

Review of the Reserve Bank Act

Release Document

March 2018

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Treasury Report: Advice on Phase 1 of the Reserve Bank Act Review

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|--------------|------------------|---------------------|-----------|
| Date: | 23 February 2018 | Report No: | T2018/321 |
| | | File Number: | MC-1-7 |

Action Sought

| | Action Sought | Deadline |
|--|---|-----------------------|
| Minister of Finance (Hon Grant Robertson) | Agree the recommendations in this report and indicate any changes to recommendations to be reflected in the Cabinet paper | Tuesday 27 March 2018 |

Contact for Telephone Discussion (if required)

| Name | Position | | Telephone | | 1st Contact |
|----------------|---|--------|------------------|-----------------|--------------------|
| Ben Gaukrodger | Senior Analyst, Macroeconomic and Fiscal Policy | [1][2] | (wk) | N/A (mob) | ✓ |
| Renee Philip | Manager, Reserve Bank Act Review | [1][2] | (wk) | [1][2] (mob) | |

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

Return the signed report to Treasury.

If agreed, **refer** a copy of this report and the attachments to the Associate Ministers of Finance (Hon Parker and Hon Jones).

Note any
feedback on
the quality of
the report

Enclosure: Yes (attached)

Treasury Report: Advice on Phase 1 of the Reserve Bank Act Review

Executive Summary

This report advises you on phase 1 of the Review of the Reserve Bank Act (the Review) and the attached (final draft) report from the Independent Expert Advisory Panel (the Panel) established to advise on the Review. It also sets out the Treasury and the Reserve Bank's views on the Panel's advice, and the next steps for phase 1 of the Review.

Consistent with the terms of reference of the Review, the Panel's report considers updating:

- the objectives of monetary policy, to require monetary policy decision-makers to give due consideration to maximising employment alongside the price stability framework;
- the decision-making model at the Reserve Bank, to require that a committee that includes external experts is responsible for monetary policy decisions and strategy; and,
- the role of the Reserve Bank Board, to ensure it is consistent with the new decision-making model for monetary policy.

The Panel has also recommended a change to how the operational objectives of monetary policy are set. This is to ensure the approach is consistent with the new decision-making model for monetary policy.

The Monetary Policy Objective

The Panel's recommendation for the monetary policy objective is to direct monetary policy towards the economic objectives of:

“achieving and maintaining stability in the general level of prices in the medium term, while supporting maximum sustainable employment.”

The Panel has also recommended that the Act be amended such that the preamble of section 1A recognise the role of monetary policy in promoting the prosperity and welfare of the people of New Zealand.

Both the Treasury and the Reserve Bank support these recommendations. The formulation of the objective implies a medium-term priority for price stability, while giving the objectives an equal weighting in the shorter-term. This approach recognises monetary policy's limited impact on inflation in the short term, given lags, and on employment and the real economy over the medium and long term, and the benefits of low average inflation over the long term.

The Monetary Policy Committee and the Role of the Board

The Panel has recommended that a Monetary Policy Committee (MPC) with external members become responsible for taking monetary policy decisions. This change is expected to enhance decision-making by ensuring that a diversity of perspectives are included in the decision-making process. It also recognises that the Reserve Bank has moved to a committee decision-making model informally already.

The Panel's recommendation is for an MPC that:

- is responsible for monetary policy strategy (that is, the choice of instrument, e.g. the interest rate) and decisions (that is, the calibration of the instrument, e.g. setting the

interest rate), with the Governor remaining responsible for operations and implementing the MPC's decisions;

- includes seven members, four being internal Reserve Bank staff and three external appointees, with the Governor as Chair;
- has all members appointed by the Minister of Finance on the recommendation of the Reserve Bank's Board; and,
- takes decisions by consensus where possible, but publishes a record of meetings that records divergent views where they exist without individual attribution. Further detail about the approach to communications would be set out in a Committee Charter agreed between the Minister and the MPC.

In addition, the Board's monitoring role would be amended to recognise the introduction of the MPC, and consideration would be given to strengthening the Board's monitoring powers.

Officials support having an MPC with external members, all of the Panel's recommendations for the consequential changes to the Board, and most of the Panel's recommendations for how the MPC should be formulated. However, both the Treasury and the Reserve Bank recommend some changes to the MPC relative to the model recommended by the Panel.

The Treasury recommends:

- making the decision-making process more transparent, by publishing the balance of MPC members' votes where a vote was required, to strengthen the accountability of the overall model; and,
- having the Treasury represented on the MPC as a non-voting member, to enhance understanding and coordination between the Treasury and the Reserve Bank.

The Reserve Bank recommends:

- initially having five members on the MPC rather than seven, to make implementation easier;
- having internal MPC members, other than the Governor, nominated by the Governor and appointed by the Board, to retain the Governor's normal employment powers over staff; and,
- having the Committee Charter set by the MPC without the agreement of the Minister, to help ensure the Bank retains operational independence.

Setting the Operational Objectives of Monetary Policy

Rather than having policy targets agreed between the Minister and the Governor, the Panel recommends that the Minister be responsible for setting the monetary policy operational objectives after receiving advice. Officials support this recommendation, on the basis that it is necessary to recognise the shift in responsibility for monetary policy from the Governor to the MPC, and also because it will allow the process for setting the operational objectives to be improved.

Next Steps

We recommend that you take a paper to the Cabinet Business Committee on 14 March, and Cabinet on 19 March, seeking high-level decisions on phase 1 of the Review. Further detailed decisions, some of which are substantive policy decisions in their own right, will be required before phase 1 changes can be implemented. Officials will report back to you on these detailed issues in April.

Recommended Action

We recommend that you:

- a **note** the contents of this report and the final draft report of the Independent Expert Advisory Panel (the Panel) on phase 1 of the Review of the Reserve Bank Act (the Review)
- b **note** that a separate Treasury Report (T2018/291) summarises feedback received from external stakeholders during phase 1 of the Review
- c **note** that the Treasury and Reserve Bank agree with the Panel on all of their recommendations except where indicated in recommendations e to i below
- d **agree** to the Panel's recommendations for phase 1 of the Review as set out in their report, subject to any specific changes to the formulation of the Monetary Policy Committee (MPC) following from recommendations e to i below, and any further changes you wish to make as per recommendation j

Agree/disagree.

- e **agree** that the number of MPC members should be set in legislation as a range between 5-7 and that there should be, either:

- i. **Option 1 (the Panel's preferred option)***
7 members initially appointed to the MPC

Agree/disagree.

OR

- ii. **Option 2 (the Reserve Bank's preferred option):***
5 members initially appointed to the MPC

Agree/disagree.

- f **agree**, for the appointment of internal MPC members other than the Governor, either:

- i. **Option 1 (the Panel and the Treasury's preferred option):***
that they are appointed by the Minister of Finance on the recommendation of the Board, after consultation with the Governor, with the Deputy Chief Executive included on the MPC as an *ex-officio* member

Agree/disagree.

OR

- ii. **Option 2 (the Reserve Bank's preferred option):***
that they are appointed by the Board on the recommendation of the Governor, with the Deputy Chief Executive and Chief Economist included on the MPC as *ex-officio* members

Agree/disagree.

- g **agree** that the MPC should be required by legislation to publish a record of its meetings and decisions, and beyond that the detailed communications approach be set in a Committee Charter (or similar mechanism) that either:

- n **agree**, for the detailed policy changes necessary to implement phase 1 recommendations, to either:
- i. return to Cabinet for detailed decisions on substantive policy issues after Officials have advised you in April (Officials' recommended approach)
Agree/disagree.

OR
 - ii. seek delegated authority from Cabinet for you and your Associate Ministers of Finance (Hon Parker and Hon Jones) to take detailed decisions without further Cabinet approval
Agree/disagree.
- o **agree** to the proactive release of the following documents after the announcement of phase 1 decisions:
- i. the Panel's final report on phase 1 of the Review
Agree/disagree.
 - ii. this Treasury Report
Agree/disagree.
 - iii. the papers provided to the Panel on phase 1 of the Review for their second meeting
Agree/disagree.
 - iv. the minutes of the first two meetings of the Panel
Agree/disagree.
 - v. the Treasury Report (T2018/291) recording the summary of stakeholder views on phase 1 of the Review
Agree/disagree.
- p **note** that public announcements of phase 1 following Cabinet decisions should be coordinated with the signing and announcement of the new PTA, and that the Treasury recommends announcing the outcome of phase 1 before the new PTA

q **refer** to the Associate Ministers of Finance (Hon Parker and Hon Jones)

Refer/not referred.

Renee Philip
Manager, Reserve Bank Act Review

Hon Grant Robertson
Minister of Finance

Treasury Report: Advice on Phase 1 of the Reserve Bank Act Review

Purpose of Report

1. This report advises you on phase 1 of the Review of the Reserve Bank Act (the Review). It provides context for the report of the Independent Expert Advisory Panel (the Panel) on phase 1 of the Review, which is attached. It also includes advice on the Panel's recommendations from the Treasury and the Reserve Bank.
2. In addition, this report informs you of the next steps for phase 1 of the Review.

Background and Context

3. As per the terms of reference, the goal of the Review is to modernise New Zealand's monetary and financial stability frameworks and the Reserve Bank's governance and accountability settings, while also protecting the Reserve Bank's operational independence, by updating the Reserve Bank of New Zealand Act 1989 (the Act).
4. This will ensure that the Reserve Bank's approach supports good economic management and reflects the changing environment in which New Zealanders live and work, which will support the development of a New Zealand economy that delivers sustainable and shared prosperity.
5. Phase 1 of the Review was established 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;
 - recommend changes to the Act in respect of the decision-making model for monetary policy, in particular the introduction of a committee approach, including the participation of external experts; and,
 - consider whether changes are required to the role of the Reserve Bank Board as a consequence of the changes to the decision-making model.
6. You established the Panel to give their views on the Review. The Panel has met with Officials on several occasions since it was established, and has considered the critical design issues necessary to recommend the phase 1 changes to the Act. The Panel's views and recommendations are set out in the final draft of their report, which is attached along with the draft minutes of the Panel's second meeting from 31 January. The Treasury and the Reserve Bank support the majority of the recommendations in the Panel's report. There are a few areas of difference, and these are set out in the following sections of this report.
7. As part of the Review process, Officials have also sought feedback from a number of stakeholders. A separate Treasury Report (T2018/291) sets out their views. A summary of the key themes from stakeholders was provided to the panel before their recommendations were finalised.
8. While the Panel has focused on the high-level issues, a number of detailed policy decisions will need to be taken before legislation is introduced. Officials recommend you take a paper to Cabinet on 19 March to confirm the high-level policy decisions that have been considered by the Panel. This will allow a public announcement to be made before the new Governor's term commences. Once these high-level policy decisions

have been taken, Officials will advise you on the detailed design and implementation issues.

The Objectives of Monetary Policy

9. Phase 1 of the Review requires that consideration of maximising employment be included in the Reserve Bank's monetary policy objective alongside the price stability framework. While consideration of employment (or labour market conditions) is consistent with the Bank's current flexible inflation targeting framework, adding this consideration to the Act does have some benefits.
10. In particular, the inclusion of employment recognises that monetary policy plays a role in stabilising the economy in periods of economic decline or upswings. The inclusion of employment also recognises that monetary policy impacts on the real economy, requiring monetary policy decision-makers to make important trade-offs between inflation control and other impacts on the economy. Conversely, the risk of adding an employment objective is that it may weaken the perceived focus of the Bank on inflation control, resulting in higher inflation expectations in the long term. These higher inflation expectations could either lead to higher inflation in the long run, or require a greater monetary policy response. The Treasury therefore considers that it is important that the legislative wording seek to minimise this risk of increased inflation expectations.
11. In conducting the Review, Officials and the Panel considered a number of other countries' approaches to specifying their monetary policy objectives (see Annex 1 in the Panel's report). While there is no standard approach, it is common practice that the monetary policy framework requires the central bank to take account of the real economy in monetary policy decision making. There are a number of ways that the objective can be specified. However, the more common practice is to give price stability priority in the medium term. This prioritisation recognises that monetary policy cannot achieve a permanently higher rate of employment above the sustainable rate in the medium term.
12. Having considered a number of specifications, the Panel has recommended the following form of wording for the specification of the economic objectives of monetary policy:

“achieving and maintaining stability in the general level of prices in the medium term, while supporting maximum sustainable employment.”
13. Officials agree that there are a number of benefits to this specification and support this proposal, subject to Parliamentary Counsel Office (PCO) drafting requirements.¹
14. The specification implies a medium-term priority for price stability, while in the short term the weighting of the objectives is non-hierarchical. This recognises that monetary policy has limited impact over inflation in the very short term due to lags, but there is significant benefit to the economy from maintaining low average inflation over longer time periods. At shorter time horizons, however, monetary policy can face trade-offs between maintaining inflation at target and its impacts on the real economy and employment. The proposed specification of the objectives requires the Bank to take account of how monetary policy impacts on the level of employment, subject to the constraint that medium term price stability should be maintained. The Panel considered

¹ Under the Legislation Act the PCO is responsible for preparing government legislation in their capacity as legal counsel to government and to Parliament. In practical terms, responsibility for policy lies with Ministers and the relevant department, while the PCO is responsible for the way that legislation is expressed and presented. The PCO works to ensure that new legislation is consistent with other statutes and legislative drafting principles.

that the word “while” best conveys this idea. This approach is consistent with a flexible inflation targeting approach, which is how monetary policy is practiced globally today.

15. Some other notable features of this specification are:
 - The use of the word sustainable: this is included to indicate that while monetary policy can assist in adjusting the employment level to the level of full employment (or capacity), it is not the primary determinant of employment outcomes. Full employment does not refer to a state of no unemployment, as some unemployment will always exist due to people moving jobs and the time it takes to match skills and demand. It can be thought of as the level of employment that would prevail if the economy is not in a cyclical decline or upswing. History has shown that monetary policy aimed at holding unemployment below this level will result in inflation and not improve long term employment outcomes. The Panel considers that the word “sustainable” appropriately recognises the stabilisation role of monetary policy in adjusting resource use to capacity.
 - The use of the word maximum: 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. For example, the Reserve Bank should not focus on short term inflation control at the expense of excessive volatility in the real economy or the exchange rate. Such an approach could increase the risk of entrenched weakness in investment and employment after a sharp downturn (“hysteresis”). If realised, these impacts may reduce the level of “full employment” in the long term.
 - The use of the word supporting: monetary policy is only one influence on the actual level of employment at any one time. The objective should not therefore require the Reserve Bank to achieve maximum sustainable employment, but require monetary policy only to contribute towards this goal. The Panel considered that the word “supporting” best achieved this outcome.
16. The Panel also recommend that the Act recognise that low and stable inflation in the medium term (and reduced volatility in the real economy and employment in the short run) is not an end in itself. Instead, these outcomes are a means by which monetary policy contributes to the welfare and prosperity of all New Zealanders. The Panel recommend that this recognition be achieved by updating the preamble of section 1A. Officials support this change, subject to Parliamentary Counsel Office drafting requirements.

The Monetary Policy Committee and the Role of the Board

17. The introduction of a formal Monetary Policy Committee (MPC) including external experts, as required in phase 1 of the Review, should strengthen the Reserve Bank’s decision-making framework. Committees tend to make better decisions than individuals over time, and limit the risk of a single decision-maker taking extreme positions. External experts will also support the inclusion of different perspectives in the decision-making process. While the Reserve Bank has already adopted a committee informally and external members advise the decision-makers on that committee, formally legislating for an MPC is a significant step that should strengthen the committee’s mandate, and consequently, the Reserve Bank.
18. While beneficial, committee decision-making has significant implications for the monetary policy accountability model. At present, the Act is based on a model of strong individual accountability, with the Governor held solely responsible for achieving the price stability objective. However, with the MPC assuming collective responsibility for monetary policy and the inclusion of employment in the Bank’s monetary policy

objectives, it is necessary to adjust the accountability model to recognise the shift in statutory responsibility.

19. The Panel has recommended that the MPC be responsible for monetary policy strategy (e.g. the choice of instrument) and all monetary policy decisions (e.g. the calibration of the instrument) at the Reserve Bank. This would mean the MPC has collective responsibility for the outcomes of its strategy and decisions, while the Governor would remain responsible for operations and implementing the MPC's decisions. The Panel has also made recommendations for the MPC's configuration (summarised in Annex One of this report). The key features are:
- Seven members of the MPC, four of whom are Reserve Bank staff and three of whom are external appointments from outside the Reserve Bank. However, the legislation should specify a range of 5-7 members to give flexibility for the MPC to evolve over time. The legislation would also set out details of how the Committee would operate in the event of vacancies and other contingencies, and the details of transitional arrangements to ensure staggered appointments.
 - All members of the MPC would be nominated by the Board and appointed by the Minister. The Governor would be consulted on internal appointments.
 - The MPC would aim to take decisions by consensus. A majority vote may be used where consensus cannot be reached, with the Governor having the casting vote. In the event of a vote, neither the individual votes nor the balance of votes would be required to be made public.
 - The MPC would publish a record of its meetings and decisions that set out divergent views amongst MPC members without attributing views to any individual.
 - A Committee Charter, agreed periodically between the Minister of Finance and the MPC, would be used to determine the MPC's detailed approach to communications, with the Act defining any matters that must be included in the Charter.
20. The Panel has also considered the implications for the Reserve Bank's governance, the accountability model and the role of the Board. The Panel's key recommendations are:
- The Board would keep under constant review the performance of the MPC, including whether the MPC is making decisions that are consistent with the MPC's statutory duty to achieve the monetary policy objective.
 - The Board would keep under constant review the performance of individual MPC members in meeting their statutory duties.
 - The Governor and the MPC members would be subject to dismissal if they did not carry out, or are not capable of adequately carrying out, their statutory functions. These statutory functions will include acting in accordance with the operational objectives for monetary policy (paragraphs 27-28 of this report elaborate). However, individual members would not be at risk of dismissal if they make a decision that they considered was consistent with achieving the monetary policy objectives, but in hindsight the objectives were not achieved, where they can adequately explain deviations from the objectives.
 - The Governor would also have statutory responsibility for implementation of the MPC's decisions and strategies, and would have specific statutory duties as Chair of the MPC.
 - The Minister of Finance would become responsible for appointing the Board Chair and Deputy Chair.

- Officials should consider adapting the Board’s monitoring powers to strengthen the accountability of the MPC.
 - No significant changes to the governance structure should be made in phase 1, but the Reserve Bank’s governance should be reviewed in detail as part of phase 2 of the Review with a view to shifting governance responsibilities from the Governor to the Board.
21. In coming to its recommendations, the panel has prioritised a model that supports high-quality decision-making; the accountability of decision-makers; and the institutional legitimacy of the Reserve Bank as a whole. In addition, the Panel has sought to recommend a model that is functional, and that limits the risks of transition from the status quo. Officials agree with these objectives.
22. Officials also support legislating for an MPC with external members and the recommendations for the role of the Board. Officials support most of the Panel’s recommendations about the MPC’s configuration. However, both the Treasury and the Reserve Bank recommend some changes to the MPC as recommended by the Panel.

The Treasury’s View on the Panel’s Recommendations

23. The Treasury is broadly supportive of the Panel’s recommendations for the MPC. However, we stress the importance of the model giving sufficient priority to a practical accountability regime, given the MPC will now be collectively responsible for monetary policy decisions. We therefore recommend publishing the balance of any vote to increase transparency about how decisions are taken. The Treasury also recommends a non-voting representative from the Treasury be included on the MPC.

Accountability and Transparency

24. The Treasury highlights the importance of accountability, because a committee model makes it more difficult to hold individuals to account for failure to meet the monetary policy objectives. This is because no individual will have full control over decisions or outcomes. As such, it may be more difficult to justify dismissal in such instances as compared to the present situation, where the Governor can be dismissed for inadequate performance in meeting targets. Further, it is not desirable to evaluate monetary policy purely on the basis of outcomes, as outcomes are affected by economic shocks and other unexpected factors.
25. For these reasons, the Treasury supports an accountability model where dismissal provisions are focussed on cases where individuals have not acted in accordance with the operational objectives for monetary policy, rather than on outcomes *per se*. However, in the Treasury’s view, this shift makes alternative accountability mechanisms much more important. Beyond dismissal, the Panel’s recommendations prioritise accountability in three key ways: by having the Minister of Finance appoint committee members; by introducing external challenge during the decision-making process; and through transparency about decisions once they are made. Moreover, the Panel’s model relies on the Reserve Bank Board retaining a role as monitoring agent.
26. It is the importance of transparency as part of this accountability model that motivates our first recommended deviation from the Panel’s model. That is, where decisions are not unanimous, the Treasury recommends making public the balance of votes of the MPC (for example, in the event that one member dissented, it would be noted that the MPC voted 6-1 in favour of the decision). At least initially, these votes would not be attributed to individuals. We consider this recommendation is consistent with the overall accountability model as discussed above, and will also make the balance of views on the MPC clearer for market participants. Moreover, given the high degree of judgement involved in monetary policy decisions, we do not consider it credible for the MPC to claim that all of its decisions are unanimous. Accordingly, the apparent benefit of such an approach (which is increased control over market expectations of the interest rate)

would be offset by the market having less trust in the MPC's statements about future decisions. If the balance of votes is not made public, the Treasury's view is that the record of the meeting should at a minimum record where a decision was not unanimous

27. Consistent with this recommendation, the Treasury would not support any changes that reduce accountability relative to what the Panel has recommended. For example, the Treasury does not support the Reserve Bank's recommendation to have internal MPC members appointed by the Reserve Bank Board on the recommendation of the Governor. This is because it would mean decision-makers are not directly appointed by a democratically elected Minister, as is the typical practice internationally, and also because it would introduce a hierarchy into the committee, with the Governor having an explicit power over other committee members. This risk would be amplified if the balance of votes is not public. Similarly, the Treasury does not support having the Committee Charter (which sets the communications approach and is more flexible than being prescriptive in the Act) set by the Reserve Bank without Ministerial involvement. This too would have the potential to significantly undermine the accountability of the MPC, as there would be insufficient means to ensure decisions are sufficiently transparent.
28. The Treasury also notes that detailed policy decisions that are beyond the scope of the Panel's report will have an impact on accountability. In particular, the Panel has recommended Officials consider enhancing the Board's monitoring powers during the detailed design of phase 1 recommendations. While specific options to enhance the Board's monitoring powers need to be considered in detail, the Treasury supports the principle of strengthening the Board's powers to strengthen accountability.

Non-voting Treasury Representative on the MPC

29. Our second alternative recommendation is that a non-voting representative from the Treasury be included on the MPC. This would give the Treasury a richer understanding of the debate and issues behind the Reserve Bank's decisions, which in turn will help to ensure that the Treasury's advice is fully informed. This benefit extends beyond the Treasury's advice on macroeconomic and fiscal policy. The Treasury's advice on other parts of the economy that will be discussed by the MPC, such as the labour and housing markets, should also be strengthened.
30. The inclusion of a Treasury representative on the MPC should also enhance decision-making by the MPC by ensuring it is fully informed about government economic and fiscal policy decisions. Moreover, if conventional monetary policy is constrained (for example if the Official Cash Rate were to approach the effective lower bound), representation from the Treasury is likely to support macroeconomic stabilisation given the possible need for more active fiscal policy.
31. The Treasury recognises that there are risks associated with the inclusion of a Treasury representative on the MPC. The Reserve Bank's operational independence could be perceived to be weakened, and the Treasury representative will be privy to market sensitive information. However, the Treasury does not consider that these risks warrant the exclusion of a Treasury representative. Clearly defining the role of the Treasury representative can alleviate the risk that the Reserve Bank's operational independence is perceived as compromised. This has been the case at the Bank of England, where the Treasury attends as an observer with no vote. Furthermore, procedural arrangements, which will be necessary for external members anyway, can manage the risks of sharing market sensitive information.

The Reserve Bank's View on the Panel's Recommendations

32. The Reserve Bank agrees with the majority of the views expressed in the Panel's report, but recommends a different course of action in three specific areas: the initial

number of MPC members; the process for appointing internal MPC members (other than the Governor); and the process for agreeing the Committee Charter.

33. With regard to the initial number of MPC members, the Reserve Bank agrees that a range of 5-7 members should be specified in the Act to allow flexibility for the future, but recommends starting with 5 members (with 3 internals and 2 externals) rather than 7 (with 4 internals and 3 externals). This model will be more cost efficient to implement and faces fewer practical constraints. The Reserve Bank notes that New Zealand's small labour market may create difficulties in recruiting external MPC members that are sufficiently qualified and free from conflict of interest. Given the potentially limited pool of candidates, having two external members rather than three should be easier to fill initially, and would also be easier to sustain on an ongoing basis.
34. With regard to the appointment processes, the Reserve Bank recommends using the current appointment process for Deputy Governors (whereby they are nominated by the Governor and appointed by the Board), to apply to internal MPC members other than the Governor. The Bank also recommends having the Deputy Chief Executive and Chief Economist as *ex-officio* members of the MPC.²
35. The Reserve Bank believes that its recommendation for internal appointments would best retain the Governor's normal employment powers over staff, where senior staff also have operational responsibilities as determined by the Governor. The proposed model creates a barrier to reorganising internal structures, as any internal changes to senior management that result in consequential changes to the MPC would effectively need to be endorsed by the Board and Minister. The Reserve Bank notes that the Board as the Minister's agent would be making the MPC appointments, supporting its effective operation, and providing a veto on the Governor's recommendation. The monitoring and communication recommendations will protect against internal members being unduly influenced by the Governor. It will also support the Bank's operational independence by precluding Ministerial involvement in staff appointments.
36. With regard to the Committee Charter, the Reserve Bank recommends that the Committee Charter should be agreed by the MPC itself, and that the MPC's Code of Conduct would form part of that document. 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.
37. The Reserve Bank believes that this arrangement would help ensure the Bank retains operational independence, insofar as the Act defines the powers of the MPC, the Policy Targets Agreement (or its equivalent) specifies the MPC's objectives, and the Minister of Finance has a role in appointments to the MPC. It would be extraordinary internationally for the Minister to reach into the communication mechanisms of the central bank, placing the Bank's operational independence at odds with best practice. The further this reach extends, the higher the risk of market volatility around Ministerial public statements related to monetary policy.

Setting the Operational Objectives of Monetary Policy

38. The Act currently requires that the Minister of Finance agree policy targets with the Governor of the Reserve Bank, prior to his or her appointment. This agreement is known as the Policy Targets Agreement (PTA) and sets the specific operational objective for monetary policy.

² Note that the Act currently requires that where there are two Deputy Governors, one shall be the Deputy Chief Executive of the Bank.

39. The mechanism through which the PTA is currently set is consistent with the single decision-maker model that underpins the Act's current design. The Governor *agrees* the PTA, and can be dismissed for inadequate performance in ensuring that the Bank meets the PTA. Amending the Act to provide for a committee decision-making model requires reconsideration of the mechanism to set the operational objectives, as the MPC, rather than the Governor, will be collectively responsible for formulating monetary policy consistent with the objectives.
40. Aside from the necessity of change due to the creation of the MPC, Officials consider that there is an opportunity to improve the process for setting the operational objectives for monetary policy by: providing a clear allocation of responsibility for undertaking a review of the monetary policy objectives; providing opportunities for public input into the review; and decoupling the setting of operational objectives from an appointment cycle to a regular review cycle (e.g. every 5 years). The current legislation can also give rise to some procedural issues when setting the PTA, particularly as there is no ability to delay the setting of the PTA if this was desirable due to certain events (e.g. if Governor's appointment, and therefore the setting of the PTA, falls just prior to an election).
41. Given these issues, the Panel report considers the issue of how to set the PTA from first principles. The Panel recommends a model for the setting of the PTA under which the Minister of Finance is responsible for the setting of the objectives of monetary policy following receipt of non-binding public advice from the Reserve Bank. The Treasury would also provide advice to the Minister of Finance on the setting of the objectives. MPC members would be required to sign up to these objectives. The Minister having a primary role in the setting of objectives is consistent with the Reserve Bank retaining operational independence for monetary policy.
42. Both the Treasury and the Reserve Bank support this model.
43. Allocating the responsibility for setting the objective to the Minister recognises the significance of this decision. However, requiring that the Bank provide formal advice captures the Reserve Bank's technical expertise and provides for a robust review process. It would be expected that the Bank would direct a research programme at providing advice on setting the objective. By moving away from an agreement model, this approach would also be able to include a public consultation element, ensuring greater public engagement in the setting of the objective. As the Reserve Bank's advice would be public it would be transparent if the Minister chooses not to follow the advice, and the Minister would thereby be held to account for his or her decisions.
44. While it would be possible to develop a model in which the MPC agreed the objectives with the Minister, there are some downsides to this model. First, a model based on agreement is less conducive to including public input than alternative models. Second, there are some practical issues with the MPC agreeing the objectives, for example with rotating committee membership not all members would have been party to the agreement.
45. Officials will report back to you with detailed recommendations in respect of the new model for setting the PTA in April.

Next Steps

Cabinet Processes for High-level Phase 1 Policy Decisions

46. We recommend that you take a paper seeking high-level decisions on phase 1 of the Review, and approval for the Treasury to issue drafting instructions, to the Cabinet Business Committee on 12 March and then Cabinet on 19 March. We request you

provide feedback on the recommendations in this paper by 27 February to enable us to reflect that feedback in the draft Cabinet paper we will provide you by 2 March. We will reflect any later feedback in subsequent iterations of the Cabinet paper ahead of the 8 March deadline for lodging the Cabinet paper.

47. We also recommend taking the PTA agreed in principal with Adrian Orr, if this differs from the one already considered, straight to Cabinet on 19 March. This will allow you to announce decisions on phase 1 of the Review and the PTA prior to Adrian Orr commencing his position as Governor of the Reserve Bank on 27 March.

Process for Detailed Phase 1 Policy Decisions

48. As noted above, Officials will advise you on detailed implementation issues once high-level policy decisions have been taken. We are aiming to provide you with that advice in early April, which would complete the model for the new committee structure and the duties of the Board, and also identify the consequential changes needed to the legislation.
49. While detailed, some of these decisions are substantive. For example, they will include the statutory responsibilities of the MPC members and the Governor, and any changes to the powers of the Board. Accordingly, we recommend that Cabinet consider the detailed issues in April. This approach would also allow Cabinet to take decisions about the scope of phase 2 of the Review at the same time (T2018/406 refers).
50. There are alternative options. One is to seek delegated authority for you and other relevant Ministers to take these detailed decisions instead of returning to Cabinet. This may be preferable if you only want to seek Cabinet decisions on phase 1 once. The Cabinet Legislation Committee would still review the draft bill, and therefore the full details of the policy. Given that some of the outstanding decisions are significant policy choices, and because you will need to return to Cabinet for decisions on the scope of phase 2, Officials do not recommend seeking delegated authority at this stage. We do, however, expect further detailed policy issues to emerge as we progress, so would recommend that you do seek delegated authority from Cabinet in April.
51. Another option is for you to delay Cabinet decisions on the MPC and the Board until advice on the detailed policy issues is ready. We do not recommend this option for two reasons. First, the interconnected nature of the MPC design means that if Cabinet were to amend any individual policy choice, changes to the underlying detail would likely be required, which would necessitate a second Cabinet paper. Second, it would delay the announcement of decisions on the MPC and the Board, making it impractical to announce them before announcing the new PTA with Adrian Orr.

Consequential Phase 1 Policy Decisions

52. In addition to the matters discussed in this paper and the detailed policy issues that will follow on the MPC and the Board, there are a number of redundant or outdated provisions in the Act that we recommend be amended. For example, the Act still contains transitional provisions from 1989 and limits the age of the Governor to 69. There are also some anomalies, such as the requirement to agree an incoming Governor's conditions of employment after they have taken office. While not all of these changes are required to implement phase 1 policy changes, amending these provisions is important to modernise the Act. Further detail on these issues will be provided in the advice on the detailed design of phase 1 in April.

Announcement and Information Release

53. The announcement of the high-level decisions on phase 1 of the Review and the new PTA with Adrian Orr will need to be coordinated. Given that the new PTA has been drafted with changes from phase 1 of the Review in mind, the Treasury recommends

announcing the high-level phase 1 decisions before announcing the new PTA, even if only immediately before.

54. Following the announcement of high-level phase 1 decisions in March, we recommend that you release the following materials on the Treasury website, subject to redactions relating to issues that are still under consideration as part of the detailed design process:
- the Panel's final report on phase 1 of the Review;
 - this Treasury Report;
 - the papers provided to the Panel for their second meeting that relate to phase 1 of the Review (T2018/15 refers);
 - the minutes of the first two meetings of the Panel (the draft minutes of the second meeting are attached to this report, the minutes of the first meeting were enclosed with Treasury Report T2018/15); and,
 - the Treasury Report (T2018/291) recording the summary of stakeholder views on phase 1 of the Review.
55. Note that the attached version of the Panel's report is a final draft, and the Panel may request minor editing changes be made to it to prepare it for publication.

Phase 2 of the Review

56. Work is continuing on phase 2 of the Review, and the Panel will meet to discuss the list of issues for inclusion in phase 2 of the Review on 2 March. A separate report (T2018/406) briefs you on that meeting and the timing for phase 2 more generally.

Consultation

57. The Treasury has developed this report with the Reserve Bank, and the Reserve Bank's view on the Panel's recommendation has been provided directly by the Reserve Bank. Except where explicitly noted, the Reserve Bank agrees with the recommendations in this report.
58. The Treasury has also had discussions with the Chair of the Reserve Bank Board during phase 1 of the Review. We will share this advice and the Panel's report with the Chair.

Annex One: Summary of the Panel's Recommendations for an MPC

| Issue | Panel Recommendation | Officials' Views |
|----------------------------------|--|---|
| Scope of Remit | MPC has responsibility for all monetary policy decisions and strategy. | Officials support |
| Size of MPC | 7 members, with flexibility to have between 5 and 7. | Officials support having 5 - 7 members, RBNZ recommends beginning with 5 |
| External/Internal Balance | Internal majority, with 4 internal members and 3 external. Governor as Chair. | Officials support |
| Type of Externals | Externals require knowledge and experience in relevant policy areas; engaged on a part-time basis. | Officials support |
| Appointment Processes | All members nominated by Board, appointed by Minister. Governor consulted on internal appointments. | The Treasury supports; RBNZ recommends Board appointments for internals on the recommendation of the Governor |
| Dismissal Processes | Governor-General removes members by Order in Council, on advice of the Minister. Board can remove external members in consultation with the Minister in limited circumstances. The Governor may appoint internal members to new roles within the Bank, which may trigger their removal from the MPC. | Officials support |
| Length and Timing of Term | 5 year terms for internals; 4 year terms for externals; all members limited to two terms in any role; staggered appointments. | Officials support |
| Decision-making Process | Decisions by consensus. Majority vote where consensus cannot be reached, with the Governor having the casting vote. In the event of a vote, neither the individual votes nor the balance of votes would be made public . | RBNZ supports; The Treasury recommends that where decisions are not unanimous, the balance of votes should be made public |
| Communications Model | Records of the MPC's meetings to be published. Divergent views to be made public but not attributed. Committee Charter agreed between the MPC and the Minister to set detail. | The Treasury supports; RBNZ recommends the Committee Charter be set without Ministerial input |
| Role of the Treasury | No role for the Treasury on the MPC. Other measures to support inter-agency coordination should be considered. | RBNZ supports; The Treasury recommends having a non-voting Treasury representative on the MPC |

Annex Two: Summary of International Monetary Policy Committee Models

| Country | Committee Size | Number of Externals | Proportion of Externals | Treasury Representative | Decision-making process |
|----------------|----------------|---------------------|-------------------------|-------------------------|-------------------------|
| Australia | 9 | 6 | Majority | 1 Voting Member | Vote |
| Canada | 6 | 0 | None | None | Consensus |
| Chile | 5 | 3 | Majority | None | Vote |
| Czech Republic | 7 | 0 | None | None | Vote |
| Euro Area | 25 | 0 | None | None | Vote |
| Iceland | 5 | 2 | Minority | None | Vote |
| Israel | 6 | 3 | Balance | None | Vote |
| Japan | 9 | 0 | None | 1 Observer | Vote |
| Norway | 8 | 5 | Majority | None | Consensus |
| South Korea | 7 | 5 | Majority | None | Vote |
| Sweden | 6 | 0 | None | None | Vote |
| UK | 9 | 4 | Minority | 1 Observer | Vote |
| United States | 12 | 0 | None | None | Vote |

| | | | | | |
|-------------------|--------------|------------|---------------------|----------------|-----------------|
| Colour thresholds | 0 to 4 (0%) | None (46%) | None (46%) | None (77%) | Vote (85%) |
| | 5 to 9 (85%) | Some (54%) | Minority (15%) | Observer (15%) | Consensus (15%) |
| | 10+ (15%) | | At least half (38%) | Voter (8%) | |

Source: Reserve Bank of New Zealand

Annex Three: International Comparison of Monetary Policy Communications Models

| | Statement | Press conferences | Interest rate forecast | Publication of input material for MPC meetings | Minutes published after | Vote count published | Individual votes published | Meeting transcripts | Regular hearings in Parliament |
|-----------------------|-----------|-------------------|------------------------|--|-------------------------|----------------------|----------------------------|---------------------|--------------------------------|
| Australia | Yes | No | No | No | 2 weeks | No | - | No | Yes |
| Canada | Yes | Yes | No | No | Never | N/A | - | No | Yes |
| Chile | Yes | Yes | No | No | 11 working days | Yes | Yes | After 10 years | Yes |
| Czech Republic | Yes | Yes | Yes | Yes, with statement | 8 days | Yes | Yes | After 6 years | Yes |
| Iceland | Yes | No | No | No | 2 weeks | Yes | Yes ¹ | No | Yes |
| Israel | Yes | Yes | No | No | 2 weeks | Yes | No | No | Yes |
| Korea | Yes | Yes | No | No | 2 weeks | Yes | Yes | No ² | Yes |
| Norway | Yes | Yes | Yes | Yes, with statement | Same day | Yes | Yes | After 12 years | Yes |
| Sweden | Yes | Yes | Yes | No | 2 weeks | Yes | Yes | No | Yes |
| Euro Area | Yes | Yes | No | No | 4 weeks | No | - | After 30 years | Yes |
| Japan | Yes | Yes | No | No | 6-10 weeks ³ | Yes | Yes | After 10 years | Yes |
| U.K. | Yes | Yes | No | Yes, 8 years later | Same day | Yes | Yes | After 8 years | Yes |
| U.S. | Yes | Yes | Yes | Yes, 5 years later | 3 weeks | Yes | Yes | After 5 years | Yes |

Sources: Banco Central de Chile and central bank websites.

1) The Central Bank of Iceland publishes the votes of individual members in the Annual Report.

2) The Bank of Korea may publish a transcript after four years with a formal request from the National Assembly.

3) The Bank of Japan publishes minutes a few days after the following MPC meeting. Between meetings, a “summary of opinions” is published that summarises the MPM discussion from the Governor’s perspective, without attributing individual opinions.