

Office of the Minister of Finance

Chair
Cabinet

RESERVE BANK OF NEW ZEALAND: NEW POLICY TARGETS AGREEMENT

Recommendations

I recommend that Cabinet:

- a. **note** that I have negotiated a new Policy Targets Agreement (PTA) in-principle with the Governor designate Mr Orr, which is attached (Annex 1);
- b. **note** that the new PTA is substantively the same as the draft presented to Cabinet prior to negotiations with Mr Orr on 19 February 2018;
- c. **note** that the key change from the current PTA is the requirement that the Bank seek to avoid unnecessary instability in employment in pursuing its price stability target, consistent with the Terms of Reference of the review of the Reserve Bank Act (the Review) and the requirements of the current Act;
- d. **note** that I intend to sign this agreement with Mr Orr on 26 March prior to his commencement as Governor, consistent with the requirements of the Reserve Bank Act 1989; and
- e. **note** that I intend to announce the new PTA alongside the announcement of our decisions on phase 1 of the Review on March 26.

Background

1. Adrian Orr will commence as the new Governor of the Reserve Bank of New Zealand on 27 March 2018. Before Mr Orr assumes the office of Governor, section 9 of the Reserve Bank of New Zealand Act 1989 (the Act) requires that I conclude a new Policy Targets Agreement (PTA) with him. The PTA defines the specific target for monetary policy. Since the Act was passed this target has been defined as a numerical inflation target.
2. On 19 February 2018 I informed Cabinet of my proposed approach to negotiations with Mr Orr for the new PTA (CAB-18-MIN-0041 refers). On 5 March I agreed a

PTA in principle with Mr Orr. The in-principle PTA is substantially the same as presented to Cabinet on 19 February 2018.

3. The PTA with Mr Orr has to be agreed before legislative changes to the Act from phase 1 of the Review are enacted. A separate Cabinet paper outlining my high-level recommendations for legislative reform of the Act regarding phase 1 of the Review is provided alongside this paper.
4. The PTA can be re-considered once legislation has been passed to amend the Act following phase 1 of the Review.

The Policy Targets Agreement

5. As the PTA with Mr Orr is to be agreed under the current Act, it must be consistent with the primary legislative objective of price stability set out in the current Act. However, I have endeavoured to reflect the outcomes of phase 1 of the Reserve Bank Review within this context. Consecutive PTAs for a number of years have also required that the Bank take account of other factors in its implementation of monetary policy, namely seeking to avoid unnecessary instability in output, interest rates and exchange rates, and having regard to the efficiency and soundness of the financial system.
6. I have agreed with Mr Orr that the numerical inflation target be retained in the new PTA. This inflation target will be set as an inflation rate of 1-3% over the medium term, with a focus on the 2% mid-point of this band. This specification makes only minor amendments to the existing target to clarify aspects relating to the calculation of the inflation measure (e.g. clarification that annual CPI inflation is the official target measure). Limiting the extent of major changes to the new PTA should provide ongoing consistency and market certainty about the operation of the monetary policy regime as phase 1 reforms continue to progress.
7. As discussed in advice to Cabinet on 19 February, the most significant change in the new PTA is the expectation that the Bank supports maximum sustainable employment in its pursuit of medium term price stability. Consistent with this, the Bank will be required to seek to avoid unnecessary instability in employment as an additional consideration in pursuing its price stability policy target. The Bank is also required to explain how its current monetary policy decisions contribute to supporting maximum levels of sustainable employment within the economy. These changes require the Bank to consider employment outcomes in a similar way to how it currently takes account of the impact of monetary policy on the real economy under its existing flexible inflation targeting approach. Thus, while enhancing the regime, the change is framed under a broad approach familiar to markets.
8. Otherwise, I have made adjustments to rationalise and clarify existing provisions of the PTA and to enhance some transparency requirements. These adjustments are not expected to substantially change the operation of monetary policy. However the changes should result in a PTA that is simpler to interpret and communicate to markets.

9. Compared to the draft presented previously to Cabinet the key changes (as outlined in Annex 2) are:
 - i. A slight re-wording of the requirement that the Bank explain how its decisions have supported maximum levels of sustainable employment.
 - ii. A slight re-ordering of the agreement by moving the expected contribution of monetary policy to the government's economic objective into a new 'context' section.

Timing and Communication

10. I intend to sign this new PTA with Mr Orr on 26 March, prior to the commencement of his term as Reserve Bank Governor the following day.
11. I intend to announce that I have agreed a PTA with Mr Orr, alongside our decisions on phase 1 of the Review, on 26 March.

Hon Grant Robertson
Minister of Finance

Date: 19 March 2018

Annex 1: Policy Targets Agreement March 2018

Context

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.

Monetary policy plays an important role in supporting the government's economic objective. The government expects monetary policy to be directed at achieving and maintaining stability in the general level of prices over the medium term and supporting maximum sustainable employment.

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 conduct of monetary policy will maintain a stable general level of prices, and contribute to supporting maximum sustainable employment within the economy.

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.
- 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, employment, 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 Monetary Policy Statement (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 explain the reasons for this; and
 - iii. explain how current monetary policy decisions contribute to supporting maximum levels of sustainable employment within the economy.
- b) The Bank shall be fully accountable for its judgements and actions in implementing monetary policy.

Annex 2: Changes in the PTA Compared to Draft Cabinet Advice

Compared to the PTA presented to Cabinet on 19 February the in-principle PTA agreed with Adrian Orr has the following changes:

- Before the individual numbered sections, a new ‘context’ section is introduced. This section incorporates the government’s economic objective, and explains how monetary policy contributes towards this broader economic objective.
- In section 1b), the definition of price stability is aligned with the definition used in section 8 of the Act i.e. “stable general level of prices”.
- In section 1b), an amended requirement that the Bank “contribute to supporting” maximum sustainable employment, replacing “contributing to maintaining” maximum sustainable employment in the earlier draft (formerly section 1c)).
- In section 2c) ii, minor simplifying grammar changes are made – “seek to avoid unnecessary instability in output, employment, interest rates, and the exchange rate”, replacing “seek to avoid unnecessary instability in output and employment and in interest rates and the exchange rate”.
- In section 3a) iii, an amended requirement that the Bank explain how current monetary policy decisions “contribute to supporting maximum levels of sustainable employment”, replacing how they “have supported maintaining maximum levels of sustainable employment”.