. Doing so undermines the legitimacy and credibility of government, which is brought to power by the public on the understanding that it can reasonably pursue the objectives on which it campaigned. This erodes public confidence in the state, thereby undermining the longevity of central bank independence itself.

4.13. More broadly, since the early 1990s the orthodoxy has been for the two sides of macroeconomic policy to be separated, and the primary burden of economic stabilisation given to central banks. As has been widely discussed, the problems with this regime became increasingly evident after the 2008 financial crisis.[20] Through the 2010s, economists, central banks, and international organisations have increasingly called for more assistance from fiscal authorities in the context of "overburdened" central banks and sluggish economic growth across most advanced economies. As the consultation document notes, the COVID-19 pandemic further highlighted the necessity of macroeconomic policy coordination. Our view is that removing the preamble paragraphs to the Remit would undermine recent progress in the direction of better macroeconomic policy coordination. Future Remits should, on the contrary, convey expectations of deeper and ongoing policy coordination between the RBNZ and the fiscal authority.

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[20] For differing perspectives on this issue see, e.g., A. Tooze, *Crashed: How a Decade of Financial Crises Changed the World* (London, 2018); O. Blanchard and L. Summers, *Evolution or Revolution? Rethinking Macroeconomic Policy After the Great Recession* (Massachusetts, 2019); C. Borio, "Central Banking in Challenging Times", paper presented at SUERF Annual Lecture, Milan, 2019; A. Korinek and J. Stiglitz, "Macroeconomic Stabilization for the Post-Pandemic World: Revising the Fiscal–Monetary Policy Mix and Correcting for Economic Externalities", *Hutchins Center Working Paper 78* (2022).

5. Conclusion

5.1. This submission has focused on how the MPC Remit could better support high levels of employment in New Zealand without unduly undermining the maintenance of price stability over the medium term. The CTU's view is that both the maintenance of price stability and the promotion of full employment are critical objectives of macroeconomic policy. Although its powers are limited, the RBNZ has an important role to play in supporting both objectives.

5.2. The CTU thanks the RBNZ for the opportunity to engage on the Monetary Policy Committee Remit Review. We look forward to further engaging with the RBNZ on this work and on other monetary and financial policy issues.

For further information about this submission, please contact:

Jack Foster
Policy Analyst
New Zealand Council of Trade Unions – Te Kauae Kaimahi
Phone: 027 800 2361
Email: jackf@nzctu.org.nz