

Monetary Policy Objectives

Purpose

Phase 1 of the Review of the Reserve Bank Act considers changes to the Act to provide for requiring monetary policy decision-makers to give due consideration to maximising employment alongside the price stability framework.

The purpose of this paper is to provide information on other countries' approaches to defining their central bank mandate in order to inform discussion among the Panel members about what considerations/models should be taken into account in specifying a legislative mandate for the Reserve Bank of New Zealand that includes full employment.

To do this, the paper outlines the legislative regimes of six central banks, all of which have different legislative objectives but all of which implement flexible inflation targeting regimes. It also covers how this translates into a secondary instrument (which more specifically sets out the central bank's policy target) and the relationship between the government and the central bank in setting the policy target. Annex one sets out the legislative objectives of 21 other central banks in order to provide a wider perspective.

The Reserve Bank's current mandate

The monetary policy objective of the Reserve Bank of New Zealand is currently set out in section 8 of the Reserve Bank Act 1989:

- The primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices.

The Policy Targets Agreement (PTA) is the secondary instrument that then sets out the policy target for the Reserve Bank in order to give effect to the price stability objective. Under the current PTA the Reserve Bank must keep future CPI inflation outcomes between 1-3% on average over the medium term, with a focus on keeping future average inflation near the 2% target midpoint. The Reserve Bank must also have regard to the efficiency and soundness of the financial system, and seek to avoid unnecessary instability in output, interest rates and the exchange rate in pursuing the price stability objective.

The framework in the PTA is a flexible inflation targeting framework. Under a flexible inflation targeting framework the central bank pursues medium term price stability but also puts weight on stabilising output/employment around sustainable levels¹. Flexible inflation targeting frameworks recognise that while, due to the 'divine coincidence', inflation targeting will also generally stabilise output/employment around sustainable levels at times the objectives of inflation control and stabilising output/employment can

¹ For a fuller explanation, see the background paper: 'New Zealand's Flexible Inflation Targeting Framework', Treasury Report (2017)

conflict, for example when a supply shock (such as a drought) lowers output and increases prices. Flexible inflation targeting regimes provide a mechanism to manage these circumstances. For example, under the PTA the Reserve Bank can look through temporary inflation impacts and focus on the medium term inflation expectation. However, if the inflation impact of a supply shock is persistent and increases inflation expectations the central bank may need to tighten monetary policy, dampening output and employment in the short run, in order to ensure price stability is maintained over the medium term (and *vice versa*).

An important consideration is that, by maintaining a medium term inflation objective, inflation targeting regimes manage inflation expectations. Well anchored inflation expectations reduce the extent of work that monetary policy needs to do to control inflation, as people's expectations of inflation are a determinant of inflation outcomes.

While flexible inflation targeting frameworks require the central bank to take account of the variability of output/employment, in our survey we did not find any central bank with a numerical target for 'full employment'. In part this is because concepts such as 'full employment' cannot be measured and can change over time. Further, as there is not a precise relationship between inflation and employment a central bank cannot target both a numerical inflation and employment/output target at the same time.²

Amending the legislation to recognise the role of monetary policy in stabilising employment/output around sustainable levels would recognise both the stabilisation role of monetary policy in the event of a recession and also recognise that at times monetary policy decision-makers must make trade-offs between the objectives of price and output/employment stability, as is currently recognised in the PTA.

Making operational the flexible inflation targeting mandate

In practice in making the flexible inflation targeting mandate operational, the Reserve Bank chooses the policy rate path that is forecast to bring inflation back to target within the "medium term". The "time-to-target" will vary so as to avoid undue volatility in output, interest rates or the exchange rate, as required by the PTA.

In the Bank's modelling, non-tradable inflation is significantly determined by the gap between actual and potential output. The measurement of potential output includes employment. The estimated "output gap" is separately compared against a range of partial indicators of capacity including various measures of the unemployment gap. By construction, there has been close co-movement of forecast unemployment and output gaps. However there will be times when indicators of output gaps and unemployment gaps vary.

In avoiding undue volatility in output, the Reserve Bank's framework has been consistent with seeking to avoid undue volatility in employment. Labour market conditions are commented on in each *Monetary Policy Statement*, along with a forecast of the unemployment rate.

² Although they could target a combination such as nominal GDP.

Questions for Panel

Panel members may like to consider the following questions:

- What should be the main aims/consideration in reforming the Reserve Bank's monetary policy objectives?
- What weight should be put on ensuring inflation expectations remain well-anchored through the setting of a clear medium-term inflation target?
- How should trade-offs between inflation and output/employment stability be managed going forward?
- Do you think the employment and/or output goal should be equally weighted with the price stability objective, or hierarchically weighted in the Act and/or in the PTA?
- Concepts such as 'full employment' cannot be measured and change over time, how should this be taken into account in the framework design?
- What do you see as the pros and cons of the different countries' approaches?
- Do you have any views of alternative mechanisms to the PTA for the setting of the monetary policy objective?

Summary of International Monetary Policy Legislative Frameworks

United States

Primary Legislation

The Monetary Policy Objective for the Federal Reserve (the Fed) is set in the Federal Reserve Act 1913, which states:

The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.

Secondary Instrument

The Fed has full discretion to interpret their legislative mandate. Since January 2012, the Fed has published a Statement on Longer-Run goals and Monetary Policy Strategy (the Statement) where it outlines how it will implement monetary policy.³ The need for a Statement is not provided for in legislation, and the Fed is not directly accountable to it. It is merely public guidance on how they intend to implement monetary policy.

The Statement interprets 'stable prices' as a target of 2% inflation over the medium term.

The Statement notes that a large number of factors, which are not controlled by the Fed, impact maximum employment, and that the level of maximum employment is not directly measurable. Because of this, the maximum employment goal is not specified numerically. The 2017 Statement notes that the median of FOMC participants' estimates of the longer-run, normal rate of unemployment was 4.8 percent.

The Statement details how the Fed will balance these two objectives:

These objectives are generally complementary. However, under circumstances in which the Committee judges that the objectives are not complementary, it follows a balanced approach in promoting them, taking into account the magnitude of the deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate.

The Statement also provides for the Committee to consider risks to the financial system in its decision-making.

³ https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf

Australia

Primary Legislation

The monetary policy function of the Bank is set out in s 10(2) of the Reserve Bank Act 1959.

It is the duty of the Reserve Bank Board, within the limits of its powers, to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia and that the powers of the Bank under this Act and any other Act, other than the *Payment Systems (Regulation) Act 1998*, the *Payment Systems and Netting Act 1998* and Part 7.3 of the *Corporations Act 2001*, are exercised in such a manner as, in the opinion of the Reserve Bank Board, will best contribute to:

- (a) the stability of the currency of Australia;
- (b) the maintenance of full employment in Australia; and
- (c) the economic prosperity and welfare of the people of Australia.

Section 11(1)(a) of the primary Legislation provides for the Bank to set its monetary policy objective

(1) The Government is to be informed of the Bank's policy as follows:

- (a) the Reserve Bank Board is to inform the Government, from time to time, of the Bank's monetary and banking policy;

Section 11(2), however provides for the Treasurer to overrule the Bank's determination of its objective and set a different objective

Secondary Instrument

In practice, the Australian Treasurer and Governor of the Bank agree on a common 'Statement on the Conduct of Monetary Policy' (the Statement) which outlines the Bank's monetary policy objective. Two key paragraphs are set out below:⁴

These objectives [the objectives in Section 10(2) of the Reserve Bank Act 1959] allow the Reserve Bank Board to focus on price (currency) stability, which is a crucial precondition for long-term economic growth and employment, while taking account of the implications of monetary policy for activity and levels of employment in the short term.

...

Both the Reserve Bank and the Government agree that a flexible medium-term inflation target is the appropriate framework for achieving medium-term price stability. They agree that an appropriate goal is to keep consumer price inflation between 2 and 3 per cent, on average, over time. This formulation allows for the natural short-run variation in inflation over the economic cycle and the medium-term focus provides the flexibility for the Reserve Bank to set its policy so as best to achieve its broad objectives, including financial stability. The 2-

⁴ <https://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-7-2016-09-19.html>

3 per cent medium-term goal provides a clearly identifiable performance benchmark over time.

The Statement explicitly describes Australia's approach as 'flexible medium-term inflation targeting', and calls for the Board to focus on price stability, while 'taking account of' the implications for activity and employment.

Section 10(2)(a) is interpreted as allowing for an inflation targeting regime (internal price stability), even though the terms 'stability of the currency of Australia' could also refer to a managed exchange rate regime (external price stability). While the Australian monetary policy regime has evolved over time, the primary legislation has remained the same since at least 1973 and a number of different monetary policy frameworks have been implemented under this set of objectives.

The Statement also notes that financial stability is a monetary policy objective.

United Kingdom

Primary Legislation

Sections 11-12 of the Bank of England Act reads:

In relation to monetary policy, the objectives of the Bank of England shall be –
(a) to maintain price stability, and
(b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment.

The Treasury may by notice in writing to the Bank specify for the purposes of section
(a) what price stability is to be taken to consist of, or
(b) what the economic policy of Her Majesty's Government is to be taken to be.

Secondary Instrument

The current direction under section 12 is a letter by Chancellor Hammond, sent on March 8 2017.⁵

It provides a 2% inflation target as a primary target. The inflation target is 'forward-looking to ensure inflation expectations are firmly anchored in the medium term'.

It also defines the Government's economic strategy. The strategy consists of four high level goals

- operationally independent monetary policy, responsible for maintaining price stability and supporting the economy;
- a credible fiscal policy, returning the public finances to health, while providing the flexibility to support the economy;
- addressing long-term economic weaknesses in order to sustain high employment, raise productivity, and improve living standards for people across the UK; and
- continuing to strengthen the financial system, improving the regulatory framework to reduce risks to the taxpayer and building resilience, so that it can provide finance and financial services to the real economy and realise better outcomes for consumers, supporting sustainable economic growth and encouraging productive investment.

⁵ <http://www.bankofengland.co.uk/monetarypolicy/Documents/pdf/chancellorletter080317.pdf>

Other matters, such as how the Bank should approach quantitative easing, are included in the remit.

Norway

Primary Legislation

Key Provisions in the Legislation (*Act of 24 May 1985 relating to Norges Bank and the Monetary System etc*):

Section 2

The Bank shall conduct its operations in accordance with the economic policy guidelines drawn up by the government authorities and with the country's international commitments....

The King in Council may adopt resolutions regarding the operations of the Bank. Such resolutions may take the form of general rules or instructions in individual cases.

The Act does not specify the primary objective of the Bank, and leaves this to the King in Council to make (the King in Council is effectively the Government, as regulations in Norway are made in the name of the King).

Secondary instrument

The Regulation made under section 2 specifies the Norges Bank mandate. Key paragraphs include:⁶

Monetary policy shall be aimed at stability in the Norwegian krone's national and international value, contributing to stable expectations concerning exchange rate developments. At the same time, monetary policy shall underpin fiscal policy by contributing to stable developments in output and employment.

Norges Bank's implementation of monetary policy shall, in accordance with the first paragraph, be oriented towards low and stable inflation. The operational target of monetary policy shall be annual consumer price inflation of approximately 2.5 per cent over time.

In general, the direct effects on consumer prices resulting from changes in interest rates, taxes, excise duties and extraordinary temporary disturbances shall not be taken into account.

Third paragraph specifies that the Norges Bank should look through specific price shocks.

The Norges Bank, in describing its mandate suggests that inflation is the primary target, with stable output and unemployment a secondary target although the regime could be described as a dual target.⁷

⁶ <http://www.norges-bank.no/en/about/Mandate-and-core-responsibilities/Legislation/Regulation-on-Monetary-Policy/>

⁷ <http://www.norges-bank.no/en/about/Mandate-and-core-responsibilities/Monetary-policy-in-Norway/>

Review

In June 2017 the Central Bank Law Commission delivered a report on a new central Bank Act.⁸ It suggested a new objective section'

- (1) The purpose of the Norges Bank's functions is to maintain monetary stability and promote stability of the financial system and an efficient and secure payment system
- (2) Norges Bank shall otherwise contribute to high and stable output and employment

Canada

Primary legislation

The Bank of Canada Act governs the Bank of Canada. Section 14 establishes the method for setting monetary policy objectives

Section 14

- (1) The Minister and the Governor shall consult regularly on monetary policy and on its relation to general economic policy.
- (2) If, notwithstanding the consultations provided for in subsection (1), there should emerge a difference of opinion between the Minister and the Bank concerning the monetary policy to be followed, the Minister may, after consultation with the Governor and with the approval of the Governor in Council, give to the Governor a written directive concerning monetary policy, in specific terms and applicable for a specified period, and the Bank shall comply with that directive.

The primary legislation does not specify a primary function for the Bank.

Secondary Instrument

Canada adopted an inflation targeting framework in 1991. The most recent joint statement between the Government and the Bank of Canada from October 2016 sets out its monetary policy objective for 5 years. The statement provides for a 2% inflation target mid-point, with range of 1-3%. No other considerations for monetary policy are included. The policy is described as a 'flexible inflation targeting framework'.⁹

The agreement does not include any other objectives for monetary policy. The Bank investigated including a financial stability consideration, but in a letter from the Governor to the Minister of Finance in September 2016, the Governor concluded that 'monetary policy should be adjusted to address financial vulnerabilities only in exceptional circumstances'. It sees financial sector reforms,

⁸ https://www.google.co.nz/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0ahUKEwiW_9_-N3XAhXIH5QKHxW6CpgQFggoMAA&url=https%3A%2F%2Fwww.regjeringen.no%2Fcontentassets%2F2527f6878b03409696b5e6cf11dcc5e0%2Fen-gb%2Fpdfs%2Fnou201720170013000engpdfs.pdf&usg=AOvVaw2y010VgN_SYwd7SRmrmVfd

⁹ <http://www.bankofcanada.ca/wp-content/uploads/2016/10/Joint-Statement.pdf>

macroprudential policy and its role as a lender of last resort as the main tools to promote financial stability.¹⁰

Sweden

Primary legislation

Article 2 of the Sveriges Riksbank Act states that

The objective of the Riksbank's activities shall be to maintain price stability.

Secondary Instrument

The Riksbank does not use a secondary instrument, and simply announces its policy intentions.

Since 1995 the Riksbank has set an objective of 2% annual CPIF inflation since 1995. In September 2017 the Riksbank introduced a 'variation band' in the inflation target of 1-3%, but stressed that it was still targeting 2% inflation.¹¹

The Riksbank exclusively decides the meaning of price stability, with no need for an agreement with the Government.

¹⁰ <http://www.bankofcanada.ca/wp-content/uploads/2016/10/Letter-Minister-Finance.pdf>

¹¹ <http://www.riksbank.se/en/Monetary-policy/Inflation/Adoption-of-the-inflation-target/>

Annex One: Primary Legislative Objectives from 21 other Central Banks

Colombia

The Banco de la Republica, on behalf of the Nation, shall oversee the preservation of the purchasing power of the currency based on the norms established in Article 373 of the Constitution and in Statute 31/1992.

Czech Republic

The primary objective of the Czech National Bank shall be to maintain price stability. In addition, the Czech National Bank shall work to ensure financial stability and the safe and sound operation of the financial system in the Czech Republic. Without prejudice to its primary objective, the Czech National Bank shall support the general economic policies of the Government leading to sustainable economic growth and the general economic policies in the European Union with a view to contributing to the achievement of the objectives of the European Union. The Czech National Bank shall act in accordance with the principle of an open market economy.

Euro Area

In accordance with Article 127(1) and Article 282(2) of the Treaty on the Functioning of the European Union, the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 119 of the Treaty on the Functioning of the European Union.

Ghana

The primary objective of the bank is to maintain stability in the general level of prices.

Without prejudice to subsection (1) the Bank shall support the general economic policy of the Government and promote economic growth and effective and efficient operation of banking and credit systems in the country, independent of the instructions from the Government or any other authority.

Guatemala

The Banco de Guatemala has as its fundamental objective, to contribute to the creation and maintenance of the most favourable conditions for the orderly development of the national economy, for which, it will propitiate the monetary, exchange and credit conditions that promote stability in the general level of prices.

Hungary

- (1) The primary objective of the MNB shall be to achieve and maintain price stability.
- (2) Without prejudice to its primary objective, the MNB shall support the maintenance of the stability of the system of financial intermediation, the enhancement of its resilience, its sustainable contribution to economic growth; furthermore, the MNB shall support the economic policy of the government using the instruments at its disposal.

Iceland

The main target of monetary policy will be price stability. The Central Bank shall also promote financial stability and the main objectives of the economic policy of the Government as long as it does not deem it inconsistent with the Bank's main objective of price stability.

India

The primary objective of the monetary policy is to maintain price stability while keeping in mind the objective of growth.

Indonesia

The goal of Bank Indonesia is to achieve and maintain the stable value of the rupiah. To achieve the goal referred to in paragraph (1), Bank Indonesia shall conduct monetary policy on a sustained, consistent, and transparent basis, taking into account the general economic policies of the government.

Israel

The objectives of the Bank are: to maintain price stability as its central goal; to support other objectives of the Government's economic policy, especially growth, employment and reducing social gaps, provided that, in the Committee's opinion, this support shall not prejudice the attainment of Price Stability over the Course of Time; for this purpose, "Price Stability over the Course of Time" means a situation in which the Committee, on the basis of the monetary policy that it has established, expects the inflation rate to be within the price-stability range determined per Subsection (b) within no more than two years, to support the stability and orderly activity of the financial system.

The Government, in consultation with the Governor, shall determine the price-stability range for the purposes of subsection (1)(a).

Japan

The purpose of the Bank of Japan is to issue banknotes and to carry out currency and monetary control. In addition, the Bank of Japan's purpose is to ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of stability of the financial system. Currency and monetary control by the Bank of Japan shall be aimed at achieving price stability, thereby contributing to the sound development of the national economy.

Mexico

The Banco de México's purpose shall be to provide the country's economy with domestic currency. In pursuing this purpose, its primary objective shall be to seek the stability of the purchasing power of said currency. The Bank shall also have the purpose of promoting the sound development of the financial system and fostering the proper functioning of payment systems.

Philippines

The primary objective of the Bangko Sentral is to maintain price stability conducive to a balanced and sustainable growth of the economy. It shall also promote and maintain monetary stability and the convertibility of the peso.

Poland

The basic objective of the activity of NBP shall be to maintain price stability, while supporting the economic policy of the Government, insofar as this does not constrain the pursuit of the basic objective of NBP.

Romania

The primary objective of the National Bank of Romania shall be to ensure and maintain price stability. Without prejudice to its primary objective of ensuring and maintaining price stability, the National Bank of Romania shall support the general economic policy of the State.

Serbia

The primary objective of the National Bank of Serbia is to achieve and maintain price stability. In addition to its primary objective, the National Bank of Serbia will also pursue the objective of financial stability. Without prejudice to its primary objective, the National Bank of Serbia will support the economic policies of the Government which are conducive to sustainable economic growth.

South Africa

The primary objective of the Bank shall be to protect the value of the currency of the Republic in the interest of balanced and sustainable economic growth in the Republic.

South Korea

(1) The purpose of this Act shall be to establish the Bank of Korea and to contribute to the sound development of the national economy by pursuing price stability through the formulation and implementation of efficient monetary and credit policies.

(2) The Bank of Korea shall pay attention to financial stability in carrying out its monetary and credit policies.

Switzerland

The National Bank shall pursue a monetary policy serving the interests of the country as a whole. It shall ensure price stability. In so doing, it shall take due account of economic developments.

Thailand

The Bank of Thailand's objectives are to carry on such tasks as pertain to central banking in order to maintain monetary stability, financial institution system stability and payment systems stability. To undertake the tasks in paragraph one, the implementation of economic policy of the government shall be taken into consideration.

Turkey

The primary objective of the Bank shall be to maintain price stability. The Bank shall determine on its own discretion the monetary policy that it shall implement and the monetary policy instruments that it is going to use in order to maintain price stability. The Bank shall, provided that it shall not conflict with the objective of maintaining price stability, support the growth and employment policies of the Government.

Consideration of employment in current monetary policy

- In setting monetary policy, the Reserve Bank chooses the policy rate path that is forecast to bring inflation back to target within the “medium term”. The “time-to-target” will vary so as to avoid undue volatility in output, interest rates or the exchange rate, as required by the PTA.
- In the Bank’s modelling, non-tradable inflation is significantly determined by the gap between actual and potential output. The measurement of potential output includes employment.
- The estimated “output gap” is separately compared against a range of partial indicators of capacity including various measures of the unemployment gap. By construction, there has been close co-movement of forecast unemployment and output gaps. However there will be times when indicators of output gaps and unemployment gaps vary.
- In avoiding undue volatility in output, the Reserve Bank’s framework has been consistent with seeking to avoid undue volatility in employment.
- Labour market conditions are commented on in each *Monetary Policy Statement*, along with a forecast of the unemployment rate.