Memorandum

To: The Independent Expert Panel

From: Reserve Bank of New Zealand

Date: 21 December 2017

Subject: The Reserve Bank's decision-making process

Introduction

This note briefly summarises the Reserve bank's approach to decision making across its three main policy areas. It includes two attachments which describe in more detail the monetary policy decision making process.

The Reserve Bank's policy decision-making approach has evolved since inflation targeting was first introduced in 1990. This has partly been in response to the widening scope of the Reserve Bank's policy decision making to included prudential supervision, and the development of macro-prudential policy. The Reserve Bank has also developed its decision making approach to reflect developments in international thinking on decision making: for example, by adding external members to the advisory Monetary Policy Committee (MPC), following the Svensson Review[1] in 2001; and by introducing the Governing Committee for policy decisions in 2014.

Current Reserve Bank decision making model

The objective of the Reserve Bank's decision-making approach is to create a system that leads to rigorous decision making. The four key components of decision-making systems are: optimal institutional design, high quality inputs, genuine deliberation, and accountability for decisions (figure 1)[2]. The elements are intrinsically inter-related: the institutional design will determine the inputs that are required, how deliberation takes place, and the mechanisms for accountability. The components cannot be looked at in isolation, but rather how they operate as a whole.

The main components of the Reserve Bank's decision-making system are:

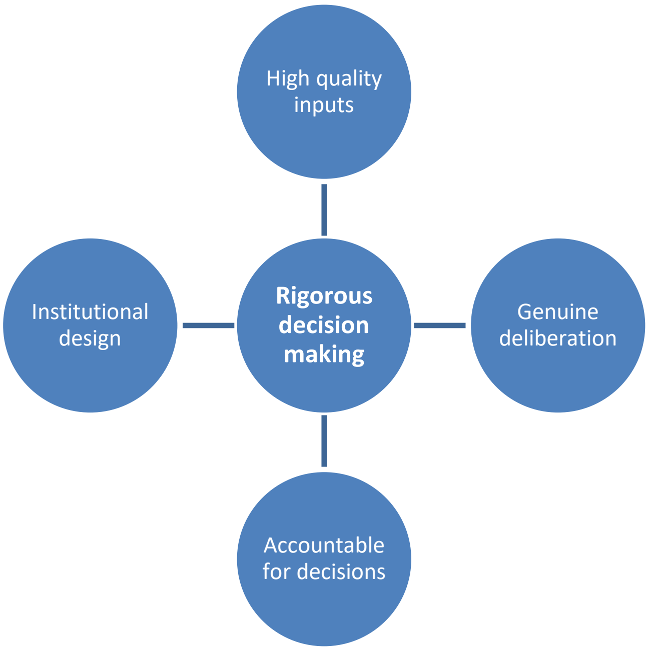
1) Institutional design

The Reserve Bank operates similar decision-making models for each of its three main policy areas of monetary, macro-financial and prudential policy, with differences specific to the nature of each policy decision (see Attachment 1).

[1] Svensson, L. E. (2001). *Independent Review of the Operation of Monetary Policy in New Zealand: Report to the Minister of Finance.* Retrieved from Reserve Bank of New Zealand: https://www.rbnz.govt.nz/monetary-policy/about-monetary-policy/independent-review-of-the-operation-of-monetary-policy-2

[2] Based on Warsh, K. M. (2016). *Institutional Design: Deliberations, Decisions, and Committee Dynamics*. In J. H. Cochrane, & J. B. Taylor, *Central Bank Governance and Oversight Reform* (pp. 173-220). Hoover Press

Figure 1: Key ingredients to sound decision making



The decision-making powers of the Reserve Bank are defined by the Reserve Bank Act. Policy objectives are agreed with the Minister of Finance through the Policy Targets Agreement (PTA) for monetary policy, and the Memorandum of Understanding (MoU) for macro-financial policy. Prudential policy strategic priorities are set out in the *Statement of Intent*, and the Minister of Finance's annual letter of expectations sets out a range of operational and policy priorities. A summary of the Reserve Bank's regulatory policy-making processes, including consultation, regulatory impact analysis, timelines and principles are described in the Reserve Bank's *Statement of Policy Making Approach*.

Monetary policy and key financial policy decisions are made by the Governing Committee, which currently comprises the Governor, the Deputy Governor and the Assistant Governor/Head of Economics. The Committee operates by consensus, recognising that the Governor has final decision-making authority under the Act. Once a decision has been finalised, each member of the Committee adopts that decision, ensuring a consistent message and a unified Bank voice on monetary and financial policy in the interests of market certainty and stability[3]. The Governor retains accountability for decisions of the Committee.

The Governing Committee receives information and proposals from separate advisory committees for monetary policy, macro-financial policy, and prudential supervision. The majority of policy decisions are taken in the various policy committees, each chaired by a governor, with all governors present.

[3] See McDermott, J. (2016, July 13). *How the Bank formulates and assess its monetary policy decisions*. Speech delivered to the Manawatu Chamber of Commerce in Palmerston North. Reserve Bank of New Zealand

2) High quality inputs

Decision making at the Reserve Bank is supported by a broad range of high quality inputs. Each advisory committee receives analysis prepared by the relevant teams from the Economics, Financial Markets, Macro-Financial and Prudential Supervision departments[4].

Significant external input from the business and financial community is a critical ingredient into the Reserve Bank's policy decision-making. Such input is obtained in a variety of ways:

- Two external advisors on the Monetary Policy Committee (MPC) provide insights from their engagement in economic sectors of interest.
- The Bank engages with the domestic business and financial market communities. It makes around 150 business visits and approximately 140 off-the-record speeches each by year.
- The Bank participates actively in the international financial and economic communities, and gathers significant intelligence through for a hosted by other central banks.
- The Bank uses a wide range of survey data, produced by itself and other parties.

In respect of financial policy, the Reserve Bank has developed clear policy-making processes that include extensive public and industry consultation, regulatory impact analysis, and the development of underlying principles that inform the approach.

Economic forecasts are integral to the monetary and macro-financial decision making process. However, policy decisions are model assisted, not totally model-dependent.

Policy decisions for monetary and financial policy follow a risk based approach. In monetary policy, a risk survey of MPC members is carefully analysed to assess the degree of uncertainty about the forecasts of key economic variables, and the balance of risks. Prudential policy also takes a risk based approach, where the scale of regulatory actions is proportional to the risk each sector poses to financial stability. Such an approach helps ensure that policy resources are devoted to areas most likely to have the greatest impact.

The Reserve Bank regularly assesses the quality of the inputs to its decision-making process. With respect to monetary policy, the Reserve Bank periodically invites overseas experts to attend and report on the process[5]. The Bank of International Settlements reports that over the past 18 years the Reserve Bank has initiated more external reviews of policy than any other central bank[6]. With respect to financial policy, the Reserve Bank is subject to the periodic IMF *Financial Stability Assessment Programme* (*FSAP*)[7].

3) Genuine deliberation

The Governing Committee deliberates on key monetary and financial policy decisions in two phases:

- In the advisory committees (each chaired by a governor), where information and

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[4] In the case of the Monetary Policy Committee, this is described in some detail in Richardson, A. (2016). *Behind the scenes of an OCR decision in New Zealand*. Reserve Bank of New Zealand Bulletin, Vol. 79, No.11.

[5] The most recent review was in February 2017, see Turner, P. (2017, April). *Reflections on the RBNZ's Monetary Policy Round.* Report prepared for Reserve Bank of New Zealand.

[6] See Bank for International Settlements. (2011, May). *Central bank governance and financial stability*. A report by a study group.

[7] The most recent FSAP was conducted in 2016/17. See International Monetary Fund. (2017). *New Zealand Financial System Stability Assessment*. Washington: International Monetary Fund.

analysis is presented, wider discussion takes place, and recommendations made.
- In the Governing Committee, where final policy decision are made. In the case of monetary policy decisions, the Governing Committee receives written advice from each MPC member. In the case of Macro-Financial and Prudential decisions, the Governors normally receive specific policy recommendations at the relevant advisory committee.

The process is designed to ensure that decision making is based on extensive information, and that in-depth discussion is facilitated. This ensures that a broad range of perspectives are considered and helps avoid group think. The objective is to build towards a consensus that allows for differences of individual opinions, but reaches a joint position that all Governing Committee members can agree to.

4) Accountability

The RBNZ is accountable to the Minister and to Parliament, and ultimately to the New Zealand public, for the decisions it makes. Two main decision review procedures exist:

- The constant review of the performance of the Governor and the Bank by the Reserve Bank Board as required by the Act, and as reported regularly to the Minister of Finance, and to the public through the *Annual Report*.
- The public review of decisions based on information that the Reserve Bank releases, and including the Bank's media presentation and public presentation to the Finance and Expenditure Committee on the release of each *Monetary Policy Statement, Financial Stability Report, SOI* and *Annual Report*.

The RBNZ is seen as one of the most transparent central banks in the world in terms of monetary policy communications[8]. In reviewing the MPC decisions, the Board has access to all the materials considered by the MPC, and the opportunity to question governors and staff. It sees the written advice provided by each member of the MPC, with the advice of the Deputy Governor and the Assistant Governor identified, though not by name. The Board discusses each decision extensively.

For a detailed description of the monetary policy process see (attached):

Richardson, A. (2016). Behind the scenes of an OCR decision in New Zealand. *Reserve Bank of New Zealand Bulletin*, Vol. 79, No.11.

Turner, P. (2017, April). Reflections on the RBNZ's Monetary Policy Round. *Report prepared for Reserve Bank of New Zealand*.

[8] Eichengreen, B., & Dincer, N. N. (2014). Dincer/Eichengreen Central Bank Transparency Data for 1998-2014. Retrieved 7 11, 2017, from Berkely Economics: http://eml.berkeley.edu/~eichengr/Dincer-Eichengreen_figures&tables_2014_9-4-15.pdf

Attachment 1: Key institutional aspects of RBNZ decision-making framework

	Responsible	Monetary	Macro-financial	Prudential
Purpose	Defined by Parliament	Act Promote stability in the general level of prices	Act Promote the maintenance of a sound and efficient financial system	Act Promote the maintenance of a sound and efficient financial system
Objectives	Agreed between Governor and Government	Policy Targets Agreement	Derived from legislation (MoU elaborates but does not constrain)	Derived from legislation
Policy decision making *Composition (currently)*	Governor	Governing Committee *(instrument independence)* 3 policy governors	Governing Committee after consultation with MoF 3 policy governors	Governing Committee after consultation with MoF 3 policy governors
Decision making method	Governor	Consensus		
Deliberation *Composition*		Monetary Policy Committee 12 incl. Governing Committee and 2 external	Macro-Financial Committee 13 incl. Governing Committee	Financial System Oversight Committee 17 incl. Governing Committee
Public input		External members, business visits	Public consultation	Public consultation
Monitoring	By Minister By Parliament	Board Statements (through FEC)	Board Statements (through FEC)	
Appointment	By Minister	Governor	(Recommended by Board)	
	By Board	Deputy Governor	(Recommended by Governor)	
	By Governor	Assistant Governor Governing Committee		
	By Governing Committee	Advisory committees		