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Economic Note

RBNZ Policy Targets Agreement signing and Reserve Bank Act Review

26 March 2018

Laying the platform but more work to be done

- The new Policy Targets Agreement retained price stability objective as the sole mandate. The Bank's annual consumer price inflation target was retained at 1% to 3%, with the ongoing focus on the 2% midpoint. An employment focus was added alongside price stability.
- Changes to the Act are pending, with legislation in the coming months set to formalise the adoption of a dual monetary policy mandate and monetary policy committee structure. Other changes are likely.
- For monetary policy, the announced changes are unlikely to significantly impact on the level of the OCR or its movements over the cycle. Price stability objectives remains in pole position, with, but with the review of the Reserve Bank Act underway substantive changes could emerge that will need to be closely watched.

The new RBNZ Policy Targets Agreement for monetary policy was released on Monday, 26th March. Importantly, the PTA retained the 1-3% CPI inflation target as the sole mandate, but added the requirement of the RBNZ to aim towards "supporting maximum sustainable employment within the economy". A dual mandate looks to be coming, but this will require legislative changes to the Reserve Bank Act, which looks a number of months away. The announcement also signalled the shift to a monetary policy committee with external advisors, which is due from 2019. To us, the changes, whilst potentially far-reaching are unlikely to significantly impact the operation of monetary policy, nor the overall interest rate cycle in the current juncture. With phase two of the review of the Reserve Bank Act underway, and changes to the Reserve Bank Act pending, developments will need to be closely monitored.

The new PTA

The Minister of Finance Grant Robertson and new Reserve Bank of New Zealand Governor Adrian Orr signed the new policy targets agreement (PTA) for the Reserve Bank Act (Act). The PTA can be best thought as the rulebook for NZ monetary policy, setting out the agreed objectives and how they should be achieved by the RBNZ.

Given that that a review of the Reserve Bank is underway and the Government had signalled their intent to substantively change monetary policy operation, there was the possibility that the new PTA was a significant rewrite of the previous version.

As our side by side comparison on page 4 shows the structure of the new PTA is slightly different. Most notably was the merging of sections 3) and 4) from previous versions, as well as some wording changes.

Importantly, the sole monetary policy mandate of price stability was retained. Importantly, clause 1a) the new PTA provided continuity, requiring the Reserve Bank to keep future annual CPI inflation between 1 and 3 percent over the medium term, with a focus on keeping future inflation near the 2 percent mid-point. The PTA also enabled the requirement that the RBNZ take into account the wider economy when setting monetary policy, by seeking to avoid

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unnecessary instability in output, employment, interest rates, and the exchange rate.

Employment objectives were added to the new PTA, but this was also conjunction with the price stability objective: "*The conduct of monetary policy will maintain a stable general level of prices, and contribute to supporting maximum sustainable employment within the economy*." This was understandable as the adoption of a dual monetary policy mandate (including both price stability and employment objectives) would require changes to the Reserve Bank Act.

The changes suggest two things. First, the employment objective will be considered insofar as it impacts of the primary price stability objective. Second, the definition of what "*maximum sustainable employment within the economy*" is clearly open to interpretation.

There were a few tweaks. **The requirement to monitor asset prices, as measured by a range of price indices, was dropped from clause 2.** This may be a consequence of the expanded RBNZ policy arsenal, which has provided the OCR with mates and has enabled the RBNZ to more directly target areas of inflation and financial stability risk. Importantly, the requirement to have regard to the efficiency and soundness of the financial system was retained.

The announcement also included a statement on Phase 1 of the Review of the Reserve Bank Act, including an overview of the new decision-making structure at the Bank. **Importantly, the statement signalled that changes are on their way, with the adoption towards a dual monetary policy as soon as a few months away.** The RBNZ press release noted: "*Work on legislation to codify a dual mandate is underway. In the meantime, the new PTA will ensure the conduct of monetary policy in maintaining price stability will also contribute to employment outcomes*."

The Government also flagged that the Reserve Bank Act will be modified to shift from a sole decision maker to a committee. At present the RBNZ has the sole authority for monetary policy decisions under the Act. Times have changed, with Robertson noting the need for "*greater recognition in recent decades of the benefits of committee decision-making structures*." Starting from 2019, and upon the passage of amending legislation, the Monetary Policy Committee (MPC) is expected to begin operation. The Government have signalled that 5-7 members for a MPC will be formalised, consisting of a majority of Reserve Bank internal staff members (the Governor will be chair), external members and a (non-voting) Treasury observer. Finance Minister Roberston signalled that the first MPC would be made up of seven members, consisting of four internal RBNZ staff, and three external members. Treasury would also have a non-voting observer on the MPC to provide information on fiscal policy.

A more widespread review of the RBNZ is also underway, with phase 2 of the Review is being scoped. It will focus on the Reserve Bank's financial stability role and broader governance reform. The final scope on phase 2 is scheduled to be made by mid-2018 and subsequent policy work will commence in the second half of 2018. This area will look into non-monetary policy functions of the RBNZ.

Key takeouts

The changes confirm that price stability objectives will continue to take precedence for monetary policy. Moreover, the 1-3% medium-term CPI inflation target and focus on the 2% midpoint were retained. Employment has been upgraded as a monetary policy consideration but remains below price stability in the pecking order.

Importantly, the PTA wisely chose not to provide a numerical employment target, which provides the RBNZ with more flexibility. The RBNZ are likely to be relieved that they will not be tied down with an explicit employment objective that could sometimes to be in conflict with its monetary policy objective. However, with clause 3 of the new PTA requiring more transparency and accountability from the Bank on monetary policy decision making, the RBNZ will have to be more thorough and explicit on its coverage of the labour market. With low inflation already entrenched both here and abroad, the changes are a recognition that the focus on monetary policy should consider objectives.

Our long-standing view has been that the new monetary rulebook might alter the timing of OCR moves at the margin, but shouldn't materially change the overall interest rate cycle. This appears to be the case. The labour market, however, is likely to come in for increased scrutiny by the market and parliament, and we expect the RBNZ to considerably extend its coverage of the labour market in monetary policy releases.

Changes are on the horizon. Changes to the Reserve Bank Act are coming. Adopting a dual monetary policy mandate would have required a change in the Reserve Bank Act, which was not feasible considering the short timeframe. There is also a considerable body of work underway, with the Reserve Bank Act Review. Changing direction without sound policy foundations and supportive evidence could result in unnecessary volatility that would be detrimental to the New Zealand economy.

The shift to formal committee with external members is not a significant departure from what the RBNZ have been doing in practice. It also brings the RBNZ more in synch with peers overseas. There will be challenges in managing communications and the monetary policy "message".

The current Reserve Bank of New Zealand Act has served NZ well, is now 30 years old, and with the battle to achieve low inflation already won, a "refresh" is needed to make the Act more relevant to address current challenges facing monetary and financial stability. **A dual monetary policy mandate is one change but we can envisage more substantive changes. New Zealand's light touch for macro-prudential policy looks increasingly out of step with what other regulators are doing overseas.**

Experience since the global financial crisis (GFC) has shown that low inflation on its own will not ensure economic and financial stability. Efforts by the RBNZ to expand the policy toolkit and provide monetary policy with more mates have bolstered the effectiveness of monetary policy. Governor Orr is likely to be a strong advocate for the RBNZ to maintain, and likely build upon, its policy arsenal. There is a balance to be struck between ensuring that the RBNZ has the tools to do the job and ceding further control of the running of the economy to unelected technocrats. **The RBNZ's traditionally light touch to financial sector regulation and prudential supervision is likely to be in for a rethink.**

The 27th of March is officially the first day on the job for incoming Governor Adrian Orr. With a new PTA being signed and with the Reserve Bank Review underway, there may be a transition period in which little is done. However, Governor Orr will not go into the meeting cold given his past markets and RBNZ experience and his strong familiarity of the key issues wishing to be addressed by the Review. The transition period is likely to be a relatively short one.

PTA Side by Side Comparison

March 26, 2018	7th November 2017
1) **Price Stability**	***1) Price Stability***
a) Under Section 8 of the Act the Reserve Bank is required to conduct monetary policy with the goal of maintaining a stable general level of prices. b) The conduct of monetary policy will maintain a stable general level of prices, and contribute to supporting maximum sustainable employment within the economy.	a) Under Section 8 of the Act the Reserve Bank is required to conduct monetary policy with the goal of maintaining a stable general level of prices. b) The Government's economic objective is to promote a growing, open and competitive economy as the best means of delivering permanently higher incomes and living standards for New Zealanders. Price stability plays an important part in supporting this objective.
2) **Policy Target**	**2) Policy Target**
a) The price stability target will be defined in terms of the All Groups Consumers Price Index (CPI), as published by Statistics New Zealand. b) For the purpose of this agreement, the policy target shall be to keep future annual CPI inflation between 1 and 3 percent over the medium-term, with a focus on keeping future inflation near the 2 percent mid-point. c) The Bank will implement a flexible inflation targeting regime. In particular the Bank shall, in pursuing the policy target: 1. have regard to the efficiency and soundness of the financial system; 2. seek to avoid unnecessary instability in output, employment, interest rates, and the exchange rate; and 3. respond to events whose impact on inflation is expected to be temporary in a manner consistent with meeting the medium-term target.	a) In pursuing the objective of a stable general level of prices, the Bank shall monitor prices, including asset prices, as measured by a range of price indices. The price stability target will be defined in terms of the All Groups Consumers Price Index (CPI), as published by Statistics New Zealand. b) For the purpose of this agreement, the policy target shall be to keep future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term, with a focus on keeping future average inflation near the 2 per cent target midpoint.
3) **Transparency and accountability**	**3) Inflation variations around target**
a) The Bank shall implement monetary policy in a transparent manner. In addition to the requirements of section 15 of the Act the Bank shall in its Monetary Policy Statement (MPS): 1. explain what measures it has taken into account in respect of meeting the requirements of section 2(c) and explain how these matters have been taken into account in its implementation of monetary policy; and 2. when inflation outcomes, and/or expected inflation outcomes, are outside of the target range explain the reasons for this; and 3. explain how current monetary policy decisions contribute to supporting maximum levels of sustainable employment within the economy. b) The Bank shall be fully accountable for its	a) For a variety of reasons, the actual annual rate of CPI inflation will vary around the medium-term trend of inflation, which is the focus of the policy target. Amongst these reasons, there is a range of events whose impact would normally be temporary. Such events include, for example, shifts in the aggregate price level as a result of exceptional movements in the prices of commodities traded in world markets, changes in indirect taxes, significant government policy changes that directly affect prices, or a natural disaster affecting a major part of the economy. b) When disturbances of the kind described in clause 3(a) arise, the Bank will respond consistent with meeting its medium-term target.

judgements and actions in implementing monetary policy.	**4) Communication, implementation and accountability**
	a) On occasions when the annual rate of inflation is outside the medium-term target range, or when such occasions are projected, the Bank shall explain in Policy Statements made under section 15 of the Act why such outcomes have occurred, or are projected to occur, and what measures it has taken, or proposes to take, to ensure that inflation outcomes remain consistent with the medium-term target. b) In pursuing its price stability objective, the Bank shall implement monetary policy in a sustainable, consistent and transparent manner, have regard to the efficiency and soundness of the financial system, and seek to avoid unnecessary instability in output, interest rates and the exchange rate. c) The Bank shall be fully accountable for its judgements and actions in implementing monetary policy.

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