

Chair

RESERVE BANK OF NEW ZEALAND: NEW POLICY TARGETS AGREEMENT

Recommendations

I recommend that Cabinet:

- a. **note** that, as required by the Reserve Bank of New Zealand Act 1989 (the Act), I intend to negotiate a new Policy Targets Agreement (PTA) with the Governor designate, Adrian Orr;
- b. **note** that this new PTA will be set under the current Reserve Bank Act which requires that it be consistent with the sole price stability objective in the Act;
- c. **note** that I propose to include maximising employment as a supplementary consideration to price stability in the March 2018 PTA, consistent with both the Terms of Reference of the review of the Act and the provisions of the current Act;
- d. **note** that I am considering a number of other minor changes to the PTA to clarify and rationalise the provisions of the PTA and to enhance transparency. This would result in a PTA that is simpler to interpret and easier to communicate to markets; and
- e. **note** that a further PTA will be negotiated once legislation arising from the review of the Act has been passed.
- f. **note** the attached draft PTA (Annex 1) which will form the basis of negotiations with the Governor designate.

Background

1. The current Governor of the Reserve Bank, Grant Spencer, is departing from the position on 26 March 2018. Following a recommendation from the Board of the Reserve Bank, I have announced that I intend to appoint Adrian Orr as the new Governor of the Bank commencing 27 March 2018.
2. Before Adrian Orr assumes the office of Governor, the Reserve Bank Act requires that I conclude a new Policy Targets Agreement (PTA) with him.
3. On 7 November 2017 I announced that the Government will undertake a review of the Reserve Bank of New Zealand Act 1989 (the review) to create a modern monetary and financial policy framework. Phase 1 of the review will recommend

changes to the Act focussing on the objectives of monetary policy and the decision-making processes of the bank. Phase 2 of the review will focus on changes to other areas of the Reserve Bank's activities.

4. I will shortly receive advice on options to amend the Act in accordance with phase 1 of the review. This advice will include providing options to amend the Reserve Bank's monetary policy objective to require that the Reserve Bank consider maximising employment alongside the price stability objective.
5. As noted to Cabinet at the time of Mr Orr's appointment, legislative reform under phase 1 of the review will occur after a new PTA is concluded with him in March 2018. However, I intend that the March 2018 PTA be amended in a manner that is consistent with the direction of legislative reform. The current Act provides scope to consider employment as a policy objective in the PTA, provided that it is included in a manner consistent with achieving price stability.
6. A further PTA will be negotiated with Mr Orr once legislation has been passed to amend the Act on the basis of the review.

The Policy Targets Agreement

7. The PTA is required to be set under section 9 of the Reserve Bank Act. It defines the specific target for monetary policy and under the current Act must be consistent with the single legislative objective of price stability. Since the Act was passed PTAs have specified the policy target as a defined numerical inflation target. However the PTA has for many years required that the Bank take account of other factors in its implementation of monetary policy, including seeking to avoid unnecessary instability in the real economy (output), interest rates and exchange rates. The Act requires that the PTA be fixed in agreement with a Governor, prior to that person's appointment. It is my intention to enter discussion with Mr Orr in early March and inform Cabinet of the proposed PTA before signing it with Mr Orr.
8. The most significant change I intend to make is to incorporate employment as a consideration for monetary policy alongside price stability in the March 2018 PTA, to the extent possible under current legislation. I intend that the Bank be required to seek to avoid unnecessary instability in employment when operating monetary policy. This will require consideration of employment outcomes in a manner similar to how the Bank currently takes account of the impact of monetary policy on the real economy. The advantage of including employment in this manner is that it is consistent with the Bank's approach to flexible inflation targeting and therefore, while enhancing the regime, does so in a manner that is well understood by markets.
9. I also intend to update the statement of the Government's objectives in the PTA to reflect our goal to promote a productive, sustainable, inclusive, export led New Zealand economy that helps deliver high levels of employment and improves the well-being of all New Zealanders.
10. Otherwise, I intend to make minor adjustments to rationalise and clarify existing provisions of the PTA and to enhance some transparency requirements. These adjustments are not intended to substantially change the operation of monetary policy but would result in a PTA that is simpler to interpret and communicate to markets.

Timing and Communication

11. I intend to commence negotiations with Adrian Orr in early March to reach agreement in principle to a new PTA.
12. I intend to notify Cabinet of the outcomes of these PTA negotiations at the same time as Cabinet considers the outcomes of phase 1 of the review. Papers on the final PTA wording and legislative reform will likely be considered by Cabinet on 19 March 2018, allowing for the new PTA to be publicly announced alongside our decisions on phase 1 of the review.

Hon Grant Robertson
Minister of Finance

Date: 19 February 2018

Annex 1: Draft Policy Targets Agreement 2018

This agreement between the Minister of Finance and the Governor of the Reserve Bank of New Zealand (the Bank) is made under section 9 of the Reserve Bank of New Zealand Act 1989 (the Act). The Minister and the Governor agree as follows:

1. Monetary Policy Objective

- a) Under Section 8 of the Act the Reserve Bank is required to conduct monetary policy with the goal of maintaining a stable general level of prices.
- b) The government's economic objective is to improve the wellbeing and living standards of New Zealanders through a sustainable, productive and inclusive economy. Our priority is to move towards a low carbon economy, with a strong diversified export base, that delivers decent jobs with higher wages and reduces inequality and poverty.
- c) Monetary policy will be directed at maintaining medium term price stability, whilst contributing to maintaining maximum sustainable employment within the economy. Monetary policy plays an important role in supporting the government's economic objective.

2. Policy target

- a) The price stability target will be defined in terms of the All Groups Consumers Price Index (CPI), as published by Statistics New Zealand:
- b) For the purpose of this agreement, the policy target shall be to keep future annual CPI inflation between 1 and 3 percent over the medium-term, with a focus on keeping future inflation near the 2 percent mid-point (option 1).

OR

For the purpose of this agreement, the policy target shall be to keep future annual CPI inflation at 2 percent over the medium term, within a band of +/- 1 percentage points (option 2).

- c) The Bank will implement a flexible inflation targeting regime. In particular the Bank shall, in pursuing the policy target:
 - i. have regard to the efficiency and soundness of the financial system;
 - ii. seek to avoid unnecessary instability in output and employment and in interest rates and the exchange rate; and
 - iii. respond to events whose impact on inflation is expected to be temporary in a manner consistent with meeting the medium-term target.

3. Transparency and accountability

- a) The Bank shall implement monetary policy in a transparent manner. In addition to the requirements of section 15 of the Act the Bank shall in its MPS:
 - i. explain what measures it has taken into account in respect of meeting the requirements of section 2 (c) and explain how these matters have been taken into account in its implementation of monetary policy; and

- ii. when inflation outcomes, and/or expected inflation outcomes, are outside of the target range (OR variation band) explain the reasons for this.
 - iii. explain how current monetary policy decisions have supported maintaining maximum levels of sustainable employment within the economy
- b) The Bank shall be fully accountable for its judgements and actions in implementing monetary policy.