Office of the Minister of Finance

Chair
Cabinet Business Committee

MODERNISING NEW ZEALAND'S MONETARY POLICY FRAMEWORK: PHASE ONE

Proposal

1. This paper recommends changes to the Reserve Bank of New Zealand Act 1989 (the Act) to require that employment be considered alongside price stability in the objectives of monetary policy and to establish a committee model for monetary policy decision-making.

2. The proposals result from phase 1 of the Government's ongoing review of the Act, and follow recommendations from the Independent Expert Advisory Panel (the Panel). Further proposals will follow from phase 2 of the review.

Executive Summary

3. Last year, the Government announced it would undertake a Review of the Reserve Bank of New Zealand Act 1989 (the Review) to modernise the monetary and financial stability policy framework. The Review is being conducted in two phases. Phase 1, on which this paper reports, was tasked with recommending changes to the objectives of monetary policy to give due consideration to maximising employment alongside price stability, and to make provision for a committee decision-making model for monetary policy. I will report to Cabinet separately on the full scope of phase 2 in the first half of this year.

4. The Panel was established to support and provide input to the Review. The Panel has met with Officials from the Treasury and the Reserve Bank several times in recent months and has reported to me on its key findings from phase 1. I have taken these findings into consideration in developing my recommendations.

5. Regarding the objectives of monetary policy, I broadly endorse the recommendations of the Panel. The first change I propose is to amend the preamble of the Act to explicitly recognise the role of monetary and financial policy in promoting the prosperity and wellbeing of the people of New Zealand and contributing to a sustainable and productive economy. This change would highlight upfront that the ultimate aim of monetary and financial policy is to improve overall wellbeing. This would provide greater clarity to the public that monetary and financial policy are not ends in-and-of-themselves but a means to support the living standards of New Zealanders.

6. The second change I propose is to re-specify the objective of monetary policy towards: achieving and maintaining stability in the general level of prices over the medium term and supporting maximum sustainable employment.

7. This would effectively direct the Reserve Bank to choose monetary policy settings that best support employment outcomes, while ensuring price stability is achieved over the medium term. The Government remains committed to ensuring monetary policy delivers low and stable inflation over the medium term, but it is important to also formally recognise the important role monetary policy plays in reducing the depth and length of periods of unemployment. This "stabilisation" role for monetary policy has been highlighted globally following the global financial crisis, and is in effect already practiced through the Reserve Bank's "flexible inflation-targeting" regime provided for in the Policy Targets Agreement (PTA) but not in the Act.

8. Regarding a committee decision-making structure for monetary policy, I endorse the Panel's recommendation for the Act to be amended to require decisions be made by a Monetary Policy Committee (MPC) that includes external members. This would bring New Zealand into line with international norms, formalise and strengthen the Reserve Bank's existing decision-making practices, and improve the consistency of the monetary policy framework.

9. There are a number of design aspects to consider in establishing an MPC, often involving trade-offs between objectives such as ensuring good decision-making, accountability, institutional legitimacy, and functionality. I broadly endorse the Panel's recommended model as best balancing the various objectives sought from a committee while ensuring the model as a whole is coherent. Accordingly, I propose the MPC have:

   a. Responsibility for all monetary policy decisions and strategy, with the Governor responsible for implementing monetary policy in accordance with these decisions;

   b. Between five and seven members, with at least two members external to Reserve Bank staff who have knowledge and experience in relevant areas;

   c. Term lengths of four years for external members and five years for internal Reserve Bank members, both limited to a maximum of two terms in any one role; and

   d. Appointments made by the Minister of Finance on recommendation of the Reserve Bank Board, and dismissals made by the Governor-General on advice from the Minister, based on current practice for the Governor.

11. I also propose that the Minister of Finance and the MPC be required to agree a committee Charter setting out detailed approaches to a defined set of issues, for example around the approach to decision-making and to communications. This would provide a degree of flexibility to allow the MPC to learn from experience and evolve its practices without legislative change.

12. A number of adjustments would be required to the role of the Board and the process for setting the PTA as a consequence of the proposed changes. While the performance monitoring role of the Board would remain, its responsibilities would be broadened to reflect the role of the MPC and to enable it to better fulfil its duties. Similarly, while an instrument akin to the PTA would still be required, an MPC would create a number of practical issues for it in its existing form. As a result, I propose the process for setting the operational objectives of monetary policy be changed to one where the Minister of Finance sets the operational objectives following the receipt of non-binding public advice from the Reserve Bank.

13. A number of second order details still need to be progressed before legislation can be introduced giving effect to these changes. I propose Cabinet delegate authority to me and the Associate Ministers of Finance to take these decisions. Full details of the reform would then be subject to Cabinet approval once the draft legislation has been prepared.

Background on the Reserve Bank Act Review

14. In November 2017, the Government announced it would undertake a Review of the Reserve Bank of New Zealand Act 1989 (the Review) [CAB-17-MIN-0495 refers]. The goal of the Review is to modernise New Zealand's monetary and financial stability policy framework. It reflects a commitment made in the Coalition Agreement between the New Zealand Labour Party and New Zealand First to review and reform the Act.

15. The Act is almost 30 years old. While the single focus on price stability has generally served New Zealand well, there have been significant changes to the New Zealand economy and to monetary policy practices since it was enacted.

16. In undertaking the Review, it is important to recognise the significant contribution the current framework has made to reducing inflation over the past three decades and contributing to relatively low levels of volatility in output. As a result, the Government remains committed to maintaining both the operational independence of the Reserve Bank and to ensuring that monetary policy delivers low and stable average rates of inflation over time.

17. The Review is being conducted in two phases. Phase 1 is currently underway and is looking at areas that were identified for reform in the pre-election period:

    a. Recommending changes to the Act to provide for requiring monetary policy decision-makers to give due consideration to maximising employment alongside the price stability framework;

    b. Recommending changes to the Act to provide for a committee decision-making model for monetary policy decisions, in particular the introduction of a committee which includes external experts; and

    c. Considering whether changes are required to the role of the Reserve Bank Board as a consequence of the changes to the decision-making model.

18. Phase 2 of the Review, expected to begin in the middle of the year, will look at other areas of reform where a review of the Reserve Bank's activities and operations are desirable. Consultation is currently underway to finalise the focus areas of phase 2, but I have already publicly indicated that it will include financial stability issues, including the macroprudential framework and tools. I expect to report back to Cabinet on a proposed approach to phase 2 in in the first half of this year.

19. An Independent Expert Advisory Panel (the Panel) was established to support and provide input to both phases of the Review. The members of the Panel are Suzanne Snively, Dr Girol Karacaoglu, and Dr Malcolm Edey. The Panel has met with Officials from the Treasury and the Reserve Bank several times in recent months and considered papers and options presented. It has reported to me on its key findings from phase 1, which I have taken into consideration in developing my recommendations. A copy of the report from the Panel is attached to this paper.

The Objectives of Monetary Policy

20. This section discusses my proposal to update the objectives of monetary policy.

<u>Background</u>

21. The Act currently specifies that the primary function of the Reserve 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 Minister of Finance and Governor of the Reserve Bank are required to agree a separate document, known as the Policy Targets Agreement (PTA), that sets specific targets for this price stability objective.

22. The objective was formulated in the late 1980s at a time when New Zealand was experiencing an extended period of persistently high inflation. The resulting price stability we have experienced has been crucial for supporting New Zealand's wider economic objectives over the past few decades. By bringing inflation down in the early 1990s, and keeping it low and stable since, monetary policy has helped to reduce economic uncertainty. This has helped households and businesses plan for the future and make more informed spending and investment decisions, which has in turn supported our collective prosperity and wellbeing.

23. It is clear in the wake of the global financial crisis that monetary policy in legislation and in practice needs to move beyond a pure price stability objective. The recognition of the importance of monetary policy as a tool to supporting the real, productive, economy, has been evolving, but now is the time to codify that in New Zealand law. A dual mandate to achieve these objectives exists in one form or another in countries such as Australia, the United States, and Norway.

24. The Reserve Bank model has evolved, via the PTA, to be a "flexible inflation-targeting" approach that takes into account the impacts of monetary policy on the real economy. However, this has never been reflected in the objectives of the Act, nor does it fully capture the role of the Reserve Bank and its work in supporting a more productive and fair economy. This legislative deficit needs to be addressed to safeguard the "flexible" nature of the existing regime, to properly take account of the real economy, and to ensure appropriate accountability and transparency going forward.

Proposed Changes to the Act

25. I broadly endorse the recommendations of the Panel and propose that changes be made to bring the Act up to date in terms of the objectives of monetary policy. These will ensure the legislative framework recognises:

    a. That monetary policy plays an important role in promoting a productive economy, in particular through reducing the depth and length of periods of unemployment, in addition to delivering low average inflation over the medium term; and

    b. That monetary and financial policy are not ends in themselves, but rather a means to support the Government's broader economic objectives of delivering sustainable and shared prosperity.

Re-specifying the Purpose of the Act and the Reserve Bank's Primary Function

26. The first change I propose is to amend the preamble to Section 1A of the Act, to explicitly recognise that the purpose of the Act is to promote the prosperity and wellbeing of the people of New Zealand and contribute to a sustainable and productive economy.

27. This change will highlight upfront in the Act that the ultimate aim of monetary and financial policy is to improve the overall wellbeing of New Zealanders. This will provide greater clarity to the public that monetary and financial policy are not ends in themselves, but a means to support the living standards of New Zealanders.

28. The Act also currently states that "the primary function of the Reserve Bank is to formulate and implement monetary policy". I recommend that it will be a function of the Bank, acting through

the Monetary Policy committee, to formulate monetary policy, and that the Bank, through the Governor, will have the function of implementing the MPC's decisions. These functions will no longer be expressed as a "primary" function, to avoid implying that monetary policy is a more important function than the Reserve Bank's other functions, such as financial stability policy.

Re-specifying the Objectives of Monetary Policy

29. The second change I propose is to re-specify the objectives of monetary policy towards achieving and maintaining stability in the general level of prices over the medium term and supporting maximum sustainable employment.

30. This specification is in line with the recommendation from the Panel, except that the Panel recommended linking the two objectives (price stability and employment) with the word "while".

31. I propose instead that the legislation not set a weighting on the objectives. Rather the legislation would make clear that both price stability and employment outcomes are important. The detailed operational guidance as to how the Reserve Bank should take account of the objectives would be set by the Government of the day through a secondary instrument, as is currently the case with the PTA. This approach, of setting the high level objectives in the Act, has the advantage of allowing for the regime to be able to be adapted over time, thus being durable to future changes in the economy or our understanding of economics.

32. In terms of the specifics of the proposed legislative objective, it importantly retains the price stability objective that is at the core of the current framework. However, it introduces a focus on the medium term, which is currently present in the PTA but absent from the Act. This recognises the importance to economic growth and wellbeing of maintaining a low average rate of inflation over the medium to long term, but also recognises that there is little benefit in seeking to eliminate temporary spikes in inflation that often dissipate themselves.

33. As discussed, including employment in the objective recognises the contribution of monetary policy to reducing the length and depth of periods of high unemployment, and seeks to ensure that in operating monetary policy the Reserve Bank does not exacerbate negative shocks to incomes. However, I am cognisant that there are limits to what monetary policy can achieve, and these are recognised in the specification of the employment objective in a number of ways.

34. First, the specification recognises that the level of employment in the economy at any point in time is determined by a range of factors, not solely by monetary policy. The proposed approach therefore recognises the Reserve Bank should aim to *support* employment, rather than attempt to hold the Reserve Bank solely accountable for *achieving* an employment outcome at a point in time.

35. Second, the specification highlights that the role of monetary policy is one of assisting the economy to adjust such that the level of employment at a point of time is close to the *sustainable* level. The sustainable level is largely determined by structural factors such as the level of skills in the economy and the regulatory system, rather than monetary policy. If monetary policy attempted to artificially stimulate the economy to boost employment beyond this level it would lead to inflationary pressures, and thereby have negative effects on the sustainable level of economic activity in the long term. It is worth noting that at the sustainable level of employment there will be some unemployment. In particular, at any point of time, there will always be people changing jobs, which implies a period of transitional unemployment for these people.

36. Finally, the proposed specification of the objective recognises that monetary policy should act in a way that best supports the long-term prosperity of New Zealanders by targeting *maximum* sustainable employment. This recognises that in operating monetary policy the Reserve Bank's

approach should be the one most conducive to high economic growth and employment outcomes in the long term.

A Committee Decision-Making Model for Monetary Policy

37. This section discusses my proposal to implement a committee decision-making model for monetary policy.

Background

38. Currently, the Governor of the Reserve Bank has sole authority for monetary policy decisions under the Act. This single decision-maker model reflects the emphasis on individual accountability in the legislative framework, and is partly a result of the popularity of the individual accountability model in the state sector reforms of the 1980s.

39. However, while clear institutional accountability was important for establishing the credibility of the inflation-targeting system, there has been greater recognition in recent decades of the benefits of committee decision-making structures. Committee decision-making bodies for monetary policy are now regarded as delivering better quality decisions on average over time through their ability to harness a broad range of perspectives and guard against the risk of extreme preferences. This has seen New Zealand's legislated single decision-maker model become increasingly out of step with international practice.

40. In practice, the Reserve Bank's decision-making practices for monetary policy have adapted to reflect this. For several years it has included external members on its internal Monetary Policy Committee, which advises the Governor on monetary policy decisions. Further, in 2013 it established an internal Governing Committee to collectively make decisions on monetary policy. However, the Act has not been updated accordingly, with final legislative decision-making authority still resting with the Governor. The Act was not designed around the *de-facto* committee decision-making practices now used, creating uncertainty about the status and durability of these practices.

Proposed Establishment of a Monetary Policy Committee

41. I propose that a committee decision-making structure for monetary policy be legislated, as recommended by the Panel. This will bring New Zealand into line with international norms, formalise and strengthen the Reserve Bank's existing decision-making practices, and improve the consistency of the monetary policy framework.

42. In establishing a Monetary Policy Committee (MPC), there are a range of design aspects that affect the efficacy of the committee. These include the scope of its remit, its size and composition, the appointment and dismissal processes, and the approach to communicating decisions. These are complex and inter-related issues, often involving trade-offs between objectives such as ensuring good decision-making, accountability, institutional legitimacy, and functionality. In coming to their recommendation, the Panel aimed to balance the various objectives sought from a committee model while ensuring the model as a whole is coherent. I broadly endorse their recommendations in the proposals below and consider that the proposed model best balances the competing objectives.

Scope of the Committee's Remit

43. I recommend that the MPC have collective responsibility for all monetary policy decisions and strategy. This would include decisions about the Official Cash Rate (OCR), but not be limited to only OCR decisions. For example, consistent with the operational independence of the

Reserve Bank, the MPC would also have responsibility for strategic choices around the monetary policy tools used by the Reserve Bank.

44. The Governor would remain responsible for the implementation of monetary policy and in doing so would be required to act in accordance with the decisions of the MPC.

Size of the Committee

45. I propose that the legislation specifies a range of five to seven members for the committee, but consider that the first MPC should have seven members. The legislative range would provide flexibility for the committee to evolve over time without requiring legislative change, as well as enabling long-term vacancies to be managed should they occur. A committee of seven members would ensure sufficient space for a range of skills and perspectives but still support deliberative decision-making. Beyond seven, the marginal benefits of additional members are likely to be small.

Balance of External and Internal Members

46. To ensure independent expertise and views are considered in monetary policy decisions, I recommend that external members (i.e. members who are *not* Reserve Bank staff) are included on the MPC as a minority. The balance would be made up of internal members (i.e. the Governor and employees of the Reserve Bank).

47. Consistent with allowing flexibility in the size of the committee, the exact number of internal and external members would not be specified in legislation. The legislation would set a minimum of at least two external members and a maximum of four internal members. However, it is my intention that the first committee of seven members would have four internal members and three externals.

48. This balance of external and internal members emphasises the importance of expertise in monetary policy, while also achieving a requisite level of diversity in decision-making. I propose that the Governor would be Chair of the committee.

49. External members should have knowledge and experience in relevant policy areas (such as economics, finance, banking, or public policy) but not be limited to monetary policy experts. They should be free from conflicts of interest and not be on the MPC to represent a particular sector. Such an approach would allow the MPC to operate as an expert committee, engaging deeply on the substance of the decisions, while also allowing for a wide range of external members to be included.

50. To ensure external members remain genuinely "external", they would be engaged on a part-time basis and would not have internal management powers. However, their engagement would still be expected to be substantive and allow them to engage fully in the MPC's deliberations.

Appointment Processes

51. I propose that all MPC members be appointed by the Minister of Finance on the recommendation of the Board of the Reserve Bank. This is based on the current process for appointing the Governor. As each committee member would hold considerable decision-making powers that have impacts on the wider public, appointments by the Minister would ensure members have democratic legitimacy in addition to being consistent with international practice. At the same time, the "double veto" provided by the Board's recommendation would ensure merit-based selection and limit the risk of political influence.

52. Internal members will be executives or employees of the Reserve Bank. I propose that the Governor and the Deputy Chief Executive be *ex-officio* members of the MPC, meaning they would be appointed to their position in the Reserve Bank by the Minister on the nomination of the Board and automatically join the MPC. This approach differs to existing practice, where the Deputy Chief Executive is appointed by the Board on recommendation from the Governor. Other internals would not be *ex-officio,* so the Ministerial appointment process would only apply to their appointment to the MPC (that is, their employment at the Reserve Bank will be a matter for the Governor). For all internal members (other than the Governor) the Board would be required to consult the Governor before making a nomination to the Minister. I consider that this approach would maintain an appropriate degree of flexibility in the Reserve Bank's senior management structures.

Dismissal Processes

53. Consistent with the appointment process, I propose that the dismissal approach currently applying to the Governor should apply to all committee members. This would allow the Governor-General to remove members on the advice of the Minister of Finance. The Minister would be able to tender that advice with or without a recommendation from the Board, but only if the Minister is satisfied that the member failed to meet criteria specified in the Act. This approach ensures democratic legitimacy and accountability while also providing a check on the actions of the Minister. Recognising their *ex-officio* positions, removal of the Governor or the Deputy Chief Executive from the MPC would also mean removal from their positions at the Reserve Bank. However, for other internal members, the Minister would have the power to dismiss from the MPC, but this would not trigger dismissal from their Reserve Bank position.

54. Consistent with the above, the Board would be able to recommend to the Minister the dismissal of members where the Board is satisfied certain statutory criteria have not been met. This is consistent with the Board's monitoring role.

55. Officials are yet to develop the exact criteria that could trigger dismissal. This will be done as part of work on second order details required to introduce the legislation. However, I propose three substantive points. First, it should be possible to dismiss individual members, including the Governor, if they fail to meet, or are not capable of adequately carrying out, their statutory duties. One of their statutory duties will be to act in accordance with the objectives set for the committee. For the avoidance of doubt, this duty relates to their intentions in making decisions; members will not be subject to dismissal for making a decision that might have been made differently with the benefit of hindsight. Instead, through its role in monitoring the MPC, the Board would have a key role in ensuring the MPC learns lessons from any errors of judgement.

56. Second, in a limited set of circumstances, I recommend the Minister of Finance would have the power to remove a poorly performing external member. While it will be necessary to develop this carefully in a way that sets out causes for dismissal, as members should not be removed for simply taking a policy stance the Minister, the Board or other MPC members disagree with, this would recognise that a member who is unnecessarily disruptive to the overall dynamic of the MPC could have a significant impact on its efficacy.

57. Third, the internal members filling the non-*ex-officio* positions may need to change if their roles within the Reserve Bank change. The Governor would retain the right to redeploy internal MPC members to different roles in the Reserve Bank (provided that such a shift is consistent with employment law and the individual's contract), and if it is no longer appropriate for the individual to sit on the MPC in their new role they would be removed from the MPC. The exact process for removing the member from the MPC will be developed by officials as part of the work on second order issues. The resulting vacancy on the MPC would be filled through the normal appointment process for internal members.

Length and Timing of Term

58. I propose internal members would have five-year terms on the MPC, limited to a maximum of two terms in any one role. For example, this would mean that a Deputy Governor's tenure (as Deputy Governor) would be limited to a single renewal (ensuring a maximum period on the MPC in the role of Deputy Governor of ten years), but if the Deputy Governor were then promoted to Governor they could serve two additional five-year terms in their new role as Governor. This would protect the Reserve Bank's operational independence by providing security of tenure and limit the risk of volatility from excessive turnover, while also introducing new perspectives over time. This would be a departure from current practice, where there is no limit on the number of terms a Governor or Deputy Chief Executive can serve.

59. External members would have four-year terms, again with a maximum of two terms. Shorter terms for external members would ensure new perspectives are brought onto the MPC more regularly, consistent with the rationale for their inclusion, while also being long enough to give them time to learn and gain experience in the role and to see through a policy cycle, given the lags in monetary policy. External members could, however, subsequently be appointed to internal roles on the MPC.

60. In addition, I recommend that appointments are staggered. This is consistent with international practice and would reduce both policy volatility and the risk of politicisation.

Use of a Committee Charter

61. As a general principle, it is important that Parliament fix the monetary policy decision-making framework to ensure an appropriate level of accountability. Moreover, legislation will protect the Reserve Bank's operational independence for monetary policy by constraining the power of the Minister. However, it is also desirable to have a degree of flexibility to allow the MPC to learn from experience and evolve its practices without requiring legislative change.

62. Accordingly, I recommend the Act requires that a committee Charter (or similar mechanism) be agreed between the Minister of Finance and the MPC. The Charter would provide further details on a defined set of issues where the Minister of Finance is likely to have an interest, where practice may need to evolve over time, or where more detail is required than can be set in primary legislation. This would include the approach to communications, and could include the approach to decision-making, discussed separately below.

63. Beyond these examples, most issues relating to committee procedure, such as meeting frequency and procedures, could be left to the MPC to determine through a separate code of conduct developed themselves.

Decision-Making Processes

64. I recommend that the MPC adopt a principle of decision-making by consensus.

65. This principle would see the MPC aiming to find a constructive resolution of issues where different views exist, with members engaging in in-depth discussions and a true exchange of perspectives before taking decisions. However, in cases where consensus cannot be reached, decisions would be taken by a majority vote with the Governor having the casting vote in event of a tie.

66. Legislation would at least need to specify a quorum for decisions, and further details on the decision-making approach could be set out in the committee Charter agreed between the MPC and the Minister of Finance, or in legislation. This will be considered further as part of the work

on second order details prior to the introduction of legislation giving effect to the recommendations in this paper.

Communications Approach

67. I propose the Act require the Reserve Bank to publish a record of the MPC's meetings, with further details on the approach to communications set in the committee Charter agreed between the Minister of Finance and the MPC. This would allow the communications model to evolve over time as the MPC matures and markets become familiar with the new model.

68. It is my intention though that the first Charter agreed with the MPC would require it to publish meeting records that reflect differences of view between MPC members where they exist, including publishing the balance of votes for any decision where a vote is required, without attributing votes to individuals. The Charter would also allow for MPC members to express individual views (for example through public speeches or articles) if they wish, after consultation with their colleagues on the MPC. This approach would balance the need for transparency about the decision-making process with the need for clarity and coherence in communicating decisions.

69. I propose that the Governor as Chair of the MPC is the sole spokesperson for decisions of the MPC.

The Role of the Treasury

70. After consultation on the report of the Panel, I recommend including a non-voting Treasury observer on the MPC. This would be to ensure that the Treasury has a rich understanding of the debate and issues and would inform the Treasury's advice. Such an arrangement would also support the MPC's decision-making (especially in terms of having information on fiscal policy) and could support the coordination of monetary and fiscal policy, especially given the additional challenges presented by pursuing a dual mandate.

71. Following the recommendation of the Panel, I have also asked Officials to develop options for improving coordination as part of the work on second order details, in case any further legislative changes are necessary to support that coordination.

Consequential Changes Resulting from these Proposals

72. The proposed changes would have a number of implications for other aspects of the current monetary policy framework. The consequential changes required to the role of the Board and the PTA are discussed below.

<u>Changes to the Role of the Board</u>

73. The Board performs a core accountability role in the existing framework by acting as a monitoring agent for the Minister of Finance. It is required to keep the performance of the Reserve Bank and Governor under constant review in terms of discharging their responsibilities, to determine the consistency of each Monetary Policy Statement (MPS) with the Reserve Bank's primary function and the PTA, and to review the Reserve Bank's use of resources. To support this role, it must prepare a publicly available annual report of its assessment.

74. Under an MPC model, the integral accountability role of the Board would remain. However, several changes would be required to ensure the Board's role is consistent with the new framework.

75. First, the new allocation of roles and responsibilities arising from the creation of an MPC would require some adjustments. In the new model the MPC would be collectively accountable for monetary policy decisions and strategy, while the Governor would be responsible for implementing the MPC's decisions. To reflect this change, I propose that the Board would be responsible for keeping under constant review the performance of:

    a. The MPC in discharging its responsibilities for monetary policy, including acting in a manner consistent with the monetary policy objectives;

    b. The individual members of the MPC in discharging their statutory responsibilities; and

    c. The Governor in discharging his or her statutory duties in implementing the MPC's decisions, including as the Chair of the MPC and the Chief Executive of the Reserve Bank.

76. The Governor's responsibilities outside of monetary policy would be unchanged, as would the Board's role in respect of monitoring the Governor in his or her responsibilities outside of monetary policy.

77. Secondly, I endorse the Panel's recommendation that the Board's monitoring activities should have a greater medium-term perspective and more emphasis on the quality and effectiveness of decision-making processes. I have asked Officials to report back on the precise specification of the Board's duties in this regard, with the intention of ensuring the Board's focus is on evaluating the MPC's overall approach to monetary policy against objectives over the medium term.

78. Finally, I propose changing the process for appointing the Board's Chair and Deputy Chair. At present, the Board appoints its own Chair and Deputy. I endorse the Panel's recommendation that this be changed to have the Minister of Finance make the appointments. This would bring it into line with common public sector practice and strengthen the link between the Board and the Minister to better support its role as the monitoring agent of the Minister.

79. The Panel has recommended wider consideration of the role of the Board in phase 2, with a view to moving some or all of the Reserve Bank's governance functions (which currently sit with the Governor) to the Board. This will include consideration of any changes to the capacity and resources for the Board necessary for it to effectively fulfil its duties in light of the changes proposed in this paper.

<u>Changes to the Policy Targets Agreement</u>

80. In the existing monetary policy framework, the PTA is an instrument agreed by the Minister of Finance and the Governor that sets operational targets for monetary policy in accordance with the Act. It provides a transparent approach to the setting these targets, whereby the Governor can be held personally accountable for ensuring the Reserve Bank acts consistently with the policy targets set within it. It also provides a mechanism by which monetary policy's operational objectives and practice can evolve over time without requiring legislative change.

81. While an instrument will still be required under the proposed framework, a committee decision-making structure raises a number of practical issues for the PTA in its existing form. As the MPC would be collectively responsible for making monetary policy decisions, it would be inconsistent for the Governor to be the sole member of the MPC to agree the operational objectives. At the same time though, simply transferring the current agreement model to an MPC would be difficult given the revolving nature of committee membership. This would either require new agreements to be negotiated every time a new member joined the MPC, or for new

members to be accountable to the agreement of previous members until it was time for a periodic renewal.

82. As a result, I propose changing to a model where the Minister of Finance sets the operational objectives for monetary policy following the receipt of public non-binding advice from the Reserve Bank. This model was recommended by the Panel after their consideration of the range of practices in other countries (refer to Annex 5 of the Panel's report for examples of international practice). It balances the Government's right to set economic policy against the need to utilise technical expertise. The Treasury would also provide advice to the Minister of Finance in its role as advisor to the Minister, with this advice being made public.

83. As both the advice of the Reserve Bank and the Treasury would be made public, I believe this approach ensures sufficient discipline in the decisions of the Minister and in this way will provide an independent constraint on inflation bias over the political cycle. I also foresee that this approach would allow for greater transparency and public input into the setting of monetary policy objectives, therefore facilitating public debate and supporting greater democratic legitimacy in the setting of operational objectives over time.

84. Officials are yet to develop the exact processes for setting the operational objectives for monetary policy, including any requirements for the Minister of Finance to publicly explain any material deviations from what Officials have advised. This will be done as part of work on second order details required to introduce the legislation.

Next Steps

85. There are a number of consequential amendments and detailed issues that still need to be identified and progressed in phase 1 before legislation can be introduced. These include second order details such as:

    a. How the transition process will occur from the status quo to the new model;

    b. The statutory duties and dismissal provisions of the MPC itself, the members of the MPC, and the Governor;

    c. How the committee Charter will work in practice and its exact scope;

    d. The precise specification of the Board's monitoring duties and powers;

    e. The detailed process for setting the operational objectives of monetary policy;

    f. The resourcing and capacity implications for the Reserve Bank to deliver the requirements of the new dual mandate for monetary policy; and

    g. A number of small amendments needed as a result of the changes in objectives.

86. There are also some obsolete or ambiguous provisions in the Act which will be updated to improve workability. This includes the provisions relating to the signing of the conditions of employment of the Governor and interim Governor arrangements.

87. I propose that Cabinet delegate authority to me and the Associate Ministers of Finance (Hon Parker, Hon Jones, and Hon Shaw) to take these detailed decisions. The full details of the reform would then be subject to Cabinet approval through the Cabinet Legislation Committee once the draft legislation has been prepared.

Consultation

Public Sector Consultation

88. The recommendations from the Panel have largely been reflected in the recommendations below. The only deviations from the model recommended by the Panel are a change to the specification of the monetary policy objective (as discussed above) and a few changes to the detailed design of the MPC. Specific differences with the Panel on the MPC are: the inclusion of a non-voting Treasury observer; reserving the power to remove poorly performing external members for the Minister of Finance (the Panel had recommended giving the Board this power in some limited circumstances); and my intention for the first committee Charter to require the publication of the balance of votes on the MPC, if the decision was not unanimous (the Panel recommended that the balance of votes would not be made public).

89. The Treasury has conducted the Review in consultation with the Reserve Bank. The Department of the Prime Minister and Cabinet has been informed.

90. The Reserve Bank generally agrees with the majority of the recommendations in this paper, but advocates a different course of action in three areas. These are so as to maintain the Reserve Bank's operational independence, and to not constrain the Governor's powers to recruit and appoint staff, as follows:

   a. **A non-voting Treasury representative on the MPC (Recommendation 16 iv)** – The Reserve Bank does not support the inclusion of a non-voting Treasury representative on the MPC. While the Reserve Bank welcomes closer coordination with the Treasury, the inclusion of a non-voting Treasury representative is unnecessary and could be seen as limiting the Reserve Bank's operational independence. Treasury representation is rare internationally – of the world's inflation-targeting central banks over 80% do not have a Treasury representative, and for the minority that do (such as the UK and Australia), such representatives have typically been historical features of their structure. In addition, other mechanisms already exist to ensure that information flows between the Treasury and the Reserve Bank to ensure that policy is set in a co-ordinated manner. For example, Bank staff already research and prepare detailed analysis of relevant government policies for each OCR decision after discussions with Treasury colleagues. Such mechanisms could be developed further, but it is not clear that including a Treasury representative on the MPC would improve policy co-ordination. Such an addition would, however, risk compromising the Bank's operational independence, and give the impression of such compromise.

   b. **The appointment process for internal MPC members (Recommendation 18)** – The Reserve Bank recommends that the Board should be required to agree (rather than merely consult) with the Governor on potential internal MPC candidates before making nominations to the Minister. The Minister would still have the power to veto the Board and Governor's joint recommendation, but by requiring the Board to agree with the Governor it would retain the Governor's normal employment powers to appoint staff to senior roles with operational responsibilities.

   c. **The process for agreeing the Committee Charter (Recommendation 23)** – The Reserve Bank recommends that the Committee Charter should be agreed by the MPC itself. While the Act would require the MPC to have a Charter, and may refer to matters to include in the Charter, the Charter would not require agreement with the Minister. This arrangement would help ensure the Reserve Bank retains operational independence, insofar as the Act defines the powers of the MPC, the PTA (or its equivalent) specifies the MPC's objectives, and the Minister of Finance has a role in appointments to the MPC.

Public Consultation

91. The Treasury also conducted targeted consultation with a mix of individuals and organisations that have a particular interest in monetary policy. This occurred in the first half of February 2018 and included meetings with banks, academics, and think tank economists, along with representatives from sector organisations such as the Council of Trade Unions. The Treasury website also provided the public with information about the Review and welcomed public feedback by email to allow anybody to contribute to the Government's consideration of these matters.

92. I was provided with a summary of these stakeholders' views and this summary will be made public after Cabinet decisions are announced.

Financial Implications

93. Implementing changes to legislate a MPC will have financial implications. It will likely increase net operating costs for the Reserve Bank by between $200,000 and $400,000 per annum. Additional operating expenses arise from recruiting, remunerating, and recompensing expenses for external MPC members, as well as providing external members a limited amount of administrative and analytical support.

94. Under Part 6 of the Reserve Bank Act, the Reserve Bank's operating expenses are met through a funding agreement, lasting five years, negotiated between the Minister of Finance and the Governor. The agreement specifies the amount of the Reserve Bank's income that may be paid or applied in meeting the operating expenses incurred by the Reserve Bank, with any residual income returned to the Crown. Any increase in the Reserve Bank's operating expenses will impact on the Crown's operating balance before gains and losses (OBEGAL) and net core Crown debt (as expenses will increase). However, the Crown is not directly funding the increase in expenses so there is no charge against the Budget allowances.

95. The current funding agreement will expire in June 2020. While the implementation date for the new MPC will depend on the legislative timetable which has not yet been set, it is likely that the MPC will be operational for no more than one year of the current funding agreement. Depending on implementation dates, the Reserve Bank may be able to manage the increase in operating costs resulting from the changes recommended in this paper within the terms of the current funding agreement. However, the increased costs will need to be reflected in future funding agreements, which may have fiscal impacts to the Crown.

96. Further, the Panel has recommended that phase 2 of the Review re-evaluate the Reserve Bank's funding model, particularly for financial policy. Accordingly, this could also lead to a variation in the funding agreement before 2020.

97. If any variation to the current funding agreement is sought I will report back to Cabinet on those changes.

Human Rights

98. There are no human rights implications arising from the recommendations in this paper.

Legislative Implications

99. The proposals in this paper will require amendments to the Reserve Bank of New Zealand Act 1989. Preliminary consultations between the Treasury and the Parliamentary Counsel Office have already occurred.

100. A legislative bid is in progress for a Reserve Bank Amendment Bill with a proposed category 2 priority (must be passed in the year). I envisage introducing and progressing a bill to progress the changes in this paper in the second half of 2018.

Regulatory Impact Analysis

101. The Regulatory Impact Analysis requirements apply to this proposal and the Regulatory Impact Statement (RIS) prepared by the Treasury is attached to this paper.

102. The Regulatory Impact Analysis Team at the Treasury has reviewed the RIS and considers that it meets the quality assurance requirements. The Government's objectives and potential ways of meeting them are clearly set out and well analysed and evidenced, including by reference to extensive stakeholder consultation.

Publicity

103. I propose to make an announcement about these changes following Cabinet's decisions. Given that a strong degree of financial market interest is expected, this announcement will be coordinated with the announcement of the new PTA on 26 March, prior to the commencement of the new Governor's term on 27 March.

104. I also intend to proactively release a number of documents to accompany the announcement. This will support transparency of the process, particularly given the likely degree of market interest. The release would include advice from Officials on phase 1 of the Review, the accompanying Panel report, minutes and papers from the Panel's meetings relating to phase 1, and the summary of stakeholders' views mentioned previously.

Recommendations

I recommend that the Committee:

1. **note** that on 6 November 2017 I informed Cabinet of my intention to announce a Review of the Reserve Bank of New Zealand Act 1989 [CAB-17-MIN-0495];

2. **note** that phase 1 of the Review was directed to make recommendations on:

    a. Changes to the Act to provide for requiring monetary policy decision-makers to give due consideration to maximising employment alongside the price-stability framework;

    b. Changes to the Act to provide for a committee decision-making model for monetary policy decisions, in particular the introduction of a committee which includes external experts; and

    c. Whether changes are required to the role of the Reserve Bank Board as a consequence of the changes to the decision-making model;

3. **note** that an Independent Expert Advisory Panel was established to provide support to the Review and has recently reported its recommendations for phase 1.

Monetary Policy Objectives

4. **note** that maintaining medium term price stability through monetary policy remains crucial to supporting the wellbeing of New Zealanders;

5. **agree** that there is a need to update New Zealand's legislative monetary policy framework to recognise the wider role of monetary policy in reducing the depth and length of recessions, including minimising periods of high unemployment;

6. **agree** to amend the Reserve Bank of New Zealand Act 1989 to provide that the purpose of the Act is to promote the prosperity and wellbeing of the people of New Zealand and contribute to a sustainable and productive economy;

7. **agree** to amend the Reserve Bank of New Zealand Act 1989 such that monetary policy is directed at achieving and maintaining stability in the general level of prices over the medium term and supporting maximum sustainable employment.

Monetary Policy Committee and Governance

8. **agree** that it will be a function of the Reserve Bank, acting through the Monetary Policy Committee (MPC), to formulate monetary policy;

9. **agree** that the Reserve Bank, through the Governor, will have the function of implementing the monetary policy that has been formulated by the MPC;

10. **agree** that these functions will no longer be expressed as a "primary" function;

11. **agree** to amend the Reserve Bank of New Zealand Act 1989 to provide that the operational objectives of monetary policy (currently set in the Policy Targets Agreement) will be set by the Minister of Finance following the receipt of non-binding public advice from the Reserve Bank;

12. **note** that the Governor's duties outside of monetary policy will not be amended, other than possible minor or other consequential changes;

13. **agree** to amend the Reserve Bank of New Zealand Act 1989 to amend the duties of the Board of the Reserve Bank, such that the Board will have a duty to monitor:

    i. the MPC in the performance of its statutory duties;

    ii. individual members of the MPC in the performance of their statutory duties; and

    iii. the Governor of the Reserve Bank in the performance of his or her statutory duties;

14. **note** that Officials will undertake further work on the precise statutory duties of the Reserve Bank Board and the MPC members as part of work on second order issues;

15. **agree** to amend the Reserve Bank of New Zealand Act 1989 to provide for the Minister of Finance to appoint the Chair and Deputy Chair of the Board of the Reserve Bank;

16. **agree** that the MPC to be established under the Reserve Bank of New Zealand Act 1989 should be required to comprise:

    i. a minimum of five and a maximum of seven voting members;

    ii. at least two voting members that are external to the Reserve Bank's staff, with knowledge and experience in relevant policy areas who are engaged on a part-time basis (subject to vacancies as positions are filled);

iii. internal Reserve Bank employees or executives, up to a maximum of four, for the balance of the committee's voting members, such that the internal Reserve Bank staff constitute a majority of the voting members (subject to vacancies as positions are filled);

iv. a non-voting observer from the Treasury;

17. **note** that I intend for the MPC to initially have seven voting members;

18. **agree** that the Minister of Finance should appoint the Governor and Deputy Chief Executive following nomination by the Reserve Bank Board;

19. **agree** that the Governor and the Deputy Chief Executive will be *ex-officio* members of the MPC, and that the Governor will be the Chair of the MPC;

20. **agree** that the Minister of Finance should appoint all other members of the MPC following nomination by the Reserve Bank Board;

21. **agree** that the Board should be required to consult the Governor regarding the recommendation to appoint the Deputy Chief Executive and the recommendation to appoint Reserve Bank staff as internal members of the MPC;

22. **agree** that the terms for MPC members should be staggered, with internal members serving five-year terms and external members serving four-year terms;

23. **agree** that there should be a maximum of two terms for any person as Governor;

24. **agree** that there should be a maximum of two terms for any person as Deputy Chief Executive;

25. **agree** that external members of the MPC and the internal members of the MPC that are not *ex-officio* are limited to two terms on the MPC in any one role;

26. **agree** that MPC members could be removed from the MPC by the Governor-General on the advice of the Minister of Finance, based on specified criteria, with or without a recommendation from the Board;

27. **agree** that the Governor retain the power to redeploy internal members of the MPC to different roles within the Reserve Bank, which may necessitate their removal from the MPC, and that the exact process for their removal will be developed by officials as part of the work on second order issues;

28. **agree** that the MPC should be required to agree a Charter, or similar mechanism, with the Minister of Finance setting out the approach to issues defined by the Act, including the approach to the MPC's communications;

29. **note** that it is my intention for the MPC to:

    i. aim to reach decisions by consensus, with decisions taken by a majority vote where consensus cannot be reached, and with the Governor having the casting vote where necessary;

    ii. require the MPC to publish meeting records that reflect any differences of view between MPC members where they exist, but without attributing views to individual MPC members;

iii. require the MPC to publish the balance of votes for any decision, where a vote is required, without attributing votes to individuals;

iv. designate the Governor as Chair of the MPC to be sole spokesperson for decisions of the MPC; and

v. aside from communicating the decision of the MPC, permit MPC members to make their individual views known, after consultation with their colleagues on the MPC;

30. **note** that Officials will develop options for improving coordination between the Reserve Bank and the Treasury as part of the work on second order details.

Financial Implications

31. **note** that proposals to legislate an MPC will likely increase operating expenses for the Reserve Bank by between $200,000-$400,000 per annum*;*

32. **note** that the Reserve Bank's operating expenses are met through a five-year funding agreement negotiated between the Minister of Finance and the Governor that specifies the amount of the Reserve Bank's income that may be paid or applied in meeting the operating expenses incurred by the Reserve Bank;

33. **note** that any increase in the Reserve Bank's operating expenses will impact on the Crown's operating balance before gains and losses and net core Crown debt, but that as the Crown is not directly funding the increase in expenses there is no charge against the Budget allowances;

34. **note** that the current funding agreement is due to expire in June 2020 and the Reserve Bank may be able to meet the increase in operating costs from the recommendations in this paper within its current funding prior to that date, but that this depends on implementation dates;

35. **note** that, beyond the current funding agreement, the operating expenses will need to be reflected in future funding agreements, which may have fiscal impacts to the Crown;

36. **note** that the Independent Expert Advisory Panel has recommended that phase 2 of the Review re-evaluate the Reserve Bank's funding model, and this may lead to changes to the current funding agreement, which may have fiscal impacts to the Crown;

37. **note** that if there is any need to vary the funding agreement I will report back to Cabinet.

Next steps

38. **note** that I intend to announce the proposed changes to the monetary policy framework after the Cabinet meeting on 19 March 2018 and before the commencement of the new Governor's term on 27 March 2018*;*

39. **note** that a number of second order issues will need to be resolved before the changes recommended in this paper can be implemented, and that implementation will require a number of incidental changes to the Act;

40. **note** that Officials' advice on second order issues will also recommend changes to obsolete and ambiguous provisions in the Act that can be improved to make the Act more workable;

41. **agree** to delegate authority to the Minister of Finance and the Associate Ministers of Finance (Hon Parker, Hon Jones, and Hon Shaw) to take decisions on these second order issues before Cabinet approves the full details of the reform at the same time as it considers the draft legislation that will give effect to the changes; and

42. **invite** the Treasury, in consultation with the Reserve Bank, to issue drafting instructions to the Parliamentary Counsel Office to progress the legislative changes required to give effect to these recommendations.

Authorised for lodgement
Hon Grant Robertson

Minister of Finance