

## Speed dating central bank style

From next year, the Reserve Bank will let go one chance each year to meet and set interest rates. That means the Reserve Bank could easily fall behind the run rate on the interest rate settings required to manage the economy. The Reserve Bank is also tweaking when they meet to try and match the timing of key data releases. That's too much fine tuning in today's data-rich environment where the data flow is much more even than in past decades. There are ways to improve how interest rates are set. Meeting less often is not one of them.

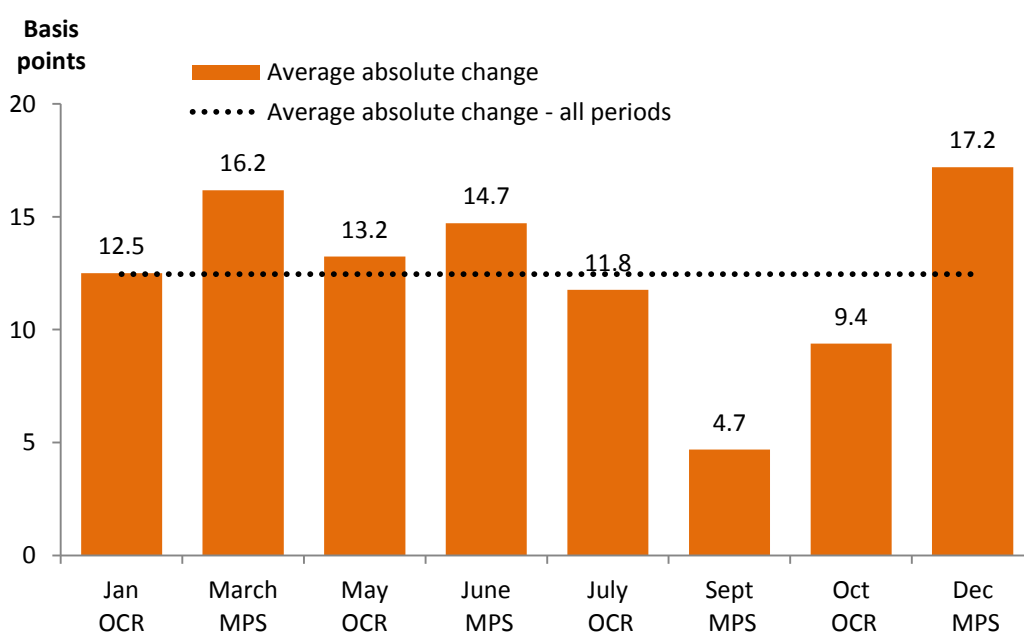
### What the Reserve Bank has proposed

From July 2016, the Reserve Bank is switching the timing of policy decisions and the year's first OCR meeting will no longer be in January. Instead, the Reserve Bank will produce Monetary Policy Statements (that include an OCR review) in February, May, August and November and hold OCR reviews on the fourth Thursday of March, June and September.

That might seem like tinkering around the edges; but omitting a January review means there will be a full three months between interest rate decisions in November and February. When interest rates adjustments are often made in 25 basis point movements, such an approach risks the Reserve Bank falling 'behind the curve' and needing to play catch up at subsequent interest rate meetings. Figure 1 shows that on average the Reserve Bank has moved interest rates at January meetings just as much as other dates in the year.

**Figure 1 January OCR reviews are used to move interest rates**

Average OCR moves since inception (17 March 1999)



NB. Since implementing the OCR regime the Reserve Bank has moved rates only once outside of regular scheduled meetings, lowering the OCR by 50 basis points from 5.75 to 5.25 percent after the 11 September 2001 attack on the US.

Source: RBNZ, NZIER calculations

## What can we learn from other central banks?

Central banks want to meet often enough to set the desired interest rate that would help stabilise inflation and output (and perhaps the exchange rate) but not so often that they risk sending mixed signals by flip-flopping between interest rates hikes and cuts too often.<sup>1</sup>

Table 1 shows that most central banks stick to setting interest rates at least 8 times a year. Some, like the Reserve Bank of Australia and the Bank of England meet more frequently while others, like the Riksbank and the European Central Bank, meet 6 times a year.

**Table 1 Not many central banks set interest rates less than 8 times a year**

Central Bank	Frequency of meeting	Committee or Governor
Reserve Bank of Australia	Monthly (no January meeting)	Committee
Central Bank of Brazil	8 per year	Committee
Bank of Canada	8 per year	Governor*
European Central Bank	Bi-monthly	Committee
Bank of Japan	Monthly	Committee
Bank of Korea	Monthly	Committee
Riksbank (Sweden)	6 per year	Committee
Bank of England	Monthly	Committee
Federal Reserve	8 per year	Committee
Reserve Bank of New Zealand	7 per year from July 2016	Governor

NB. The Bank of Canada operates a Governing Council consisting of internal staff even though it is not required to by legislation. Responsibility for the decision is the Governor's alone (see Siklos and Neuenkirch 2014 for a similar assessment).

Source: NZIER, *Bank for International Settlements (2007)*

The ECB faces a non-trivial coordination problem in getting all the members of its Governing Council together (6 members of the Executive Board plus the Governors of the central banks of the 19 euro area members) so might be expected to meet less frequently than the Reserve Bank of New Zealand which doesn't face the same pressures. New Zealand is also a small open economy that is exposed to large commodity price shocks. So we might need to meet more frequently than larger closed economies.<sup>2</sup>

## Moving the dates of interest rate decisions will not better match the data timing

One of the defining features of the modern era is the proliferation of economic data. There is now a wide array of official and non-official quantitative data on not just the New Zealand economy but on our key trading partners too. That makes the data flow much more regular and flat rather than being punctuated with spikes for releases like inflation or GDP.

And along with a richer array of data, central bank researchers have developed and then refined methods for forecasting current economic activity and prices.<sup>3</sup> Since GDP is released with such a long lag (see Figure 2) and

<sup>1</sup> Guthrie and Wright (2004) show that the optimal strategy is to design interest rate changes such that the costs and benefits of changes are equalised while Sack and Wieland (2000) argue that uncertainty about how the economy operates and a desire to influence longer term rates make central banks reluctant to change the direction of interest rate changes too rapidly.

<sup>2</sup> A point made by Stefan Gerlach (2009): "Large, less open and highly diversified economies generally experience smaller shocks than small and highly open economies that tend to be dominated by developments in a few sectors." Gerlach (2009) also notes that that large committees that seek consensus decision-making are likely to meet less frequently than committees that do not require consensus (presumably including single decision-makers).

<sup>3</sup> Some of the Reserve Bank's own work provides methods to estimate economic activity and inflationary pressure using rich data sources (see for example, Giannone and Matheson 2007, Matheson 2006 and Matheson 2010).

is subject to revisions, these other estimates of economic activity are a better read on future inflation than GDP alone. So there is no longer much need to align decision-making to GDP or inflation releases.

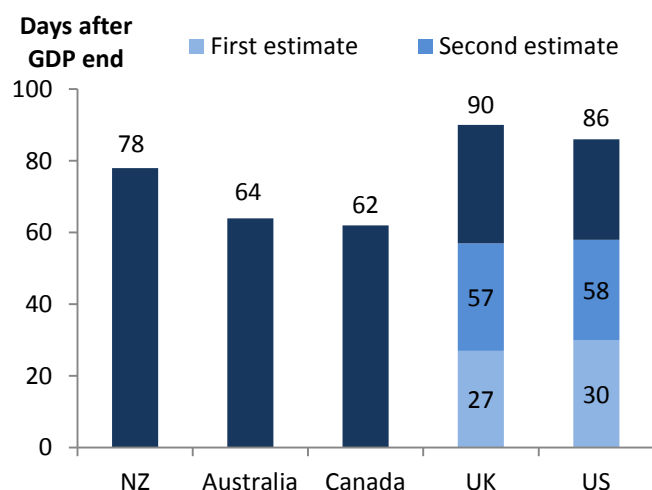
Instead, the Reserve Bank’s own work points to the usefulness of survey data – the Quarterly Survey of Business Opinion (QSBO) and the ANZ Bank Business Outlook (ABBO) in particular – for getting a steer on the current state of the economy.<sup>4</sup> A January OCR makes good use of both surveys.

To be fair, New Zealand has less access to official reads on inflation and GDP data than elsewhere. Unlike other countries, New Zealand does not produce a monthly CPI index, a point raised as an omission in Lars Svensson’s review of monetary policy in 2001. Other countries also get an earlier read on GDP relative to the Reserve Bank (see Figure 2).

Until recently, most of Statistics New Zealand’s efforts have gone into lifting the quality of GDP rather than timeliness (Figure 3 shows the evolution of the number of days after the end of the period that GDP comes out). That’s at least partly because many of the components such as retail trade are now released as they come to hand, reducing the signal in the official GDP data release, which no longer moves markets to the same extent that it did in the past.

**Figure 2 Others get an earlier read on GDP**

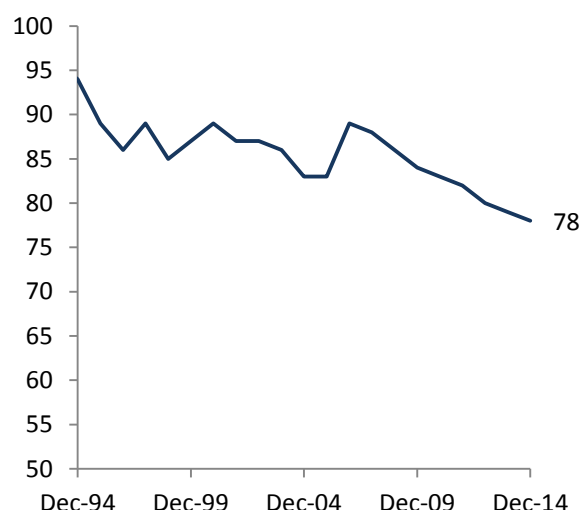
Days between release and end of period, December 2014



Source: Statistics NZ, ABS, Statistics Canada, ONS, BEA

**Figure 3 Timeliness is improving a little**

Days between release and period end, December 1994-2014



Source: Statistics NZ, NZIER calculations

### There are better options to improve how monetary policy is set

Rather than trying to fine tune the timing of interest rate decisions, we believe there are better options for improving the conduct of monetary policy given the current environment.

#### Set monetary policy using a committee

Reducing the number of policy decisions and the time taken to debate each policy decision is entirely consistent with a Governor overloaded with too many key functions. Right now the Governor is responsible for functions that span monetary policy, macro-prudential policy, prudential supervision, payments systems and providing and maintaining sufficient quality and quantity of currency.<sup>5</sup>

That’s a lot more responsibility vested in a single decision-maker than in other countries where prudential regulation will often be undertaken by a separate authority such as Australia’s Prudential Regulation Authority.

<sup>4</sup> See Matheson (2010) that details the relative importance of a range of data for estimating the current state of the cycle.

<sup>5</sup> Aldridge and Wood (2014) suggests: “The Reserve Bank of New Zealand, a ‘full service central bank’, is among those with the widest range of responsibilities and powers”.

It never used to be like this. But in the wake of the Global Financial Crisis the Reserve Bank ramped up efforts in the macro-prudential space and picked up additional tasks under additional legislation:

- the Insurance (Prudential Supervision) Act 2010 which means the Reserve Bank is responsible for licensing and imposing prudential standards on insurers
- the Non-bank Deposit Takers Act 2013 (NBDT), which set up the Reserve Bank to license NBDTs
- the less resource intensive Anti-Money Laundering and Countering Financing of Terrorism Act 2009, which means the Reserve Bank is responsible for detecting money laundering.

With such a wide range of responsibilities, a committee approach would allow a deeper analysis and bring a wider range of views within the monetary policy function. There is evidence that committees make superior decisions than individuals (see for example, Gerlach-Kristen 2006, Blinder 2007, and Blinder and Morgan 2008), by processing a wider range of data and opening up debate to a wider range of perspectives.

And over time central banks have changed their ways. Alan Blinder, a former Vice Chairman of the Board of Governors of the Federal Reserve notes:

*“Among the most notable, but least discussed, hallmarks of what I have called the “quiet revolution” in central banking practice has been the movement toward making monetary policy decisions by committee.”*

Today almost all central banks— many of which are responsible for fewer tasks than the Reserve Bank of New Zealand – set monetary policy by committee (see Table 1 for a selection).

#### **Tighten up internal timing between interest rate decision-making and communicating the decision**

The Reserve Bank used to run roughly a three-week process to bring an MPS and associated interest rate decisions together. Week 1 was a series of meetings to discuss the relevant data and stories, including the international outlook, financial markets and domestic economy. Week 2 was finalising the interest rate decisions and the Statement prior to proofing and sending the document to get printed. Week 3 was preparation for the Thursday release.

One smart thing would be to drop hard printing of the MPS and move to electronic printing. That would free up time for decision-making and reduce the risk of external leaks.

One further step would be to make and release the policy decisions immediately after the forecast week discussion and then release the MPS after the press conference and one page statement. Such an approach would reduce the gap between the data and decision allowing any change in interest rates to be more closely aligned to the economic story. Such an approach is consistent with the process followed by both the Reserve Bank of Australia and the Federal Reserve, for example.

In summary, tightening up on internal processes and setting monetary policy by committee are likely to be better than tinkering with the timing of decisions in today’s data rich environment. Letting go of making interest rate decisions in January of each year is potentially costly since this reduces the options with which the Reserve Bank can manage the economy. Meeting less often will not mean more flexibility to manage the economy.

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This Insight was written by Dr Kirdan Lees at NZIER, 31 August 2015

For further information please contact [Kirdan.lees@nzier.org.nz](mailto:Kirdan.lees@nzier.org.nz) or 021 264 7336

NZIER | (04) 472 1880 | [econ@nzier.org.nz](mailto:econ@nzier.org.nz) | PO Box 3479 Wellington

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