



THE TREASURY

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Monetary Policy Objectives Options for Reform

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Government objective for reform

A key aim of the Reserve Bank Act Review (as set out in the Terms of Reference) is to:
[Recommend changes to the Act to provide for requiring monetary policy decision-makers to give due consideration to maximising employment alongside the price stability framework](#)

The policy rationale for a dual objective is that monetary policy impacts on a country's long-term level of employment/output (and therefore living standards) through both:

Providing for price stability: high and variable inflation has negative impacts on a country's income levels through impeding the role prices play in ensuring resources are allocated to their best use; and

Stabilising employment around 'sustainable' levels in the short term: Large deviations of employment from sustainable levels can have long run impacts on a country's income level, for example by resulting in skills declines.

While there is a general complementarity between these objectives, as greater demand for use of a country's resources will lead to inflation, there are events (such as supply and price shocks) that may lead to inflation and output moving in opposite directions at times.

Benefits of reform

- **Current practice:** In setting monetary policy, the Reserve Bank already gives consideration to employment as part of its ‘flexible inflation targeting’ framework. This framework involves the Bank choosing a policy rate path that is forecast to bring inflation back to target within the ‘medium term’. The Bank has discretion over how quickly to return inflation to target and this ‘time-to-target’ flexibility allows the Bank to avoid undue volatility in output, interest rates or the exchange rate, as required by the Policy Targets Agreement (PTA). Since volatility in output and employment are closely related, the Reserve Bank’s framework is consistent with avoiding undue volatility in employment in pursuit of the price stability objective.
- **Strengthening the current system:** Formalising a requirement to give consideration to employment in the legislation will:
 - ensure that this consideration is durable and cannot be removed from a future PTA,
 - ensure that the Reserve Bank is accountable for the impacts of monetary policy on employment.
 - potentially allow for flexibility in how an employment objective in the PTA is specified.

Existing legislation

The Bank's **purpose** is currently set out in **Section 1A** of the Reserve Bank Act:

The purpose of this Act is to provide for the Reserve Bank of New Zealand, as the central bank, to be responsible for—

- a) formulating and implementing monetary policy designed to promote stability in the general level of prices, while recognising the Crown's right to determine economic policy; and*
- b) promoting the maintenance of a sound and efficient financial system; and*
- c) carrying out other functions, and exercising powers, specified in this Act.*

The **primary objective** of monetary policy is set out in **Section 8** of the Act:

The primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices.

Section 10 of the Act requires that:

In formulating and implementing monetary policy the Bank shall—

- a) have regard to the efficiency and soundness of the financial system:*
- b) consult with, and give advice to, the Government and such persons or organisations as the Bank considers can assist it to achieve and maintain the economic objective of monetary policy.*

The Minister has the power to override the objective in section 8 by replacing it with another objective (section 12).

Policy Targets Agreement (PTA)

- The Act requires the Minister of Finance to agree a Policy Targets Agreement (PTA) with a Governor, before the Governor's appointment, that sets the target of monetary policy consistent with the section 8 objective.
- The current PTA is based on the price stability objective but also requires the Bank to ensure that monetary policy does not unduly exacerbate volatility in output (and by consequence employment) in pursuing that price stability objective. It does this by requiring:
 - The Bank to target a medium term inflation target;
 - The Bank to look through temporary price shocks and focus on medium term inflation outcomes;
 - In pursuing the price stability objective the Bank seek to avoid unnecessary instability in output, interest rates and the exchange rate and have regard to financial stability.

The role of the Act versus the PTA

- As legislation is changed infrequently the Act should provide an enduring framework that sets the high level objectives and is flexible enough to be appropriate in a range of economic circumstances
- Officials consider a secondary instrument should continue to be empowered by the Act to set specific targets and the weighting of objectives that are suited to the time
- However the current set up of the PTA has some weaknesses: there is no formal channel for public consultation or to provide advice to the new Governor and no formal role for the Bank to advise on the target. Further it will need to adapt in the context of committee decision making.
- Officials are considering different ways the secondary instrument could be designed that would mitigate these weaknesses, such as
 - The Minister (or executive council) solely sets the target (UK model) and may publicly consult
 - The Minister sets the target following advice from the MPC
 - The target is set following a public review process (e.g. Canada)
- In any of these options the Treasury would continue to advise the Minister and the instrument would be de-coupled from the Governor appointment

Updating the Bank's purpose in section 1A

- In recognition of the proposed broader legislative remit, both the Reserve Bank and the Treasury support updating section 1A of the Act to better define the Bank's purpose - i.e. to state how maintaining monetary and financial stability contributes to sustainable growth in output and employment, and hence the prosperity and welfare of the people of New Zealand. There appears to be no substantial costs to clarifying the Bank's purpose, while there is a benefit in terms of better conveying to the public how the Bank contributes to societal welfare. An updated purpose statement could include wording similar to the Australian legislation:

It is the purpose of the Reserve Bank of New Zealand, within the limits of its power, to maintain monetary and financial stability so as to help promote sustainable growth in output and employment, and hence contribute to the prosperity and welfare of the people of New Zealand.

Proposed criteria for assessment of objective

- Officials seek the panel's view on the following proposed criteria to assess options to amend the objective of monetary policy:
 - Providing a credible commitment to price stability and avoiding inflation bias
 - Puts sufficient weight on the short-run stabilisation of employment around sustainable levels in order to support maximum employment levels in the long term
 - Legislation should be durable over time and therefore appropriate to a range of economic circumstances
 - Objectives, and how the framework will operate, should be easy to communicate to the public
 - Provide an objective, or set of objectives, that are achievable through monetary policy tools

Options for reform of the policy objective

In updating the Reserve Bank Act to give due consideration to employment, officials are considering a number of options.

A significant choice is as to whether the Act (versus the PTA) should include an employment objective on an equal footing to price stability, or subordinate to it

Also, given the close link between output and employment, there is a choice whether to include references to just employment or both output and employment in any potential amendments. A reference to output would capture capital utilisation – but it could also be seen as a third objective and thus complicate the objective.

There is also a choice as to whether to refer to employment, full employment, maximum employment, sustainable employment or the Government's employment goals.

All of the above options would be complimented by changing the PTA to more precisely define how the Bank should support employment.

Option 1: Amending section 8 (no hierarchy)

Including an employment objective equally in section 8 of the Act alongside the Bank's existing price stability objective would mimic the legislation of the Reserve Bank of Australia and US Federal Reserve. Potential amendments could take several forms:

*Option i
(RBA Model):*

The Bank (or MPC) shall formulate and implement monetary policy directed to the economic objectives of:

- 1) Achieving and maintaining stability in the general level of prices*
- 2) The maintenance of full employment.*

Option ii

The Bank (or MPC) shall formulate and implement monetary policy so as to ... promote effectively the goals of maximum employment and stable prices.

Assessment: non-hierarchical specification

Potential advantages

- Non-hierarchical objectives would provide maximum flexibility over time as to how to weight the price and employment objectives in the PTA.

Potential disadvantages:

- This specification could create more of an inflation bias in the long-run and could de-anchor inflation expectations overall leading to higher inflation.
- The Reserve Bank will have two variables in its objectives (unemployment and inflation) with only one instrument (interest rates). In the event of a supply shock, which causes inflation and unemployment to rise simultaneously, monetary policy will face a trade-off as to which objective to focus on. As the Reserve Bank may be unable to meet both its legislative objectives in this event its credibility may be undermined which may make it more difficult to maintain low inflation in the long run.

Option 2A: Amending section 8 (hierarchical)

- A hierarchical specification could be provided in section 8 or in a subsequent section. For example section 8 could be amended as follows:

The Bank (or MPC) 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, and otherwise supporting high and stable output and employment.

Option 2B: Updating the Bank's secondary objectives

Including an employment objective in a section subsequent to section 8 would treat employment as a secondary objective. This would most closely mimic the legislation that underpins the Bank of England, Norges Bank, Bank of Israel and Bank of Turkey. A subsequent section could take several forms:

In formulating and implementing monetary policy the Bank shall —

a) have regard to the efficiency and soundness of the financial system:

*Existing
Wording
in the Act*

*Option 2Bi
(Norway)*

Otherwise contribute to high and stable output and employment

*Option 2Bii
(UK)*

Subject to maintaining price stability, support the economic policy of the Government, including its objectives for growth and employment

*Option 2Biii
(Israel)*

Support other objectives of the Government's economy policy, especially growth, employment and reducing social gaps, provided that, in the Committee's opinion, this support shall not prejudice the attainment of Price Stability over the course of time.

*Option 2Biv
(Turkey)*

Provided that it shall not conflict with the objective of maintaining price stability, support the growth and employment policies of the Government.

Some of these options may require a mechanism to specify government policy.

Assessment: hierarchical specification

Potential advantages:

- Including an output/employment objective as a subordinate objective would be most consistent with the current practice of monetary policy under flexible inflation targeting.
- This approach would emphasise that in weighting the objectives, price stability has primacy over the medium term – and therefore avoid inflation bias and help to maintain anchored inflation expectations, increasing the likelihood of achieving low inflation over the long term.

Potential disadvantages:

- The Act would specify the hierarchy of objectives and would be less flexible over time. There may be events in future that suggest a different hierarchy of weighting is appropriate.

Questions for the Panel

- What are panel members' views on amending section 1A of the Act to more clearly define the Bank's role in terms of supporting employment, output and raising living standards?
- What are panel members' views on the criteria used to assess reform to the monetary policy objective?
- What are panel members' views on the options presented to amend section 8 or 10 of the Act to provide for due consideration of employment in the setting of monetary policy?
- What are panel members view on the different options for the form of words (e.g. maximum employment, full employment, sustainable employment, output and employment)
- What are panel members' views on the mechanism to set the target for monetary policy (i.e. alternatives to the current PTA process)?