Review of the Reserve Bank Act

Release Document

March 2018

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[1] 9(2)(a) - to protect the privacy of natural persons, including dead people.

[2] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage.

[3] 18(d) - the information requested is or will soon be publicly available.

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Policy Targets Agreement March 2018

Date:	05 February 2018	**Report No:**	T2018/176
		File Number:	MC-1-1-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Provide** feedback on this report and attached Cabinet paper at the 7 February meeting with officials **Agree** to take the attached paper to Cabinet on 19 February, subject to any changes you indicate	7 February 2018

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Daniel Wills	Senior Analyst	[1][2] (wk)	N/A	✓
Renee Philip	Manager	[1][2] (wk)	[1][2] (mob)	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Arrange a meeting with Adrian Orr in early March to discuss his conditions of employment and discuss the March 2018 PTA. Note that Adrian Orr is travelling overseas between 13 - 18 March.

Note any feedback on the quality of the report	

Enclosure: Yes (attached)

Treasury Report: Policy Targets Agreement March 2018

Executive Summary

You have announced that Adrian Orr will be appointed Governor of the Reserve Bank ("the Bank") on 27 March 2018. Prior to that date, you are required to agree a Policy Targets Agreement (PTA) with Adrian Orr setting the specific target for monetary policy. As part of this process, we recommend that you take a paper to Cabinet on 19 February outlining your high-level approach to these negotiations with Adrian Orr, and that you commence discussions with Adrian Orr as soon as is convenient following this.

This paper provides Treasury advice on the March 2018 PTA. Additionally, officials and the Independent Expert Advisory Panel are advanced in their discussions on options to amend the Reserve Bank's monetary policy objectives in accordance with phase 1 of the review of the Reserve Bank of New Zealand Act ("the Act"). This paper updates you on these discussions. You will receive full advice on options for amendment to the Act in the week commencing 19 February in time for Cabinet decisions on legislative reform to be made in March. This will allow you to announce changes to the PTA at the same time as you announce Cabinet decisions on legislative reform.

As the March 2018 PTA will be negotiated under the Act as it stands, it must be consistent with the primary price stability objective set out in the current Act. The advice in this report is nonetheless consistent, to the extent possible, with the proposed direction of legislative reform. In particular, we suggest adding consideration of employment as a requirement within the PTA. You will also need to update the statement of Government policy in the PTA in line with the current Government's priorities.

Additionally, this paper recommends a number of more minor changes to the PTA that are intended to better communicate the policy target and simplify the language in the PTA. We consider that these changes will cumulatively make the PTA an easier document to interpret and will thereby improve monetary policy communication.

Appendix 1 to this paper provides you with a proposed draft PTA. Appendix 2 provides you with the current PTA for comparison. Appendix 3 provides a list of the changes we recommend to the PTA to assist you in your conversations with Adrian Orr. Appendix 4 discusses some technical matters in relation to aspects of the PTA that we do not recommend changing.

The Reserve Bank have been consulted in the development of this advice.

Recommended Action

We recommend that you:

a **Note** that you will be required to agree a PTA with Adrian Orr by 27 March 2018

b **Agree** to take the attached paper to Cabinet on 19 February (lodge 15 February) informing Cabinet of your intention to commence negotiations on the next PTA with Adrian Orr, subject to the Treasury making any amendments you request

Agree/disagree.

c **Note** that Adrian Orr's employment conditions will need to be finalised but cannot be signed until he takes up his position on 27 March d Agree, subject to officials making any amendments you request, to use the attached draft PTA as a basis for your discussions with Adrian Orr

Agree/disagree.

e **Agree,** subject to officials making any amendments you request, that the Treasury provide this advice on the PTA to Adrian Orr through the Reserve Bank Board

Agree/disagree.

f **Note** that this paper precedes full advice on legislative amendments to the Reserve Bank's monetary policy objectives, but to the extent possible is consistent with that advice, and

g **Indicate** if you wish for this paper to be shared with the Independent Expert Advisory Panel.

Yes/no

Renee Philip
Manager

Hon Grant Robertson
Minister of Finance

Treasury Report: Policy Targets Agreement March 2018

Purpose of Report

1. You are required to agree a new Policy Targets Agreement ("PTA") with the next Governor of the Reserve Bank, Adrian Orr, prior to his appointment on 27 March 2018.

2. We recommend that you take a paper directly to Cabinet on 19 February (lodge 15 February) informing Cabinet of your intended approach to PTA negotiations with Adrian Orr. A draft Cabinet paper reflecting the recommendations in this report is attached. We suggest that before signing the PTA with Adrian Orr the agreed PTA be taken to Cabinet on 19 March 2018, at the same time as proposals for legislative reform.

3. This report follows Treasury Report T2017/2634 that outlined the Treasury's view on the operation of New Zealand's flexible inflation targeting framework. The proposed new PTA is set out in appendix 1. The current PTA is in appendix 2. Appendix 3 lists the proposed changes to assist you in your discussions with Adrian Orr.

Analysis

The PTA and the review of the Reserve Bank Act

4. The Reserve Bank of New Zealand Act ("the Act") requires that a new PTA setting the target for monetary policy be agreed with the Governor of the Reserve Bank prior to the commencement of that Governor's term. You are therefore required to negotiate a new PTA with Adrian Orr prior to 27 March when he takes up office. The March 2018 PTA will be set under the current Act which requires that it is consistent with the objective of price stability.

5. You have announced a review of the Act. Phase 1 of the review is considering options to amend the Reserve Bank's monetary policy objectives to include employment alongside the current price stability objective. Our advice on the PTA in this paper recommends changes to the PTA consistent with the proposed direction of legislative reform.

6. An Independent Expert Advisory Panel ("the Panel") has been established to provide advice as part of the review. Officials have had discussions with the Panel in respect of the specification of the legislative monetary policy objective. You will receive advice on the specification of the legislative objective in the week commencing 19 February. While there are a number of acceptable ways that the objective could be specified, and the exact wording of the recommendation is still under discussion, a working consensus is developing around a model as follows:

   > "The monetary policy committee shall formulate and implement monetary policy directed to the economic objectives of achieving and maintaining stability in the general level of prices over the medium term while supporting maximum sustainable employment"

7. This specification of the objective maintains the commitment to price stability in the medium term while also recognising the role that monetary policy plays in maintaining employment at sustainable levels.

8. The next section of this report recommends an amendment to the PTA to include consideration of employment in the PTA. The suggested option is consistent with what

is allowable under the current Act but also consistent with discussions on the direction of reform. You will also be able to update the PTA following the passage of legislation should you wish to make further changes in light of changes to the legislation.

9. This paper also recommends that you change the statement of Government policy in section 1(b) of the PTA and recommends a number of more minor changes to the PTA in order to simplify and clarify the language in the PTA.

Inclusion of an employment objective in the PTA

10. The current PTA sets out a flexible inflation targeting regime. Under flexible inflation targeting the central bank directs monetary policy at meeting the inflation target in the medium term but also puts weight on stabilising the real economy in the short term. The current PTA does this by requiring that the Bank seek to avoid unnecessary instability in output, interest rates and the exchange rate in pursuing its medium term price stability objective. The PTA also requires the Bank to look through temporary fluctuations in inflation and focus on the medium term inflation trend and repeats the requirement in the Act that the Bank have regard to financial stability in monetary policy operation.

11. Your stated policy is to update the Act by widening the Bank's objectives to ensure that due consideration is given to maximising employment. To translate this consideration of employment into operational practice it also needs to be included in the PTA. The current Act is flexible enough to allow for the inclusion of consideration of employment in the PTA, however how this is included is constrained by the Act. Namely, under the current Act the PTA must retain price stability as the primary objective.

12. We recommend that the PTA be updated in March to include consideration of employment in the same manner as the Bank is currently required to give consideration to output stability (i.e. by requiring that the Bank seek to avoid unnecessary instability in employment in pursuing the price stability objective). This approach would be consistent with the flexible inflation targeting approach, under which the Bank currently operates, and is well understood by markets.

13. We also consider that the PTA can be restructured so that it provides a clearer specification of the flexible inflation targeting framework and therefore the dual considerations to which monetary policy will have regard once the Act is amended. Our proposed PTA has rationalised a number of clauses thereby making the multiple considerations of monetary policy an integral part of the policy target. In this regard section 2, which sets the policy target, would provide:

> "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 its medium term target."

14. This wording retains the medium term inflation anchor but also requires the Bank to seek to minimise the extent to which output or employment differs from sustainable levels. Operationally the Bank will take these matters into account in determining the time horizon over which it expects inflation to return to target. We consider that the Bank's consideration of these factors could be further enhanced by providing an expectation that the Bank be transparent as to how it has taken employment and other factors into account. We therefore suggest adding a requirement to the PTA that:

> “The Bank must explain in its monetary policy statements what factors it has taken into account in its implementation of monetary policy, including the factors it has considered in determining the time horizon over which it forecasts inflation to return to target”

15. The PTA could include further transparency provisions in respect of how the Bank takes account of employment. While we do not recommend that the PTA include a numerical employment target (as concepts such as ‘full employment’ are both unobservable and time-varying), the PTA could include a directive such as requiring the Reserve Bank to monitor and report on the measures of unemployment or under-employment that it has taken into account. We recommend you discuss this option with Adrian Orr.

Government’s broader objectives

16. You will also need to give consideration to the specification of the statement of Government policy that is included in section 1(b) of the PTA. Successive Governments have amended these objectives in updating the PTA.

17. We recommend updating this section to recognise the objectives of the review. For example the provision could read “The Government's economic objective is to promote a sustainable, export led New Zealand economy that helps deliver high levels of employment and New Zealanders’ desired quality of life”.

18. We also suggest clarifying that flexible inflation targeting is one mechanism to achieve these objectives through providing in this clause that “Monetary policy directed at maintaining medium term price stability while contributing to maximum sustainable employment plays an important part in supporting this objective.”

Clarifications to the PTA

19. The above sections dealt with the substantive changes that we recommend to the PTA. The PTA is a document that has had multiple amendments over time and consequently there are now some over-lapping clauses and areas where the drafting could be clarified. We propose a number of amendments to the PTA that are aimed at clarifying and tidying up the PTA. These proposals are not substantive policy changes, but will result in a simpler document to interpret and therefore assist in the communication of the inflation targeting regime. The main change is to simplify the wording of the target, but we also recommend some other simplifications.

Clarifying the specification of the inflation target

20. The current policy target is to keep future CPI inflation outcomes between 1 and 3 percent on average over the medium term, with a focus on keeping future average inflation near the 2 percent midpoint.

21. We recommend keeping the current level of the inflation target - the reasons for this are discussed in appendix 4. We also recommend that this target continue to be specified as a future inflation target. This is consistent with the Bank’s operational approach of setting policy such that forecast inflation will converge to the target at a point of time in the future and is well understood by markets.

22. We also recommend retaining both a point target and a range that specifies the acceptable level of variation around the point target that the Bank should work within. There are arguments that can be made in favour of both point targets and ranges.

23. The benefit of a range is that it provides the central bank with more flexibility in the operation of monetary policy and recognises the inherent uncertainty in monetary policy operation. It also assists in communicating the expectation that inflation

outcomes will be somewhat variable. Without a range, or tolerance band, commentators may become overly focused on the point target and deviations from the point target may undermine the central bank's credibility.

24. The argument in favour of a point target is that it provides a better anchor for inflation expectations than a range. In turn, more anchored inflation expectations reduce the extent to which a central bank's monetary policy needs to respond to meet the medium term inflation objective, therefore reducing volatility in output and employment. The 2 percent mid-point to the range was included in the 2012 PTA for this reason. Prior to that, inflation expectations had drifted to the top half of the 1-3 percent range. Modelling work undertaken by the Reserve Bank suggests that the inclusion of the 2 percent mid-point has helped to anchor longer-term inflation expectations around this point, thereby achieving its aim[1]. Maintaining the mid-point to the target is likely to be important in the context of adding employment as an objective of monetary policy in order to ensure inflation expectations remain anchored, and so that the market does not interpret the change as a loosening of the commitment to inflation control.

25. There are however some technical issues with the current specification of the target that we recommend amending. Namely, the current target is set as an *average* inflation rate over the medium term. The wording "on average" is unnecessary as the intention is that the end point of the inflation forecast fall within the range, near the mid-point, rather than taking an average calculation over time. We therefore recommend removing the words "on average" and also to clarify the future nature of the target by removing the word "outcomes". The PTA does not currently refer to the *annual* increase in the CPI. This word needs to be included to ensure the correct specification of the target.

26. The current specification of the target, amended for the points raised above, would balance these competing considerations and would read:

> "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."

27. An alternative would be to focus on the 2 percent target and specify a tolerance band (i.e. acceptable level of variation). This alternative at the margin provides a sharper focus on the point target and may be easier to communicate. This specification would read:

> "The policy target shall be to keep future annual CPI inflation at 2 percent over the medium term, with a variation band of +/- 1 percentage points."

28. We recommend you discuss these alternatives with Adrian Orr.

Simplifications of the PTA

Reporting on deviations from target

29. It is important that the inflation targeting regime tolerates deviations of inflation outcomes from the future target given that monetary policy operates under uncertainty and with lags, and that inflation is inherently volatile. However, significant deviations of inflation outcomes from the future target, particularly if they are prolonged, may undermine the credibility of the inflation target by undermining inflation expectations.

30. Section 4(a) of the current PTA requires that when the annual rate of inflation is outside the medium term target range (1-3 percent), or when this is projected to occur, the Bank shall include an explanation within the Monetary Policy Statement (MPS) as to

[1] Lewis and McDermott, (2016), New Zealand's experience with changing its inflation target and the impact on inflation expectations

why such outcome has occurred, or is projected to occur, and set out a plan to return inflation to target. The PTA therefore already imposes a reporting requirement on the Bank when inflation is outside of the target range of 1-3 percent. This adds to the requirements for the MPS as set out in section 15 of the Act.

31. We consider that the approach in section 4(a) of requiring extra reporting when inflation falls outside of the 1-3 percent medium term range (or variation band) should be retained. However, we suggest that the wording be updated to provide for a clearer and simpler directive. Our recommendation is that this provision read:

    "when inflation outcomes, and/or expected inflation outcomes, are outside of the target range (variation band) the Bank shall explain the reasons for this."

32. Our proposed PTA also provides a more logical structure to the transparency provisions.

Redundant clauses

33. The PTA provides that the Bank "shall monitor prices, including asset prices, as measured by a range of price indices". In practice the Bank does monitor a range of price indices in order to judge inflation pressures. The Bank also monitors asset prices, particularly as part of its macro-prudential monitoring function.

34. Under the Act, the PTA is required to set the policy target for monetary policy. Arguably therefore this requirement to monitor asset prices is not a good fit with the PTA as it does not relate to the policy target. It could also be argued that the reference to asset prices is superfluous as it is covered by the requirement to have regard to financial stability which is included in the Act and the PTA. On the other hand the provision is not harmful given the Bank will need to monitor prices in order to fulfil its functions. On balance, we recommend removing this clause as it is unnecessary and would assist in simplifying the document.

35. This paper has discussed a number of discrete changes to the PTA. In order to implement all these changes and move to a simpler document we propose some restructuring of the PTA as set out in appendix 1.

Consultation

36. The Reserve Bank has been consulted on the content of this paper. The Treasury spoke to a number of economists and market participants over 2016 to inform this advice.

Appendix 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. Price stability

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 promote a sustainable, export led New Zealand economy that helps deliver high levels of employment and New Zealanders' desired quality of life. Monetary policy directed at maintaining medium-term price stability while contributing to maximum sustainable employment plays an important part in supporting this objective.

Update Government policy objective

Requirement to monitor prices deleted

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 minor amendments to current wording).

Clarify target wording

<u>OR</u>
For the purpose of this agreement, the policy target shall be to keep future annual CPI inflation at 2 percent over the medium term, with a variation 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:

Reinforce flexible inflation targeting regime and rationalise drafting

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.

Enhance and clarify transparency expectations

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 factors it has taken into account in its implementation of monetary policy, including the factors it has considered in determining the time horizon over which it forecasts inflation to return to target; 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. [Option: the Bank shall report on the measures of unemployment and underemployment it has taken into account].

b) The Bank shall be fully accountable for its judgements and actions in implementing monetary policy.

Appendix 2: The current Policy Targets Agreement

The Minister and the Governor agree as follows:

1. Price stability

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 promote a growing, open and competitive economy as the best means of delivering permanently higher incomes and living standards for New Zealanders. Price stability plays an important part in supporting this objective.

2. Policy target

a) In pursuing the objective of a stable general level of prices, the Bank shall monitor prices, including asset prices, as measured by a range of price indices. 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 CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term, with a focus on keeping future average inflation near the 2 per cent target midpoint.

3. Inflation variations around target

a) For a variety of reasons, the actual annual rate of CPI inflation will vary around the medium-term trend of inflation, which is the focus of the policy target. Amongst these reasons, there is a range of events whose impact would normally be temporary. Such events include, for example, shifts in the aggregate price level as a result of exceptional movements in the prices of commodities traded in world markets, changes in indirect taxes, significant government policy changes that directly affect prices, or a natural disaster affecting a major part of the economy.

b) When disturbances of the kind described in clause 3(a) arise, the Bank will respond consistent with meeting its medium-term target.

4. Communication, implementation and accountability

a) On occasions when the annual rate of inflation is outside the medium-term target range, or when such occasions are projected, the Bank shall explain in Policy Statements made under section 15 of the Act why such outcomes have occurred, or are projected to occur, and what measures it has taken, or proposes to take, to ensure that inflation outcomes remain consistent with the medium-term target.

b) In pursuing its price stability objective, the Bank shall implement monetary policy in a sustainable, consistent and transparent manner, 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.

c) The Bank shall be fully accountable for its judgements and actions in implementing monetary policy.

Appendix 3: List of changes to the PTA

The following is the list of changes that have been made to the draft PTA as compared to the current PTA:

- The inclusion of employment as a consideration to which monetary policy decision-makers must have regard (section 2(c));
- Rationalising the sections of the PTA that provide for the flexible inflation targeting regime into one section to clearly communicate the multiple considerations to which decision-makers must have regard (section 2(c));
- Require greater transparency as to how the Bank has taken factors (including employment) into account in the setting of monetary policy (section 4(ai));
- Update the statement of Government policy to recognise the current Government's priorities and the focus on employment (section 1(b));
- Delete the requirement that the Bank must monitor prices as this is unnecessary to include in the PTA;
- Keep the level of the current policy target and also retain both a range and point target but amend the wording of the policy target to provide a clearer specification of the target by:
  - Removing the specification of the target as an average;
  - Removing the word outcomes as it is a future target;
  - Ensure the CPI target is set as an annual increase in the CPI as the word annual is currently missing.
- We have provided two options as to how you could specify the target (2(b)).
- The transparency provisions have been drafted more simply and wording altered to provide a more simple specification (4(a)).
- We also provide an option to require that the Bank report on the measures of unemployment and underemployment it has taken into account to further enhance transparency as to how the Bank takes account of the employment objective (4(a)(iii)).

Appendix 4: The inflation target

The level of the target

1. The current inflation target is a future range of 1-3 percent with a mid-point of 2 percent. There have been a number of arguments advanced by commentators over recent years in favour of either a higher or lower inflation target.

2. The main argument in favour of increasing inflation targets is in order to ensure that central banks will have enough scope to lower interest rates in the face of a large contractionary economic shock that may result in monetary policy reaching the effective lower bound of interest rates (ELB). An increase in the inflation target will increase nominal interest rates and therefore provide more room for stimulatory monetary policy if the economy experiences a large negative shock.

3. However, a disadvantage of increasing the inflation target is that a higher inflation target would lead to higher costs of inflation at all times, whereas the risks of a lower bound event occur infrequently. Given this, the costs of a higher inflation target may outweigh the benefits.

4. Other commentators have argued in favour of lowering the inflation target. One argument for this change is that it would provide the Reserve Bank with more scope to increase interest rates during an extended period of weak inflation, therefore leading to a reduced build-up of financial stability risks from a prolonged period of low interest rates. However, arguments against a lower inflation target are that:

    a. a lower inflation target marginally increases the risk that the ELB may be reached, thereby providing monetary policy marginally less space to respond to shocks;

    b. small positive amounts of measured inflation may be beneficial given:

        i. inflation measures are considered to be biased upwards, with the bias often thought to be in the order of 1 percent;

        ii. at low, or negative, levels of inflation consumers may delay consumption and firms delay investment thereby creating a drag on the economy; and

        iii. small positive rates of inflation may aid the economy in adjusting by allowing real wages to adjust instead of requiring adjustment to occur through employment levels.

    c. prudential policies are best suited to manage risks to financial stability.

5. On balance, we do not see a strong case for a change from a target centred on 2 percent. This target balances the competing arguments discussed above. New Zealand's inflation target has been changed a number of times in the past and frequent changes to the level of the target could undermine the credibility of the regime.

The use of CPI inflation as the target

1. The current price measure used for inflation targeting in New Zealand is the All Goods CPI. This measure captures the prices of a representative basket of goods and services purchased by New Zealand households. It is produced by Statistics New Zealand on a quarterly basis.

2. The CPI measure has a number of key advantages including the fact that it is: a widely understood and used price measure by the general public; has been used as the key inflation indicator since the late 1980s; is regularly reviewed and updated for accuracy; is produced independently from the RBNZ; is timely (published around one month after the end of a quarter), and contains sub-component series that can be used to explain

inflation trends. Reflecting these advantages, the target measure of inflation is measured by the CPI across a variety of major developed economy central banks with formal inflation targeting frameworks, including those such as Canada that have recently reviewed CPI as part of their inflation targeting frameworks[2,3].

3. Given the above, we consider that CPI inflation remains a suitable measure for the inflation target.

[2] Bank of Canada (2016), Renewal of the inflation-control target: Background Information – October 2016

[3] IMF (2006), Implementing Inflation Targeting: Institutional Arrangements, Target Design, and Communications