

# Coversheet: Reserve Bank Act review

Advising agencies	<i>The Treasury</i>
Decision sought	<i>Amending the Reserve Bank Act to include employment in the monetary policy objective, codify a committee for monetary policy decisions and make consequential changes including to the role of the Policy Targets Agreement.</i>
Proposing Ministers	<i>Minister of Finance</i>

## Summary A: Problem and Proposed Approach

<p><b>Problem Definition</b></p> <p><b>What problem or opportunity does this proposal seek to address? Why is Government intervention required?</b></p>
<p>The proposals in this RIS alter current Government interventions but do not put in place new Government interventions.</p> <p>The first proposal relates to the objectives of monetary policy. Under the Reserve Bank of New Zealand Act 1989 (the Act) monetary policy is directed towards the single objective of price stability. Since 1989 the Reserve Bank’s practice in implementing monetary policy has evolved and it is recognised that, while it remains important to maintain price stability in the medium-term, monetary policy is also an important tool in assisting in stabilising the real economy, for example in helping to reduce the depth and length of periods of unemployment. Updating the legislation to include consideration of employment recognises this second objective of monetary policy and ensures that this consideration will be taken into account in the future.</p> <p>The second proposal relates to the mode of decision-making for monetary policy. Under the Act, the Governor has sole responsibility for monetary policy decisions and the implementation of monetary policy, although informally the Reserve Bank makes monetary policy decisions through a Governing Committee. Evidence suggests that committees make better decisions on average than individuals because they include diversity of perspectives and guard against extreme views, but at present there is no requirement for monetary policy decisions to be made by committee. Further, the approach to decision-making is constrained by the Act, which has been designed around a single decision-maker.</p>
<p><b>Proposed Approach</b></p> <p><b>How will Government intervention work to bring about the desired change? How is this the best option?</b></p>
<p>The first proposal is to amend the objectives of monetary policy as set out in the Act to require that the Reserve Bank give consideration to employment outcomes alongside the price stability framework. The recommended option in this RIS is to require that employment be considered in monetary policy decisions, provided that price stability is maintained over the medium-term. This is to ensure that low inflation is maintained over the medium-term.</p>

The second proposal is to amend the legislation to require that monetary policy decisions be made by a monetary policy committee (MPC). This is the best option as committees should make better decisions than individuals on average over time, it would ensure the legislation is updated to match the existing practice of the Reserve Bank in using committee decision-making for monetary policy, and it will ensure that a committee approach continues to be used in future.

## Section B: Summary Impacts: Benefits and costs

### Who are the main expected beneficiaries and what is the nature of the expected benefit?

The main non-monetised benefit is to ensure that monetary policy decision-makers continue to give due regard to the short term impacts of monetary policy on the real economy. This is intended to improve the wellbeing of New Zealanders by ensuring that monetary policy seeks to minimise, or does not exacerbate, periods of economic decline.

The benefits of introducing an MPC in the legislation, with the design features recommended in this RIS, are that it will: (1) allow for the committee to be designed from first principles and ensure that the legislation is consistent with, and appropriate for, the preferred committee decision-making model; (2) ensure that a committee decision-making model continues to be used in the future; (3) better ensure quality decisions over time, as evidence shows committees produce better decisions on average; (4) bring New Zealand in line with international practice.

### Where do the costs fall?

The main monetised cost is the employment and recruitment costs associated with external monetary policy committee members. Future dividends from the Reserve Bank to the Government may be reduced to meet this cost.

### What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?

There is a risk that market participants may interpret the Reserve Bank's new employment objective as weakening its focus on inflation. This could result in people expecting higher inflation in the future, meaning that the Reserve Bank would need to hold interest rates higher in order to maintain inflation at target. This risk is mitigated under the options for changing the objective which retain a commitment to price stability in the medium-term. The Reserve Bank can also mitigate this risk by publicly communicating its commitment to a numerical inflation target. Further risks and mitigation are discussed in section 5.3 and implementation risks are discussed in section 6.2.

### Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.

Not applicable.

# Section C: Evidence certainty and quality assurance

## Agency rating of evidence certainty?

Modern central bank remits commonly require the central bank to consider output or employment stabilisation alongside price stability. Central banks in other countries (Australia, USA) have regard to both objectives without losing credibility in managing inflation, provided that the framework sets a clear medium-term inflation anchor. There are times when the two objectives will conflict and the central bank will need to make trade-offs between the objectives. The preferred option in this RIS requires the central bank to make those trade-offs in a way that does not threaten price stability in the medium term.

The consensus of the decision-making literature is that committee decisions tend to be better than decisions made by an individual. Committee decision-making is also more common at central banks internationally. There is no optimal configuration of a monetary policy committee, with wide variation across central banks reflecting different local circumstances.

*To be completed by quality assurers:*

### Quality Assurance Reviewing Agency:

Regulatory Quality Team, The Treasury

### Quality Assurance Assessment:

The Regulatory Quality Team at The Treasury considers that this Regulatory Impact Statement meets the quality assurance requirements.

### Reviewer Comments and Recommendations:

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.

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# Impact Statement: Reserve Bank Act review

## Section 1: General information

<b>Purpose</b>
The Treasury is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing key policy decisions to be taken by Cabinet.
<b>Key Limitations or Constraints on Analysis</b>
<p>This RIS is limited to considering options that are in line with the Government’s terms of reference of the review of the Reserve Bank of New Zealand Act 1989. For this reason the only options to amend the objectives of monetary policy that have been considered are options that include consideration of employment in the monetary policy objective, and in designing the monetary policy committee all options include external members.</p> <p>Given there are a large number of possible combinations of different design parameters of the committee, this RIS only considers certain options.</p> <p>There has been a limited time frame to complete the review and for consultation.</p>
<b>Responsible Manager (signature and date):</b>
Renee Philip Macroeconomic and Fiscal Policy Team Economic System Directorate The Treasury 7 March 2018

# Section 2: Problem definition and objectives

## 2.1 What is the context within which action is proposed?

The Reserve Bank of New Zealand (Te Putea Matua) is New Zealand’s central bank. It formulates and implements monetary policy, promotes a sound and efficient financial system and has the sole right to produce currency in New Zealand. It is almost 30 years since the Reserve Bank Act came into force.

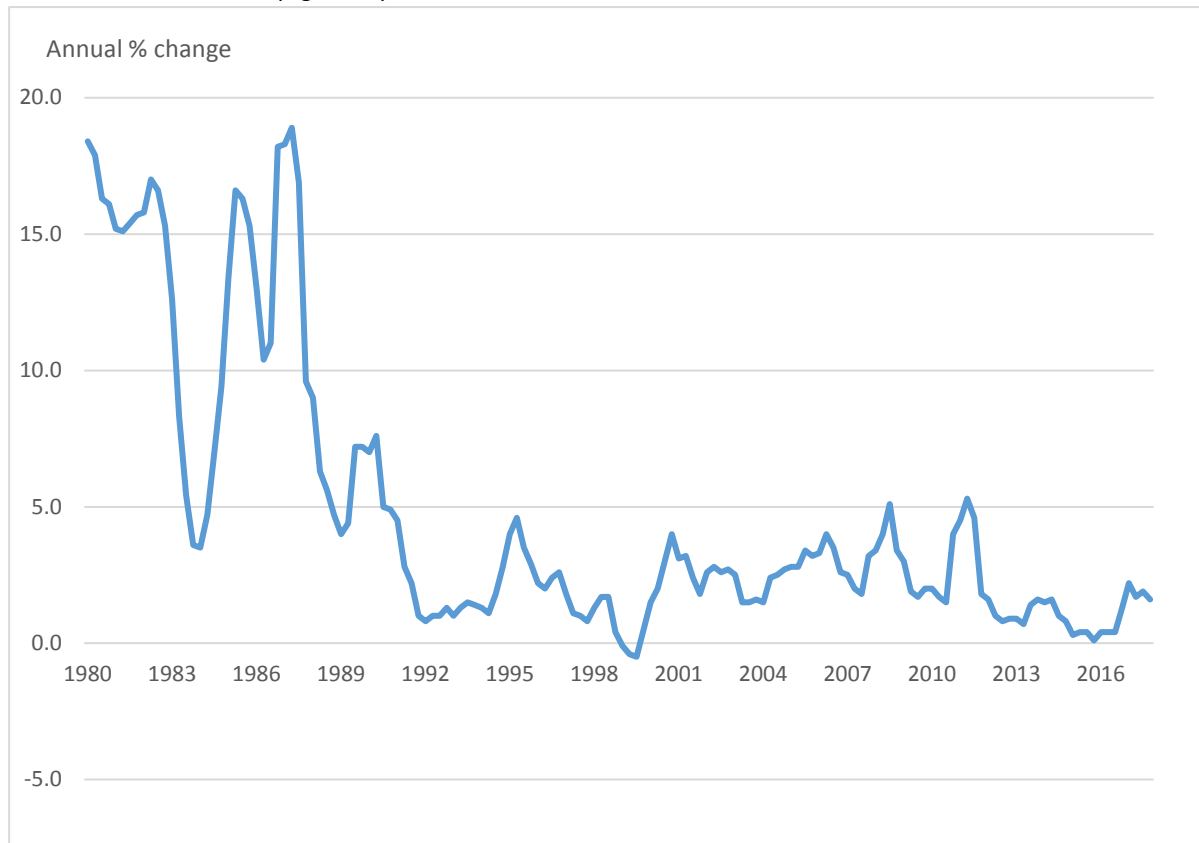
The Reserve Bank Act’s singular focus on price stability, coupled with providing for operational independence of the Reserve Bank to achieve the policy targets, was a response to high inflation in New Zealand (and internationally) in the 1970s and 1980s and the development of academic literature at that time. The inflation rate in New Zealand had been over 10 per cent for almost a decade, and economic growth was the lowest in the OECD. Inflation control was imperative to New Zealand at this time to improve exporter competitiveness and economic growth. The single objective also recognised developments in the academic literature that highlighted that stimulatory monetary policy cannot be used to increase a country’s long-run ability to produce output sustainably, and central bank independence provided a credible commitment to low inflation.

The focus on inflation control in the design of the Act also drove the institutional design of the Reserve Bank and allocation of roles between the Reserve Bank and Minister of Finance. The Act made the Governor a ‘single decision-maker’, who could be removed from office for inadequate performance in meeting the price stability goal, as set out in the Policy Targets Agreement (PTA). In addition, the Reserve Bank was given operational independence, to ensure that monetary policy was set on a time consistent basis and not subject to political influence. This combination of strong individual accountability and operational independence were essential in delivering a credible institutional framework. This framework assisted Parliament in committing successive governments to achieving price stability over the long term. In that time, the legislation has generally served New Zealand well and has contributed to a long period of low and stable inflation (see figure 1 over page).

The operation of monetary policy has evolved since 1989 and become more flexible. This evolution has been reflected in successive changes to the PTA. While early PTAs under the Act took a relatively strict approach to inflation control, PTAs have, for a number of years, provided for a ‘flexible inflation targeting’ approach under which the Reserve Bank targets a low rate of inflation in the medium term, but must take account of developments in the real economy when doing so. This means that the Reserve Bank has the flexibility to take a more gradual approach to achieving its inflation target than it would under a strict inflation-targeting regime, and that inflation outcomes may deviate from target for some time. ‘Flexible’ inflation targeting has become the norm among the world’s leading central banks, and has been adopted in over 30 countries, including the United Kingdom, Canada, Australia, the United States, and most recently India.

Monetary policy has come under scrutiny in many countries in recent years, particularly following the global financial crisis (GFC). This reflects a number of challenges, including a slow economic recovery and very weak inflation in many countries despite a prolonged period of very low interest rates. In some countries, conventional monetary policy has been exhausted with interest rates reaching near zero, and some central banks have used a range of so-called unconventional tools.

Annual CPI inflation (figure 1)



Although the New Zealand economy has been affected by the global environment post-GFC, monetary policy in New Zealand has not been subject to the same extent of challenges as have occurred abroad. New Zealand's economic growth has been stronger since the GFC than many international peers, and although the Official Cash Rate (OCR) has reached historically low levels, it did not reach near-zero as in some other countries.

Inflation has been persistently low in recent years reflecting an unusually long period of falling prices in the tradables sector and a decline in average non-tradables inflation. Factors restraining tradables inflation included a decline in oil prices over 2014-15, low global inflation, and a high New Zealand dollar that reduced import prices. Despite the recent episode of low inflation, inflation has averaged close to 2% p.a. over a longer period (e.g. the last 10 years). Longer term inflation expectations remain well anchored at the mid-point of the target band (2%), suggesting that the inflation target remains credible.

Since 1989 the Reserve Bank's approach to decision-making has also evolved. The Reserve Bank's Governing Committee now takes decisions on monetary policy, but the Governing Committee has evolved within the constraints of the Act, which means that the present arrangements are not optimal. For example, the Governor maintains a veto on decisions, reflecting his or her legal responsibility, while the Governor also appoints all members of the Governing Committee. These features means that there is a hierarchy within the committee which could influence decisions.

The Government announced a review of the Reserve Bank Act in November 2017. The terms of reference outlined that phase 1 of the review would:

- recommend changes to the Reserve Bank of New Zealand Act 1989 (**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 to provide for a decision-making model for monetary policy decisions, 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.

This RIS covers the high-level proposed changes relating to phase 1 of the Review being considered by Cabinet in March 2018.

Further detailed changes will need to be made as part of phase 1 of the Review, and Cabinet will consider these issues at the same time that it considers the draft legislation that will give effect to the changes. If required, a further RIS for those second order changes will be prepared at that time.

Separately, the Reserve Bank and the Treasury are developing a list of areas where further investigations of the Reserve Bank's activities are desirable, which will be considered in phase 2 of the Review. Any changes from phase 2 would result in a separate Amendment Bill. If required, a separate RIS will be prepared for any applicable proposed changes arising out of phase 2 of the Review.

## 2.2 What regulatory system, or systems, are already in place?

New Zealand's monetary policy framework is set out in the Reserve Bank of New Zealand Act 1989 (**the Act**) and the Policy Targets Agreement (**PTA**). The Act sets the Reserve Bank's overall objective in conducting monetary policy. The PTA sets out the specific target for monetary policy and is agreed between the Minister of Finance and the Reserve Bank Governor each time a Governor is appointed or reappointed. The main elements of the Act are summarised here.

### *Monetary policy objectives*

**Section 1A** of the Act sets out the responsibilities of the Reserve Bank, including *'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'*

**Section 8** of the Act, provides that the primary function of the Reserve Bank is to *'formulate and implement monetary policy directed to the objective of achieving and maintaining stability in the general level of prices'*. This is known as a 'price stability objective'.

### **Policy Targets Agreement**

**Section 9** of the Act requires that the Minister of Finance agree with an incoming Governor of the Reserve Bank specific targets for the conduct of monetary policy in a PTA, which must be consistent with the price stability objective. The PTA is set every five years, consistent with the term of a Governor, but may be amended by the parties at other times. As a public



document the PTA is important in providing transparent communication of the targets of monetary policy to the public and markets.

The current PTA<sup>1</sup> (signed November 2017):

- Sets out an inflation target, to keep future All Groups Consumers Price Index inflation outcomes between 1-3% on average over the medium term with a focus on keeping average inflation near the 2% midpoint;
- Requires that the Reserve Bank look through temporary deviations in inflation; and
- Requires that, in conducting monetary policy aimed at the price stability target, the Reserve Bank shall have regard to financial stability and seek to avoid unnecessary instability in output, interest rates and the exchange rate.

While all PTAs have set an inflation target, the Act is broad enough to allow alternative targets to be set provided that they are consistent with the price stability objective.

#### *Other notable sections of the Act*

**Section 10(a)** of the Act provides for an additional consideration (which is also in the PTA), for the Reserve Bank to *'have regard to the efficiency and soundness of the financial system'* in formulating and implementing monetary policy.

**Section 12** of the Act creates provisions for the Government of the day to change the primary monetary policy objective to something other than price stability. This must be done in a transparent manner (through Order in Council), allowing the Government to be held to account for its decision. A decision to change the objective of monetary policy must be reviewed every year. The Act therefore recognises the right of the Government of the day to determine the macroeconomic framework. This right of the Government is also set out in the Purpose section of the Act (Section 1A).

To support the democratic legitimacy of the Reserve Bank's operational independence for monetary policy, the Act also promotes the transparency of monetary policy through the requirements to issue Monetary Policy Statements (MPS), which are referred to the House of Representatives (they are considered by the Finance and Expenditure Committee). The Act also provides a comprehensive regime to hold the Reserve Bank, through the Governor as decision-maker, to account for monetary policy implementation (see next section).

#### *Institutional framework for monetary policy*

The roles and responsibilities of the key individuals and groups in the monetary policy framework are summarised below:

**Role of the Governor:** The Governor of the Reserve Bank, appointed by the Minister of Finance on the recommendation of the Reserve Bank Board, has the authority to make all decisions about the Reserve Bank's strategy and operational policy. The Governor effectively holds the powers of both a CEO and a board of directors. While the Governor

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<sup>1</sup> The full Policy Targets Agreement as at 7 November 2017 can be found at <https://www.rbnz.govt.nz/monetary-policy/policy-targets-agreements/pta-november-2017>

may delegate decision-making power to others, the Governor is held fully responsible for the Reserve Bank's performance. The Governor is solely and clearly responsible for monetary policy performance and for performing the functions of the Reserve Bank in respect of prudential policy. Inadequate performance in respect of either of these functions can trigger dismissal.

**Role of Deputy and Assistant Governors:** Section 43 of the Act creates the statutory requirement for either one or two Deputy Governors to be appointed. Deputy Governors are appointed by the Board on recommendation of the Governor. From time to time a governor has also appointed an Assistant Governor, however this position is not a statutory requirement and holds only those responsibilities delegated to the Assistant Governor by the Governor.

**Role of the Governing Committee:** Over recent years the Reserve Bank has established a Governing Committee. The Governing Committee is responsible for the Reserve Bank's major economic and financial policy decisions, including decisions on monetary policy. The Governing Committee comprises the Governor, Deputy Governor(s) and Assistant Governor (Chief Economist), and seeks to reach a consensus on all issues. However, the Governor retains the right of veto on committee decisions. Publicly, the Governing Committee practices collective responsibility and takes a consensus approach to communications. The Governing Committee is a significant practical deviation from the legislative model and does not have a statutory basis.

**Role of the Reserve Bank Board:** The Act establishes a board of directors for the Reserve Bank (**the Board**) to hold the Governor to account for his or her decisions. Aside from recommending the appointment of the Governor and appointing Deputy Governors, the Board's primary role is performance monitoring. The Act requires that the Board must report annually on all aspects of the Reserve Bank's performance and sets out that the Board has a duty to keep under review the Governor's performance in ensuring that the Reserve Bank achieves the policy targets, including assessing whether the Reserve Bank's MPSs are consistent with the PTA. The Board also has an advisory role, with the Act enabling the Board to advise the Governor on any matter relating to the performance of the Reserve Bank's functions and the exercise of its powers. The Act sets out that the Governor is a member of the Board.

**Role of the Minister:** The Act provides the Minister of Finance powers to appoint and dismiss Board members. Board members are appointed for a term of five years and appointments have previously been timed such that no more than two Board member vacancies will occur in the same year. Over recent years a practice has also developed that the Minister of Finance sends the Reserve Bank an annual letter of expectations. The Minister of Finance has also sent a letter of expectations to the Board. The Minister is also responsible for jointly agreeing a PTA with the Governor, and is responsible for appointing the Governor (on recommendation from the Board) and can advise the Governor-General to remove the Governor from office under certain conditions.

**Role of the Treasury:** The Treasury has a role in providing advice to the Minister of Finance on the Act, significant Reserve Bank policy, PTAs, funding agreements and on any other matters relating to the Reserve Bank that the Minister of Finance requests from time-to-time. It is also within the Reserve Bank's mandate to provide advice to the Minister of Finance on any of these matters and the Minister may request advice from the Reserve Bank

on any matter related to its functions (section 33).

### *Previous reviews of the monetary policy framework*

Reviews of the monetary policy framework have occurred periodically in New Zealand. In 2001 the New Zealand Government commissioned a comprehensive independent review of monetary policy by Professor Lars Svensson<sup>2</sup>. A more recent review was undertaken by the Finance and Expenditure Committee in 2007<sup>3</sup>. The Reserve Bank and the Treasury have periodically reviewed the monetary policy framework prior to the signing of a new PTA, for example, a review was undertaken by the Treasury in 2011<sup>4</sup> to inform the Treasury's advice on the PTA in 2012.

## **2.3 What is the policy problem or opportunity?**

The Reserve Bank is one of many central banks globally that practices 'flexible inflation targeting'. Flexible inflation targeting is characterised by a medium-term focus on price stability, but shorter term flexibility to take other economic objectives such as minimising short-term fluctuations in the real economy into account. However, the existing regime is not well specified in the Act. As outlined in section 2.1, the focus of monetary policy in the Act is primarily on price stability; it is the PTA that requires the Reserve Bank to consider a broader range of factors when setting policy. There is an opportunity to update the Act and embed the 'flexible' nature of the inflation-targeting regime more durably in the legislation and, in so doing, recognise the wider considerations that the Reserve Bank should take into account when setting monetary policy.

There have also been developments in international best practice for governance and decision-making at central banks and a growing recognition of the benefits of committees in bringing a diversity of views and avoiding the influence of extreme preferences. The Reserve Bank itself has shifted to an informal committee structure. There is an opportunity to formalise a committee-based decision making structure at the Reserve Bank and in so doing, an opportunity to investigate the optimal committee structure and accountability framework.

### **What is the policy seeking to do?**

*Monetary policy objectives: modern monetary policy regimes aim to stabilise inflation in the medium term while stabilising employment and output around their sustainable levels*

There are many benefits of using monetary policy to achieve price stability. High or volatile inflation can create economic uncertainty that undermines the ability of households and businesses to make efficient spending and investment decisions, which can reduce the productive potential of the economy and ultimately reduces the living standards of New Zealanders. Prolonged periods of negative inflation (deflation) can create incentives to delay consumption, which can reduce demand and cause a sustained economic downturn. Price

<sup>2</sup> <http://www.treasury.govt.nz/publications/reviews-consultation/monpolreview>

<sup>3</sup> [https://www.parliament.nz/resource/en-nz/48DBSCH\\_SCR4210\\_1/ca222aa3f55150d5b46da2efa40c1346691bc527](https://www.parliament.nz/resource/en-nz/48DBSCH_SCR4210_1/ca222aa3f55150d5b46da2efa40c1346691bc527)

<sup>4</sup> <http://www.treasury.govt.nz/publications/informationreleases/monetarypolicy/framework>

stability also supports equity goals by avoiding unexpected redistributions of purchasing power between savers and borrowers.

Inflation is determined, in part, by people's expectations of future inflation (as workers will demand pay rises to cover expected future price rises, which in turn determine how much firms need to increase their prices). Periods of high, volatile, or negative inflation can be self-perpetuating and difficult and costly for policymakers to get under control. This means that a crucial ingredient for maintaining low inflation is a nominal anchor: a focal point for people's expectations of prices, wages and interest rate movements. Many countries have found that a commitment to low and stable inflation and an independent central bank provide a sound anchor. When wage and price setters act consistently with the inflation target they create a strong tendency for inflation to converge on the target.

As well as its role in achieving and maintaining price stability, monetary policy is one of the main tools policymakers have to attempt to moderate cyclical fluctuations of the economy and to help it adjust to unexpected events. The role of monetary policy in this regard is to help the economy to adjust and assist in returning resource use to "full employment" quicker than otherwise – in this way monetary policy reduces the duration of economic downturns or booms. This stabilisation role is important because, while periods of high unemployment are costly and socially disruptive in themselves, extended periods of unemployment or economic slack can also reduce a country's long-run ability to produce output - and therefore reduce citizens' living standards. For example, skill erosion and capital scrapping (often known as 'hysteresis' in the literature) can occur in a downturn. This stabilisation role of monetary policy has been particularly important since 2008, as stimulatory monetary policy has been used by central banks around the world for an extended period in an attempt to stimulate economic activity following the GFC.

In seeking to return the economy to 'full employment' the central bank is not targeting a zero unemployment rate: there are structural drivers of unemployment (such as the level of unemployment benefits, any mismatches between the workforce's skills and the skills demanded by firms, and the efficiency with which employers and employees can find one another) and some frictional unemployment will always exist as people change jobs. Instead, 'full employment' can be thought of as referring to the level of unemployment that would exist when the economy is operating at its sustainable level (ie, it is not in an upturn or a downturn).

The level of 'full employment' (or in regards to the economy's production capacity: potential output) is largely determined by structural factors that are outside the central bank's control. Attempts to use stimulatory monetary policy to permanently increase employment/output above the full employment or sustainable level will lead to a higher average inflation level, not an increase in the maximum sustainable level of employment itself<sup>5</sup>. Monetary policy only impacts on long-run employment/output through its role in achieving medium-term price stability, and minimising variations in output and employment away from their sustainable levels thereby avoiding hysteresis.

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<sup>5</sup> The ability of monetary policy to influence output in the short run is due to nominal rigidities in the economy. Wages and prices often don't respond to economic shocks in the short-term, but in the long-term prices do adjust. Stimulatory monetary policy would merely increase prices rather than influencing demand or output.

***Monetary policy that aims to stabilise inflation can also help stabilise employment but the relationship is not perfect and sometimes trade-offs need to be made between these objectives***

Using monetary policy to achieve low and stable inflation can assist in returning the economy to full employment. In a downturn following a demand shock, unemployment (of labour or capital resources) puts downward pressure on wages and prices – reducing inflation pressures. Stimulatory monetary policy will increase demand (and stabilise output and employment) and also help to offset the fall in the inflation rate. Conversely, in an upturn when prices and wages (and therefore inflation pressures) are increasing, contractionary monetary policy can be used to both reduce demand and inflation. This relation between inflation and unemployment is a short term relationship. As discussed in the paragraph above, in the long term the sustainable level of employment or output is largely determined by structural factors.

If this short-term relationship between inflation and unemployment held perfectly, then a single price stability objective for a central bank would achieve the same outcome as a dual objective targeting both inflation and employment. However, there are circumstances and factors that mean that the relationship does not hold perfectly and thus central banks can face a short run trade-off between stabilising inflation and employment/output.

This could, for example, occur in a downturn that is driven by a supply shock. A large increase in global oil prices, for example, would raise production costs (and prices) in New Zealand and thereby harm economic growth. Stimulatory monetary policy would stabilise output but would exacerbate the impact on inflation. Contractionary monetary policy would keep inflation low but exacerbate the decline in output. If the price impact is temporary, then the optimal response is for the central bank to look through it. However, if these impacts were widespread or the price impact long-lasting, a trade-off will need to be made between price stability and returning the economy to full employment.

These short run trade-offs between price and employment/output stabilisation are recognised in flexible inflation-targeting regimes, for example by allowing deviations from targets in response to specific shocks and/or requiring consideration of factors other than price stability.

***Outcomes sought from the monetary policy decision making framework***

Achieving inflation and output stabilisation with monetary policy relies on decisions made by monetary policymakers. The decision-making framework should result in high-quality deliberation and decision-making, with appropriate accountability and institutional legitimacy.

***The problem definition***

The Reserve Bank Act was written at a time when creating a regime to control inflation was paramount, following a period of high inflation and a growing realisation that attempts to use monetary policy to boost employment above its sustainable level would be time inconsistent, and only result in higher inflation in the long-run. However, today, inflation-targeting central banks – including the Reserve Bank – practice a flexible inflation targeting approach recognising the trade-off that sometimes arises between stabilising the real economy on the one hand and inflation on the other.

The current PTA does support a flexible inflation targeting approach and recognises the role monetary policy can play in responding to supply shocks by requiring the Reserve Bank to

avoid unnecessary volatility in output, interest rates and the exchange rate. Including an employment objective in the Act would provide a more durable approach to recognising the trade-offs facing monetary policy than relying on the PTA – as otherwise the Minister of Finance and Governor could revert to strict inflation targeting without wider public discussion.

The single decision-maker model in the Act was designed for a framework with a single objective (price stability). The evolution to a flexible inflation-targeting regime gives the Reserve Bank significant discretion as to how to weight different factors and means that there is not a single metric by which to measure the quality of the Governor's decisions. This makes the strong individual accountability model, based on the ability to dismiss an individual for failure to meet a target, less relevant than at the time the Act was passed.

Additionally, a large body of academic literature suggests committees, including in monetary policy settings, produce better decisions on average than individuals. This is because committees protect against extreme preferences, while supporting knowledge pooling and the introduction of different analytical and decision-making frameworks. The academic research in favour of committee decision-making models is also consistent with practice used by other central banks and financial regulators. The Reserve Bank's single decision-maker model is an outlier internationally.

While the Reserve Bank has adopted a committee decision-making model following the introduction of the Governing Committee in 2013 (which covers both monetary and financial policy decisions), the model is a deviation from the single decision-maker model prescribed in the Act.

The Governing Committee has been instituted within the constraints of the Act, which prescribes a single decision-maker. This had led to anomalies. For example, three different processes exist for the appointment of the four current members of the Governing Committee, which has consequences for accountability and incentives. There is nothing in the legislative framework to stop a Governor from stepping back from the current committee approach and returning to a sole decision-maker model. Further, under the current Act, external members have no formalised role in decision-making. External members are one mechanism to bring in diversity of views and different analytical frameworks and heuristics.

Finally, the current duties of the Board and the process for setting the PTA in the Act will need to be reconsidered in light of the shift to a committee decision-making model recommended below. The current approach of the Governor agreeing the PTA with the Minister will not be consistent with a committee decision-making approach. In addition, the Act currently does not provide a robust or transparent process for reviewing the PTA (or other document setting out the operational objectives if the PTA is to be replaced), and does not provide clear roles and responsibilities for undertaking longer term reviews and advising the Minister of Finance on setting monetary policy objectives.

A strong mandate and a high degree of political legitimacy is critical for the Reserve Bank to ensure that it can act consistently and predictably. It follows that the choice of the Reserve Bank's monetary policy objective and decision-making model should be a decision for Parliament and set in legislation. We expect that doing so would strengthen public and political support for the Reserve Bank.



## 2.4 Are there any constraints on the scope for decision making?

The Government has stated its intention to make changes to the Act to provide for requiring monetary policy decision-makers to give due consideration to maximising employment alongside the price stability framework. In addition, the Government has indicated it wishes to make changes to the Act to provide for a decision-making model for monetary policy decisions, in particular the introduction of a committee approach, including the participation of external experts. Options that do not achieve these objectives are not considered further in this RIS.

There are other ways in which developments in the economy or international best practice may suggest a change to the Act – for example in relation to financial stability policy – that are not considered here. These will be considered in phase 2 of the Reserve Bank Act Review and evaluated in a separate RIS document.

## 2.5 What do stakeholders think?

It is difficult to define a specific group of stakeholders given monetary policy is both a specialised professional area, but also has extensive impact on wider society. The changes will have the biggest impact on the Reserve Bank itself, given that it impacts their decision-making process first and foremost. The Treasury has worked with the Reserve Bank closely as part of the Review.

An Independent Expert Advisory Panel (the Panel) was appointed by the Minister of Finance to provide input and support for the Review. The Panel – made up of Suzanne Snively ONZM (chair), Dr Malcolm Edey, and Dr Girol Karacaoglu – met twice to substantively discuss the issues in Phase 1 of the Review and since then have discussed the issues to confirm their report to the Minister. The Panel also met with the Minister and some other stakeholders. The Treasury has worked closely with the Panel in developing advice to the Minister. The Panel's report is largely consistent with the recommendations made in this RIS, with the only significant deviations being in the design of the Monetary Policy Committee. 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 the recommendation 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).

Outside of the Reserve Bank and the Panel, the Treasury has 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 bank, academic and think tank economists, along with people from sector representative organisations such as the Council of Trade Unions. The Treasury website also provided the public with information about the Review and welcomed any feedback from people by email, so anybody could contribute to the Government's initial consideration of these matters. Four written submissions were received on phase 1 of the Review. The Treasury does not consider that the issues affect Māori in particular and so has not conducted targeted consultation with iwi or hapū.

The summary of the views expressed by stakeholders will be made public when Cabinet decisions are publicly announced. It was provided to the Minister of Finance at the same

time as the Minister received the views of the Panel. The Panel was given a draft summary to assist them in providing their advice.

Generally speaking, a majority of the stakeholder feedback received through the Treasury's process was that the current legislative framework for monetary policy was working well and that the Government should be careful in how employment is added as a consideration for monetary policy decision-making. A minority of stakeholders were strongly supportive of the Government's commitment to including employment in the relevant sections of the Act.

On formalising a committee for monetary policy decision making, the consensus of stakeholders was that they were either supportive or comfortable with the idea. There was broad agreement on some of the details of the committee structure, while other areas were more contested. Areas of agreement included that the membership of the committee should be about 5 to 7 members, that their appointment term should be 3 to 5 years (with one reappointment possible), and that external members should ideally be non-conflicted, independent experts. Disagreements were largely about whether there should be a majority of internals or externals (with most favouring a majority of internals), as well as whether or not the committee should be required to publicly release high-level minutes and the results of any vote.

Other than public submissions during the select committee process, there are no plans for further consultation at this point. This is due to the Government's plan to see its pre-election commitments implemented in a timely way and the ability of the public to submit to the Finance and Expenditure Committee. It is possible that some consultation will take place on draft versions of the Bill before it is introduced to Parliament.



# Section 3a: Options identification – monetary policy legislative objectives

## 3a.1 What options are available to address the problem?

The Terms of Reference ask the Review to develop options to amend the Reserve Bank of New Zealand Act to require that, in formulating monetary policy, the Reserve Bank must give due consideration to employment alongside the price stability framework. A number of options were considered. The choice of options is considered under two parameters:

- 1. How the objectives are prioritised;
- 2. The precise wording of the employment objective.

### 1. Priority of Objectives

The main choice in determining the framing of the monetary policy objective is whether the Act should include an employment objective alongside the price stability objective with no weighting preference specified, or whether the specification should be hierarchical with price stability a priority in the medium term, but not in the short term.

All options considered specified the price stability objective as a medium term objective. This is because monetary policy operates with lags and cannot well manage inflation in the very short term and because managing temporary fluctuations in inflation can cause undesirable volatility in output.

While a large number of options are possible the following main categories of options were considered:

#### *Option 1: An unweighted objective*

This option could be drafted in various ways, but the two main options are to present a list or to use the word “and” to link the two objectives:

*monetary policy is directed to the economic objectives of:*

- 1) *Achieving and maintaining stability in the general level of prices over the medium term;*  
*and*
- 2) *The employment objective*

*Or*

*monetary policy is directed to the economic objectives of achieving and maintaining stability in the general level of prices over the medium term and supporting the employment objective.*

#### *Option 2: A preference for price stability in the medium term, with the employment objective otherwise be considered equally with price stability*

Two ways this option could read are:

- (a) *monetary policy is directed to the economic objectives of achieving and maintaining stability in the general level of prices over the medium term, while supporting the employment objective.*

(b) *monetary policy is directed to the economic objective of achieving and maintaining stability in the general level of prices over the medium term and otherwise supporting the employment objective.*

**Option 3: Provide for employment as a secondary objective**

This option would read:

*In formulating and implementing monetary policy [directed at price stability] the Bank shall —*

a) *have regard to the employment objective*

**2. Specification of the employment objective**

The Treasury considered whether in referring to employment the objective should refer to:

- *'Full employment';*
- *Sustainable employment;*
- *'Maximum sustainable employment'.*

**3a.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?**

The following criteria were used to assess options. The objective statement should:

- 1. Be achievable through monetary policy tools.** Any monetary policy objective needs to recognise that in the long run monetary policy can determine the rate of inflation, but it cannot directly determine real variables such as employment or economic growth.
- 2. Provide a credible commitment to price stability over the medium term and avoid inflation bias.** There are a number of long term economic benefits that arise from keeping inflation low and stable over the medium term, however this does not require inflation to be at target at all times. The use of monetary policy to try and stimulate the economy beyond its sustainable level in the past led to high inflation and high inflation expectations (often known as 'inflation bias') and hence the objective should seek to avoid this outcome.
- 3. Put sufficient weight on the short-run stabilisation of unemployment.** The focus of the Review is on ensuring that the Reserve Bank puts due weight on maximising employment in undertaking monetary policy. This includes ensuring that the role monetary policy can play in reducing the length and depth of economic downturns is sufficiently recognised in the legislation and ensuring that the monetary policy makers give weight to both inflation and employment when these objectives conflict in the short term.
- 4. Create durable legislation.** The macro-economic policy framework needs to be flexible enough to deliver positive economic outcomes in a range of circumstances. As legislation is changed infrequently the monetary policy objective should be specified in legislation in such a way that it is durable over time.
- 5. Provide for clear communications and implementation.** The framework should be easy to communicate and operationally implementable.

### 3a.3 What other options have been ruled out of scope, or not considered, and why?

#### *Having no objective in the legislation*

The Treasury has ruled out not having an objective for monetary policy set in the Reserve Bank Act. Norway and Canada do not specify a primary objective for monetary policy in their Central Bank's Legislation. Instead they provide for the Government to write, or the Reserve Bank and the Government to agree on, a monetary policy target.<sup>6</sup>

The advantage of not setting the primary objective in the Act would be allowing greater flexibility for the Government of the day in the formulation of a monetary policy objective. However, given the significance of this policy decision, we consider it appropriate for Parliament to set the high level objectives of monetary policy.

Furthermore, removing price stability from the Act entirely would provide a lesser commitment to maintaining low levels of inflation over time and, if it led to inflation bias, could lead to higher inflation expectations and potentially higher inflation in the long term and therefore damage economic growth.

#### *Growth versus level of employment*

The Treasury considered if the employment objective should be specified in terms of the growth rate of employment or the level of employment. The Treasury recommends that it is specified in terms of levels and ruled out growth rates. This recognises that in setting monetary policy, central banks typically take account of the extent to which the level of employment deviates from the level of full employment (known as the employment gap), rather than deviations of employment growth from its sustainable growth rate.

#### *“Employment” versus “Employment and output”*

The Treasury considered whether the legislative objective should refer to “employment” or to “employment and output”. For example, the objective of the Norges Bank (set via secondary regulations) refers to both output and employment.

The argument for including output is that it is a more comprehensive description of the level of economic activity. However, while the level of employment and output are highly related, the precise calibration of monetary policy to meet an employment objective may not be the same as to meet an output objective, and therefore adding both objectives could make it more difficult for the Reserve Bank to communicate whether it is meeting its objectives. On balance the preferred option only includes an employment objective.

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<sup>6</sup> A recent review of the Norges Bank legislation has recommended introducing a policy objective

## Section 4a: Impact Analysis- monetary policy legislative objectives

**Marginal impact:** How does each of the options identified at section 3.1a compare with the counterfactual, under each of the criteria set out in section 3.2a? *Add, or subtract, columns and rows as necessary.*

	Option 1			Option 2			Option 3		
	Full Employment	Sustainable Employment	Maximum Sustainable Employment	Full Employment	Sustainable Employment	Maximum Sustainable Employment	Full Employment	Sustainable Employment	Maximum Sustainable Employment
<b>1. Objectives achievable through monetary policy tools</b>	0	0	0	0	0	0	0	0	0
<b>2. Credible commitment to price stability</b>	-	-	-	0	0	0	0	0	0
<b>3. Sufficient weight on stabilisation</b>	++	++	++	++	++	++	+	+	+
<b>4. Create durable legislation</b>	++	++	++	+	+	+	+	+	+
<b>5. Provide for clear communications and implementation</b>	+	+	+	+	+	+	+	+	+
<b>Overall assessment</b>	++	++	++	++	++	++ <i>(Preferred Option)</i>	+	+	+

**Key:**

++ better than doing nothing/the status quo

- somewhat worse than doing nothing/the status quo

+ somewhat better than doing nothing/the status quo

-- worse than doing nothing/the status quo

0 about the same as doing nothing/the status quo

### *Priority of objectives*

Three options were considered for the priority of objectives above.

Monetary policy has a limited impact on inflation in the short term due to lags in implementation and in the long term monetary policy can only influence nominal variables in the economy. All of the options recognise this limitation by focusing on medium-term price stability, and as a result, all options are able to meet criteria 1 — i.e. the objectives are achievable through monetary policy tools — to the same extent as the status quo.

All of the options also include recognition of the stabilisation role of monetary policy so are better able to communicate this role than the status quo (criteria 5).

While any of the options in this RIS are a suitable way to specify the dual price stability/employment objective, at the margin the Treasury prefers option two.

**Option one:** This option gives maximum flexibility in how to weight the two objectives of price stability and employment over time. This would make the Act durable (criteria 4) and would allow any ranking between the objectives to be specified in the Policy Target Agreement (or equivalent secondary instrument). However, the downside of this flexibility is that it may be interpreted as a less credible commitment to price stability (criteria 2), which could create inflation bias over time.

**Option two:** This option provides a clear priority for price stability in the medium to long term (criteria 2), while also requiring consideration of employment outcomes subject to medium term price stability being maintained (criteria 3). In addition to recognising that monetary policy has a limited impact on inflation in the short term due to lags in implementation, the prioritisation of price stability in the medium term also recognises the importance for economic growth and wellbeing of maintaining a commitment to low and stable inflation over a longer time period.

**Option three:** This option scores highly against criteria 2 as it essentially formalises the existing objectives (as specified in the current PTA). However, this option scores less highly against criteria 3 and 4 as it still keeps open the possibility that a future Governor and Minister could revert to a stricter inflation targeting model. Further, while the legislative objective will have a clearer focus on employment, in practice it would not necessarily enable the Reserve Bank to place a much greater weight on the stabilisation of employment than is already the case.

### *Specifying the precise wording of the employment objective*

The Treasury considered three main options: ‘maximum sustainable employment’, ‘full employment’ and ‘sustainable employment’.

The Treasury recognises that it is important that the objective is consistent with what monetary policy can do (criteria 1). In particular monetary policy cannot increase the trend level of employment, rather its role is to assist the economy in returning to its trend level faster than it otherwise would have.

While “full employment” and “sustainable employment” similarly convey the concept of the trend level of employment, on balance, the Treasury prefer the word “sustainable” to “full”. The use of the term “full” employment, could be misinterpreted as referring to zero unemployment, while the word “sustainable” communicates more clearly the concept that

monetary policy's role is to assist in the adjustment of employment to its trend level – that is its role is one of stabilisation.

The Treasury also supports including the term “maximum” sustainable employment, to recognise that in implementing monetary policy, the Reserve Bank should seek to minimise the depth and duration of economic downturns, so as to avoid hysteresis effects that could lead to worse employment outcomes for a sustained period.

#### *Changes to the purpose of the Act (section 1A)*

In addition to the distinct objectives of monetary policy highlighted above, a number of external stakeholders have suggested that the Act should better convey the role of monetary policy in contributing to the broader wellbeing of the people of New Zealand – recognising that stable inflation is not an end in and of itself, but a means by which monetary policy ultimately helps supports living standards. To reflect such a change, the Treasury considered updating Section 1A of the Act, which states that:

- (1) *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.*
- (2) *This section does not limit the functions or powers given to the Bank by any other enactment.*

The Treasury supports updating section 1A of the Act to recognise that the Reserve Bank's functions ultimately contribute to the prosperity and wellbeing of the people of New Zealand. This would reflect the broader purpose of the Reserve Bank's functions and better communicate to the Public how the Reserve Bank contributes to societal wellbeing.

A number of consequential changes will need to be made to Part 2 of the Act in light of the change in objective statement.

# Section 3b: Options identification – codifying a committee

## 3b.1 What options are available to address the problem?

### *Codifying a committee for monetary policy decisions*

As discussed above, the Minister has asked for the Review to recommend changes to the Act to provide for the introduction of a committee approach for monetary policy decisions, which include the participation of external experts.

The Reserve Bank currently operates an informal committee decision-making model for monetary policy decisions, but does so under legislation that is designed for a single decision-maker model. This has constrained how the Reserve Bank’s committee is structured and how it operates.

As set out in section 2.3, there are multiple reasons for codifying a Monetary Policy Committee (MPC). The benefits of introducing an MPC in the legislation, with the design features recommended in this RIS, are that it will: (1) allow for the committee to be designed from first principles and ensure that the legislation is consistent with, and appropriate for, the preferred committee decision-making model; (2) ensure that a committee decision-making model continues to be used in the future; (3) better ensure quality decisions over time, as evidence shows committees produce better decisions on average; (4) bring New Zealand in line with international practice.

However, committee decision-making models are not without challenges. For example, “group think” can lead those in a committee to strive for unanimity against their better instincts. Agency problems, such as “social loafing” (discussed in detail below), can also be more pronounced in committees, should individuals not feel sufficiently responsible for the decisions of the committee. There can also be communications challenges in a committee decision-making model, such as the potential for members to publicise different viewpoints, which could lead to market uncertainty. Committee design can help mitigate these challenges.

The Treasury regards all options for the design of the MPC considered in this RIS to be better than the status quo of not having a codified MPC. Primarily, this is because codifying the MPC would ensure that the legislation no longer acts as a constraint on structuring a committee and instead provides an enduring framework for ensuring an MPC remains a permanent part of the decision-making process in the future.

Accordingly, the Treasury recommends that an MPC be codified. This is consistent with the Minister’s desire that an MPC be formally introduced (as expressed in the Terms of Reference).

### *Accountability*

The Treasury considers that a move to an MPC fundamentally changes the monetary policy accountability model. In particular, the current Act is based on the individual accountability of the Governor, who holds the functions that would normally sit with a board and is the Reserve Bank’s chief executive. This single decision-maker model is supported by a number of mechanisms in the Act, such as clear and specific goals set through the PTA, and the

ability to remove the Governor from office for inadequate performance. These mechanisms are included in the Act to provide for a high degree of individual accountability in achieving the price stability goal.

In the new model, where the Governor has less individual control over decisions and outcomes, and the MPC assumes collective responsibility for decisions, the Treasury considers that transparency and the ability to show robust decision-making processes become more important to ensure sufficient accountability of the MPC. This focus on ensuring appropriate accountability underpins many of the Treasury's recommendations below. For example, the recommendation of the publication of a record of MPC meetings and the balance of votes in the case of decisions that are not unanimous.

The Treasury has also considered other criteria in assessing the various options, and these are discussed in detail in section 3b.2 below.

### *Designing the MPC*

A number of different design choices need to be made when introducing the MPC. In particular, choices need to be made in relation to the following parameters:

1. Scope of the MPC's remit
2. Size of the MPC
3. Balance of external and internal members
4. Type of external members
5. Appointment processes
6. Dismissal processes
7. Length and timing of terms
8. Decision making processes
9. Communications approach
10. The role of the Treasury

There are a significant number of potential "design choices" for each of these parameters, and an even greater number of ways that choices could be packaged together into different options for the MPC. This means it is not practical to evaluate and compare every conceivable design choice or package. In addition, it is crucial that each option considered in this RIS (being packages of design choices for each of these parameters) contains a package of choices that work together coherently.

Therefore, the Treasury has limited the design choices for each parameter to those which are considered viable and appropriate, and has limited the potential options for the design of the MPC to four coherent options outlined in the table on the following page. The Treasury considers that these four options provide a representative overview of the various trade-offs involved.



The Treasury has limited the potential options that are assessed in this RIS to the following packages of design choices for the parameters:

Parameters	How set?	Option 1	Option 2	Option 3	Option 4
Scope of the MPC's remit	<i>Legislate</i>	Monetary Policy Committee			
Size of the MPC	<i>Legislate</i>	Five to seven members			
Balance of internal and external members	<i>Legislate</i>	Internal majority <sup>7</sup>	External majority	Internal majority <sup>8</sup>	Internal majority <sup>8</sup>
Type of externals	<i>Legislate for qualification criteria; other details set out in MPC Charter/contracts</i>	Part-time members with knowledge and experience in relevant policy areas			
Appointment processes	<i>Legislate</i>	Mixed approach <sup>8</sup>		Minister focussed approach <sup>9</sup>	
Dismissal processes	<i>Legislate</i>	Governor-General can dismiss by Order in Council on the advice of the Minister on specified criteria.			
Length and timing of term	<i>Legislate</i>	Internals: 5-year terms. Externals: 4-year terms. All: limited to one renewal in any one executive role. All: Staggered terms			
Decision-making process	<i>Legislate</i>	Aim for consensus (majority vote where consensus cannot be reached)			
Communications	<i>Legislate for publishing record of MPC meetings; details set out in MPC Charter<sup>10</sup></i>	Broadly balanced	Broadly individualistic	Broadly balanced	Broadly balanced
Role of the Treasury	<i>Legislate</i>	No representative	Representative (non-voting)	No representative	Representative (non-voting)

<sup>7</sup> Three external members if there are seven total members on the MPC; two external members if there are five total members on the MPC.

<sup>8</sup> The Board appoints internal members other than the Governor on the recommendation of the Governor. The Minister appoints the Governor on the Board's recommendation (i.e. no change to the current appointment process for the Governor). The Governor, Deputy Chief Executive and the Chief Economist would be ex-officio members of the MPC. The Minister appoints the external members on the Board's recommendation.

<sup>9</sup> All MPC members are nominated by the Board and appointed by the Minister, with the Governor being required to be consulted over internal appointments. The Governor and the Deputy Chief Executive are ex-officio members of the MPC.

<sup>10</sup> Legislation requires that the MPC Charter be: (a) agreed periodically by the Minister or the MPC; and (b) include matters relating to communications approach, whilst actual detailed requirements will be set out in the MPC Charter.

The relevant potential design choices that could be made in respect of each of the parameters and the overall options for the design of the MPC that are considered in this RIS are discussed below.

#### ***Scope of the MPC's remit***

The following two potential design choices are considered for the scope of the MPC's remit:

1. The MPC as an "Interest Rate Committee", which will be responsible for setting the OCR.
2. The MPC as a "Monetary Policy Committee", which would have a wider responsibility for monetary policy decisions and strategy. By 'strategy' the Treasury is referring to decisions such as what instrument to use (e.g. OCR/Quantitative Easing ("QE")/Foreign Exchange ("FX") intervention), and by 'decisions' the Treasury is referring to the calibration of that instrument (e.g. determining what the OCR should be).

All four options considered in this RIS include an MPC that is a "Monetary Policy Committee". The strengths, weaknesses, and trade-offs of these potential design choices with regard to each parameter are discussed below in section 3b.3.

#### ***Size of the MPC***

The following two potential design choices are considered for how many members should be on the MPC:

1. An MPC with five to seven members (with legislation specifying a range).
2. An MPC with eight or more members.

Design choice one is preferred. All four options considered in this RIS provide for an MPC with five to seven members (with legislation specifying a range). The strengths, weaknesses, and trade-offs of these potential design choices are discussed below in section 3b.3.

#### ***Balance of external and internal members***

The Treasury recommends that external members are included in the MPC. This is because external members would bring different viewpoints to the decision-making process, introduce challenge and promote the inclusion of diverse views in the decision-making process. This also introduces different skills, knowledge, information and analytical frameworks and reduces the effect of 'hierarchy' within the group (where a member holds power over other members as a Governor would over staff), which would in turn reduce the risk of "group think".

This recommendation is consistent with the Minister's desire that the MPC include external members (as expressed in the Terms of Reference).

All four options considered in this RIS for the design of the MPC include external members on the MPC.

With the inclusion of external members on the MPC, the following two potential design choices are considered regarding what the balance of internal and external members could be:

1. External majority.
2. Internal majority (three external members if seven total members; two external members if five total members).

One of the options considered in this RIS include a majority of external members and three options include a majority of internal members. The strengths, weaknesses, and trade-offs of these potential design choices are discussed below in section 4b.

#### ***Type of external members***

The following two potential design choices are considered for what types of external members will sit on the MPC:

1. Persons with knowledge and experience in relevant policy areas (such as economics, finance, banking, or public policy).
2. Representatives of particular groups (such as representatives from particular industries, community groups, or regions).

Consideration is also given for whether external members should be appointed on a full-time or part-time basis.

All four options considered in this RIS have external members that are persons with knowledge and experience in relevant policy areas (such as economics, finance, banking, or public policy) who are appointed on a part-time basis. None of the options include a design choice where externals are representatives of particular groups, and none of the options include a design choice where external members are employed on a full-time basis. The strengths, weaknesses, and trade-offs of these design choices are discussed below in 3b.3.

#### ***Appointment processes***

The following two potential design choices are considered for the appointment processes:

1. *Minister focussed approach*: All MPC members will be nominated by the Board and appointed by the Minister, with the Governor consulted over internal appointments. The Governor and the Deputy Chief Executive will be *ex-officio* members of the MPC.
2. *Mixed approach*: The Board appoints internal members (other than the Governor) on the recommendation of the Governor. Minister appoints the Governor on the Board's recommendation (i.e. no change to the appointment process for the Governor). The Governor, the Deputy Chief Executive, and the Chief Economist would be *ex-officio* members of the MPC. The Minister appoints the external members on the Board's recommendation.

Technically, references to 'appointment' and 'dismissal' in this RIS for the *ex-officio* members are references to their appointment to, and dismissal from, their respective roles/offices in the Reserve Bank.

Two of the options considered in this RIS provide for appointments in accordance with the 'Minister focussed approach' (which is preferred by the Treasury) and two options provide for appointments in accordance with a 'mixed approach' (which is preferred by the Reserve Bank). The strengths, weaknesses, and trade-offs of these potential design choices are discussed below in section 4b.

### *Dismissal processes*

The following three potential design choices are considered for the dismissal processes:

1. The Governor-General can dismiss members by Order in Council on the advice of the Minister on specified criteria.
2. The Board can dismiss members in consultation with the Minister and the Governor on specified criteria.
3. The Governor can dismiss members in consultation with the Minister and the Board on specified criteria. The Governor-General can dismiss the Governor by Order in Council on the advice of the Minister on specified criteria.

In each case, the Governor would 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. The Treasury is still considering how this would operate in practice.

The criteria for dismissal will include dismissing individual members, including the Governor, if the members fail to meet, or are not capable of adequately carrying out, their statutory duties. The Treasury is still considering the statutory duties of members and the specific criteria for their dismissal.

All four options considered in this RIS for the design of the MPC include design choice 1 above. The strengths, weaknesses, and trade-offs of these potential design choices are discussed below in section 3b.3.

### *Length and timing of term*

The following two potential design choices are considered for how long members' terms should be:

1. Terms of 5 or more years
2. Terms of less than 5 years

Also, consideration is given to whether members' terms should be staggered and whether members are limited to one renewal in any executive role.

All four options considered in this RIS include terms of five years for internal members and terms of four years for external members. All members' terms are limited to one renewal in any executive role and terms will be staggered. The strengths, weaknesses, and trade-offs of these potential design choices are discussed below in section 3b.3.

### **Decision-making processes**

The following two potential design choices are considered for the decision making process:

1. Consensus (with majority vote where no consensus)
2. Voting

All four options considered in this RIS require the MPC to aim to reach decisions by consensus, with decisions taken by a majority vote where consensus cannot be reached (Governor has casting vote). The strengths, weaknesses, and trade-offs of these potential design choices are discussed below in section 3b.3.

### **Communications approach**

The following three potential design choices are considered for the communications approach of the MPC:

1. *Individualistic*: A model that focusses on transparency and accountability of individual MPC members' views in the decision-making process. For example, records of meetings could attribute the range of views and any individual votes could be made public. Members could be also permitted to make speeches with no constraints.
2. *Balanced*: A communications model that balances transparency about the decision-making process with clarity and coherence of the Reserve Bank's communication of decisions. For example, records of meetings that reflect the range of views and the balance of any votes (e.g. 6-1 in favour of a decision) could be made public (but no attribution of individual views or votes), and members could be required to consult with the MPC before they made any speeches.
3. *Consensus*: A model that focusses on clarity and coherence of the Reserve Bank's communication of decisions. For example, records of meetings with the consensus view could be published with no information on voting published. Members could only be permitted to make speeches that support the consensus view.

There are a range of communications approaches that could be implemented, and the above design choices are just representative examples along this continuum (i.e. there are a fluid range of approaches along this continuum).

Three of the four options considered in this RIS include a broadly balanced communications approach and one includes a broadly individualistic communications approach. A strict consensus communications approach was not included in any of the options in this RIS. Further details, including the strengths, weaknesses, and trade-offs of these potential design choices are discussed below in section 4b.

The Treasury is not proposing that all of the details of the communications approach will be specifically set out in legislation. Rather, the legislation would outline the statutory minimum and detailed requirements would be left to be set out in the MPC's Charter. However, the Treasury considers that the communications approach is very important in the overall design of the MPC, as it is a key plank of the overall accountability model, and therefore the communications approach is discussed in this RIS.

Section 4b considers whether the Minister or the MPC itself should set the Charter.

### *The role of the Treasury*

The following two potential design choices are considered for whether the Treasury will be represented on the MPC, and if so, in what capacity:

1. No Treasury representation
2. Non-voting representative from the Treasury

Two of the options considered in this RIS provide for a non-voting representative from the Treasury to be a member of the MPC and two options do not provide for a representative from the Treasury. The strengths, weaknesses, and trade-offs of these potential design choices are discussed below in section 4b.

The other design choices for the MPC are not dependent on whether or not a representative from the Treasury is a member of the MPC (i.e. whether or not a representative from the Treasury is a member of the MPC can be considered in isolation from the other design choices).

### 3b.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The following criteria have been developed for the purpose of assessing the likely impacts of the options under consideration:

1. High-quality deliberation and decision-making: the MPC should support high-quality decision-making by enabling deliberation, debate and the challenge of ideas. The group dynamic should enhance the achievement of positive outcomes for the Reserve Bank, by including different analytical frameworks, skillsets, and information sets.
2. Accountability and incentives: the MPC as a whole should be accountable for decisions, and for publicly communicating the rationale for those decisions. Individually, members should be accountable for meeting their statutory duties, and the overall dynamic should limit the risk that decisions are influenced by hierarchies inside or outside the MPC.
3. Institutional legitimacy: given the considerable powers delegated to the MPC, the MPC should be designed to build and maintain wider public support and legitimacy.
4. Functionality and transition costs: the committee model should be practical and suited to the Reserve Bank's roles, while the costs and risks of transition should be managed.

There are trade-offs between these objectives when designing the MPC. For example, there could be a trade-off between institutional legitimacy and transition costs – choices about the approach to communications will determine the level of transparency, which has consequences for institutional legitimacy; however, those same choices will also affect the risk of transition from the status quo and potentially the clarity of the MPC's communications. In coming to its recommendations, the Treasury has sought to balance these objectives while ensuring the MPC model is coherent as a whole.

The Treasury highlights the importance of accountability, because a committee model makes it more difficult to hold individuals to account for failures to meet the monetary policy objectives. This is because no individual will have full control over decisions or outcomes.

Reasonable people can place different weights on each of these criteria. For example, there are greater transition risks of moving to an individualistic communications approach given that this is a bigger departure from the Reserve Bank's existing practice. Equally, a shift away from a single-decision maker model to a committee structure means a new accountability model has to be developed, and it may be reasonable to sacrifice some transition costs to ensure accountability is retained.

Also, different design choices when combined can mitigate the risks/disadvantages of certain design choices in isolation. For example, the Treasury would only be comfortable supporting a consensus communications approach if there was a majority of external members on the MPC.

Therefore, the Treasury recognises that there are other options (than those that are recommended in this RIS) that could also be reasonable and appropriate.

As discussed above, the Treasury considers that all options for the design of the MPC considered in this RIS are better than the status quo of not having a codified MPC.

### 3b.3 What other options have been ruled out of scope, or not considered, and why?

As discussed above, there are a significant number of potential design choices that could be made in respect of each of the parameters in section 3b.1, and it is not practical to evaluate every conceivable design choice. Therefore, in order to ensure that the analysis is manageable, the potential design choices within each parameter that are discussed in this RIS have been limited to those that the Treasury considers to be the most appropriate. Accordingly, some potential design choices have been ruled out of scope for this reason.

Further, there are a significant number of ways that the above design choices could be packaged together into different options for the design of the MPC. It is not practical to evaluate and compare every conceivable potential options package. Also, it is important that each option contains a mix of design choices that work together as a coherent package. The Treasury considers that the options considered in this RIS provide a representative overview of the various trade-offs involved.

Therefore, some design choices for each parameter are the same across the various options (such as decisions on the scope of the remit and the size of the MPC). This means that none of the options considered in this RIS include some of alternative design-choices considered in this RIS (e.g. none of the options include an MPC with 8 or more members). Where this is the case, we discuss below those relevant potential design-choices, including the applicable strengths, weaknesses, and trade-offs.

#### *Scope of the MPC's remit*

All options considered in this RIS provide for the MPC to be a 'Monetary Policy Committee', and none of the options provide for the MPC to be an 'Interest Rate Committee'.

The Treasury's recommendation is for the MPC to have overall legal responsibility for all monetary policy decisions and strategy (i.e. a 'Monetary Policy Committee'). By 'strategy' the Treasury is referring to decisions such as what instrument to use (e.g. OCR/QE/FX intervention), and by 'decisions' the Treasury is referring to calibration of that instrument (e.g. determining what the OCR should be). In turn, the Governor would be responsible for executing monetary policy in a manner consistent with the MPC's decisions.



Giving the MPC overall legal responsibility for all monetary policy decisions and strategy will ensure that it has sufficient control to influence the outcomes it will be held responsible for. Moreover, it ensures that the benefits of committee decision-making are harnessed for the most substantive monetary policy decisions.

The alternative is to limit the MPC's responsibilities to instrument calibration (e.g. OCR decisions) (i.e. an "Interest Rate Committee"). This option is not recommended as it is insufficient if the intention is for the most significant monetary policy decisions to be taken by the MPC. This is because the Reserve Bank has instrument independence, which means that the conduct of monetary policy could be through instruments other than the OCR.

### *Size of the MPC*

All options considered in this RIS provide for the MPC to have five to seven members (with legislation specifying this range), and therefore none of the options include any other number of members.

There is no "right" size for a committee and no consensus in the academic literature on decision-making, although there is evidence that there are diminishing returns from adding more than seven members a committee. Practice across central banks varies, although smaller economies tend to have smaller committees than larger economies.

Larger committees benefit from more perspectives, information, knowledge and skills. The literature on decision-making suggest larger committees are also less volatile, (given that the influence of each individual member is relatively less than on a small committee), enhance flexibility and innovation potential in the face of a changing environment, and allow for better relationships with external stakeholders.

These benefits need to be balanced against the coordination challenges that arise from a larger committee. In particular, smaller committees tend to support a more deliberative dynamic. Smaller committees also limit the risk that reduced individual accountability leads to reduced effort (known as "social loafing"). Moreover, in the New Zealand context smaller committees offer some practical benefits in that they: (a) require fewer members from the relatively small pool of talent in New Zealand; and (b) are less costly.

The Treasury recommends that the MPC have five to seven members. An MPC of this size will ensure sufficient space for a range of skills and perspectives, while still supporting deliberative decision-making. Beyond seven members, the marginal benefits of additional members is likely to be small. Our recommendation also limits the practical challenges associated with an MPC of a larger size.

The Treasury recommends legislating a range, rather than a specific committee size. This will give flexibility for the MPC to evolve over time without requiring legislative change. It would also allow vacancies to be accommodated due to resignations. It should be recognised that changes to the size of the MPC could be used to influence policy decisions. However, we consider that setting a narrow range, specifying the balance of internal and external members and placing constraints on the Minister's appointment powers will be sufficient protection against this risk.

A smaller MPC has been ruled out because it would preclude having a quorum of external members alongside an internal majority.



### ***External members on the MPC***

The Minister has specified that the committee design will include external members. The Treasury agrees that external members should be included, on the basis that they bring different viewpoints to the decision-making process, introduce challenge and prioritise the inclusion of diverse views in the decision-making process. Indeed, this is the motivation for why the Reserve Bank currently employs two external advisors. External members also introduce different skills, knowledge, information and analytical frameworks, and reduce the effect of 'hierarchy' within the group (where a member holds power over other members), which in turn reduces the risk of group think. Accordingly, all options considered in this RIS include external members and none do not.

### ***Type of external members***

All options considered in this RIS provide for the external members of the MPC to be persons with knowledge and experience in relevant policy areas (such as economics, finance, banking, or public policy), and therefore none of the options provide for other types of external members (such as representatives of particular groups, including representatives from particular industries, community groups, or regions).

The Treasury's recommended approach would allow the MPC to operate as an expert committee, engaging deeply on the substance of the decisions while also allowing for a relatively wide range of external members to be included on the panel. This would provide flexibility, which is important given the relatively small number of pure monetary policy experts in New Zealand. At the same time, it should ensure more diversity in the decision-making processes.

We do not recommend a model, as used in some countries, where external members represent particular interest groups, industries or regions. A representative model risks having decisions biased in favour of those groups that are represented on the MPC, which would undermine the legitimacy of the MPC's decisions. Moreover, given the impossibility of fairly representing all aspects of society in a committee, there would likely be a public perception that the decisions would favour the groups represented, regardless of whether that were the case.

To ensure that external committee members remain "external", the Treasury recommends that MPC members be engaged on a part-time basis. Engaging external members on a full-time basis would make external members virtually indistinguishable from other bank staff, which would limit the ability of external members to bring an outside perspective. Full-time external members would also make the approach more costly. While it will be necessary to manage conflicts of interest, part-time employment enables external members to be engaged in other parts of the community, which would help them to bring different perspectives to the MPC.

Notwithstanding this, external members' engagement at the Reserve Bank should be substantive, allowing them to engage fully in the MPC's deliberations.

### ***Dismissal processes***

All four options considered in this RIS provide for the Governor-General to dismiss MPC members by Order in Council on the advice of the Minister on specified criteria and none of the options provide for any other dismissal process.

Consistent with the appointment process, the Treasury recommends applying the current approach to dismissing the Governor to all MPC members. That is, the Governor-General can remove members by Order in Council, on the advice of the Minister. As is the case now, the Minister would be able to tender that advice, with or without a recommendation from the Board, if the Minister is satisfied that the member has failed to meet certain criteria as specified in the Act. Recognising their ex-officio positions, removal of the Governor or the Deputy Chief Executive from the MPC practically means that they are removed from both their positions in the Reserve Bank and the MPC. However, for internal members other than the Governor and the Deputy Chief Executive, the Minister would have the power to dismiss the member from the MPC, but not from their position. The Treasury recommends this approach as the Minister needs to be able to dismiss the MPC members to ensure democratic legitimacy and accountability. It also reduces risk of hierarchies in the MPC (as discussed in the following paragraph). However, it does result in some scope for politicisation.

The Treasury does not favour allowing the Governor to dismiss MPC members in consultation with the Minister and the Board because it would introduce hierarchy into the MPC whereby one member of the MPC (the Governor) will hold power over other members.

Also, the Treasury considers that there are benefits in having a single consistent high-level approach for both appointments and dismissals of MPC members. Therefore, as the Treasury recommends a Minister focussed approach for the appointment of MPC members, it also considers it desirable for the Minister to be able to advise the Governor General to dismiss MPC members.

The criteria for dismissal would include dismissing individual members, including the Governor, if the members fail to meet, or are not capable of adequately carrying out, their statutory duties. However, the exact circumstances that may trigger dismissal are still being considered by the Treasury.

In a narrow set of circumstances, the Treasury also considers it necessary that the Minister has the power to remove a poorly performing external member after a recommendation from the Board. The Treasury makes this recommendation because an MPC member that is unnecessarily disruptive to the overall dynamic of the MPC could have a significant impact on the efficacy of the MPC. It would be necessary to develop this mechanism in a way that clearly sets out the possible criteria for dismissal, as members should not be removed for simply taking a policy stance that the other MPC members, the Board or the Minister disagree with.

#### ***Length and timing of term***

All four options considered in this RIS provide for internal member appointments of five year terms (limited to one renewal in any one internal position), external members appointments of four year terms (limited to one renewal). All four options propose that all appointments be staggered, and none of the options provide for any other possibilities.

The length of MPC members' terms affects the performance of the MPC in two key ways. First, and most directly, the length of term dictates the frequency with which new perspectives join the MPC, and therefore plays a role in facilitating diversity in the MPC's thinking and minimising group-think. Second, the length of a term impacts the influence a Minister can have over the MPC through appointments, as longer terms necessarily reduce the number and frequency of appointments a Minister of Finance makes.

These factors typically lead to maximum term lengths. Internationally the typical term of appointment is 5-8 years, often but not always renewable, although practice varies. In the US, members of the Federal Reserve Board (the equivalent of the MPC) are appointed for 14 years. The Governor and Deputy Governors at the Reserve Bank of New Zealand are appointed for fixed renewable terms of up to 5 years.

New Zealand's small pool of qualified candidates also brings practical issues into consideration. The challenge of finding qualified candidates domestically means that a degree of flexibility in the duration of appointment may be warranted to secure higher quality members over time. This is especially true if external members from overseas are a likely source of talent.

The length of members' terms could also vary between internal members and external members. Terms need to be long enough to give external members sufficient time to learn and gain experience.

Long terms for internal members protect against politicisation and are consistent with the norm for senior public servants in New Zealand. This is the approach recommended by the Treasury.

The Treasury recommends five year terms for all internal MPC members. Members' terms would be renewable once, which in the case of internal members, applies to their term in any one internal position. For example, this would mean the 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 the 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. Similarly, it would ensure that the internal members filling the non ex-officio positions rotate over time in a manner consistent with the appointment process, taking into account the changing roles of internal members within the Reserve Bank. The Treasury's view is that this recommendation would protect the Reserve Bank's operational independence by providing security of tenure. It would also limit the risk of volatility due to excessive turnover, while still bringing in new perspectives over time.

For external members the Treasury recommends four year terms, which would be renewable once. The Treasury considers that terms of fewer than three years would not be long enough to give external members time to learn and gain experience in the role, especially given the lag in monetary policy. As the Treasury is recommending that external members be persons with knowledge and experience in relevant policy areas (such as economics, finance, banking, or public policy), four year terms would be sufficient to give external members sufficient time to learn and gain experience given their prior knowledge/experience. Allowing one renewal is practical as makes it possible to retain high-calibre individuals.

The Treasury recommends that appointments be staggered. This is consistent with international practice and reduces the risk that the entire committee is replaced at once. This should reduce policy volatility and also limit the risk of politicisation. It would require that initial appointments be staged in such a way to ensure staggering occurs. The practical effect of introducing staggered terms while retaining the double veto (i.e. appointment by the

Minister on the recommendation of the Board) would likely be a reduction of the Minister's influence.<sup>11</sup> Staggered terms reduce volatility and the risk of politicisation, as volatility and politicisation would be more likely to occur if an entire committee is replaced at once. Staggering members' terms would also have a highly desirable practical benefit, in that it would allow for more consistent decision-making over time because it avoids a situation where all MPC members are new to their roles.

### *Decision Making Processes*

All four options considered in this RIS provide for decisions to be made by consensus (with vote where no consensus).

An alternative model would be for decisions to be based on a vote. In a voting model, the Governor would have a casting vote only where votes are split. Both models have advantages and disadvantages and there is an unsettled debate about the most effective model, with neither model likely to always deliver better results.

Arguments in favour of requiring consensus include that it supports more in-depth discussions and the exchange of perspective and, sometimes, more accurate judgement. It is also workable with multiple communications models. As committees increase in size it becomes harder to reach a consensus, so there are practical constraints to the use of a consensus model. More significantly, a consensus model of decision-making promotes the convergence of members' views over time and in the Treasury's view this makes a transparent communications model more important. For this reason consensus decision-making could undermine the diversity benefits of moving to an MPC with external members, and is counter to the rationale for including external members on the MPC.

Voting has the advantage of making every group member reveal their preference, which forces members to deliberate and reduces the risk of "free-riding" or "social loafing". This is particularly the case where the Board would be monitoring the performance of the committee, as each committee members' view would be identifiable. Like consensus, the voting model supports multiple communications models. Relative to a consensus model, there is also less concern about group-think emerging in a situation where committees vote. Nevertheless, voting does not guarantee that members will argue their true position. Where a public consensus exists the desire to be perceived as competent by aligning with that consensus may reduce a committee member's willingness to advocate for an alternative. However, there are weaknesses in a voting approach. Voting requires structured processes and strong chairing to ensure thorough deliberation. While consistent with multiple communications models, coordinating communications would be more difficult in the voting model.

Regardless of whether committees take decisions by vote or consensus, the culture of the Reserve Bank and the MPC will be a major factor in determining the effectiveness of committee decision-making. Maintaining a culture that promotes contemplation and meaningful debate before decisions are taken would likely be at least as important as

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<sup>11</sup> For example, consider an MPC of five members, where one member is replaced each year. It would take a minimum of an entire parliamentary term before a Minister could appoint a majority of the MPC members. Factoring in the length of time it would take for the Minister to appoint a majority of Board members, it could be much longer than 3 years before a Minister can exert full influence over appointments.

whether decisions are made after voting or by consensus.

The decision-making approach could either be fixed in legislation or the legislation could set out minimum requirements (quorum, tie-breaking procedures) with any further detail either agreed between the MPC and the Minister as part of an MPC Charter or left to the MPC to determine.

In either model it would be necessary for meeting processes to support an open and deliberative approach amongst committee members.

While the Treasury considers that both models are workable, we recommend that decisions be made by consensus (with a vote where there is no consensus, and the Governor having a casting vote if there are equal votes). The Treasury considers aiming for consensus will support more in-depth discussions and the exchange of perspectives. However, this recommendation is conditional on there being a communications model that follows either a Balanced or Individualistic approach, as a Consensus communications approach along with a consensus decision-making model would result in an unsatisfactory low level of accountability for individual MPC members.

## Section 4b: Impact Analysis – codifying a committee

**Marginal impact:** How does each of the options identified at section 3.1 compare with the counterfactual, under each of the criteria set out in section 3.2? *Add, or subtract, columns and rows as necessary.*

	Status quo	Option 1	Option 2	Option 3	Option 4
<b>Deliberation and good decision-making</b>	0	++	+	++	++
<b>Accountability and incentives</b>	0	+	++	++	++
<b>Institutional legitimacy</b>	0	+	+	++	++
<b>Functionality and transition costs</b>	0	0	--	-	-
<b>Overall assessment</b>	0	+	+	++	++ (Preferred Option)

### Key:

- ++ better than doing nothing/the status quo
- + somewhat better than doing nothing/the status quo
- 0 about the same as doing nothing/the status quo
- somewhat worse than doing nothing/the status quo
- worse than doing nothing/the status quo

Some design choices vary across the options (decisions relating to the balance of external and internal members, the appointment process, the communications approach of the Committee and whether there will be a Treasury representative). Therefore, these are the key differences between the four options. We discuss below those relevant potential design choices, including the applicable strengths, weaknesses, and trade-offs.

**The Treasury's preferred option is Option 4.** The Treasury considers that this option best achieves an appropriate balance of the criteria, especially given the focus on ensuring that the MPC and its members are appropriately accountable. However, the Treasury recognises that it would not be unreasonable to weigh other criteria such as institutional legitimacy higher, which could result in other options being preferred by a reasonable person.

The Treasury's preferred option differs slightly from the model recommended by the Independent Expert Advisory Panel (who recommended Option 3).<sup>12</sup>

#### *Balance of internal and external members*

One of the options considered in this RIS for the design of the MPC includes an external majority on the MPC and three options include an internal majority (with three external members if seven total members).

There is no international consensus over the right balance of external members and internal members.

Some experts take the view that it is necessary to have a greater number of external members than internal members in order to reduce the tendency towards groupthink. This is because the Governor's position makes him/her likely to be a dominant figure on the MPC, which would increase the likelihood of group think. Having a majority of external members on the MPC reduces the effect of 'hierarchy' within the group (where a member holds power over other members) and is the option most likely to reduce group think, introduce challenge, and prioritise the inclusion of diverse views in the decision-making process. This option is also the most conducive to introducing different skills, knowledge, information and analytical frameworks. .

However, a counter view would be that external members should not be able to overrule the internal members if all of the internal members agree. This is because the internal members are likely to have greater expertise and carry greater accountability for decisions. This view considers that having a large minority of externals is sufficient to guard against group think.

Having a majority of external members would also introduce higher risk during transition and would have the greatest cost and resource implications. It would also carry a higher risk of reducing expertise in decision-making. External appointees could be ill-suited to the role or lack the necessary judgement or expertise. The small pool of qualified candidates in New Zealand may make such problems more likely. While these risks also apply to the Governor and any internal candidates, external candidates do have slightly different incentives (e.g. external members may be

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<sup>12</sup> Note that although Option 3 and Option 4 both include a broadly balanced communications approach, the Treasury recommends that the balance of any votes (e.g. 6 to 1 in favour of a decision) should be made public, while the Independent Expert Advisory Panel recommended that this not be made public.



more likely to “grandstand” in their role to further their careers), which brings specific additional risks. Also, having a majority of external members would raise the possibility that the Reserve Bank would have to implement monetary policy decisions that it internally disagrees with, which could lead to practical challenges with communications.

Overall, the Treasury considers that having an internal majority (with three external members if there are seven members in total or two external members if there are five members in total) would still result in a sufficient number of external members to provide challenge to the Reserve Bank. It would also reduce the risk of externals with less expertise than internal members reducing decision quality, be less disruptive in the transition period, and have the lowest cost. The Treasury considers that this split would provide the necessary accountability and robustness in decision-making. However, it may be less effective at reducing group think and introducing challenge, as well as new skills, knowledge, information and analytical frameworks. It would also carry a greater risk of hierarchy within the MPC influencing decisions.

On balance, the Treasury’s preferred option is for an internal majority. However, this is contingent on the MPC adopting a degree of individualism in the approach to communications (i.e. either an individualistic or balanced communications approach, as discussed below). These communications models would ensure sufficient transparency in the decision-making process, which would allow for greater external scrutiny of the MPC’s decisions. It would also increase the incentive for internal members to question and challenge the Governor’s position. If a consensus based communications model were to be favoured instead, the Treasury would recommend having a majority of external members to ensure that there was sufficient protection against the risk of group think.

### ***Appointment processes***

Two of the options considered in this RIS provide for appointments<sup>13</sup> in accordance with a “Minister focussed” approach and two options provide for appointments in accordance with a “mixed” approach (each approach is discussed above in section 3b.1 of this RIS).

The power of appointment and dismissal could greatly influence the incentives of MPC members by creating hierarchies, relationships and obligations. The Treasury considers that it would be inappropriate for the Governor to hold this power over other MPC members as this could reduce the quality of decision-making. This suggests that appointment and dismissal powers should be held by either the Board or the Minister.

Alternatively, there is an argument that, due to internal members’ management responsibilities within the Reserve Bank, there should be some role for the Governor in the appointment process for internals, while the Board’s more intimate knowledge of the Reserve Bank’s operations and processes means they are also well positioned to make judgements on the appropriateness of internal appointments. Additionally, there are some costs associated with having Board and Minister driven appointments below the level of executive management, as it could reduce the Governor’s flexibility to manage the organisation.

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<sup>13</sup> Technically, references to ‘appointment’ and ‘dismissal’ in this RIS for the ex-officio members are references to their appointment to, and dismissal from, their respective roles/offices in the Reserve Bank.



The mixed approach to appointments would best retain the Governor's traditional employment powers over staff, where senior staff also have operational responsibilities as determined by the Governor. The Minister-focussed approach would create a barrier to reorganising internal structures, as any internal changes to senior management that resulted in consequential changes to the MPC would effectively need to be endorsed by the Board and the Minister. Under the mixed appointments approach, the Board, as the Minister's agent, would be making the MPC member appointments, supporting its effective operation and providing a veto on the Governor's recommendation. Appropriate monitoring by the Board and an individualistic or balanced communication approach would protect against internal members being unduly influenced by the Governor. The mixed approach would also support the Reserve Bank's operational independence by precluding Ministerial involvement in staff appointments. This is the Reserve Bank's recommended approach.

The Treasury's recommended approach is the Minister-focussed approach (i.e. that the Minister appoints all members of the MPC on the recommendation of the Board, with the Governor consulted by the Board on internal member appointments). This is consistent with the current process for appointing the Governor. As each MPC member will hold considerable decision-making powers, the Treasury considers ministerial appointments necessary to ensure members have democratic legitimacy. Ministerial appointments would be consistent with typical international practice. The arrangement whereby the Minister appoints on the recommendation of the Board should be retained to limit the risk that policy decisions are politically influenced. A consistent approach for all members would also be simple, and the proposed approach would limit the risk of introducing a hierarchy into the MPC.

For the reasons outlined above, the Treasury considers that the Minister-focussed appointments approach is better than the mixed appointments approach in terms of ensuring sufficient accountability and incentives (and hence Options 3 and 4 are better than Options 1 and 2 in this regard). The Minister-focussed appointments approach is also better than the mixed appointments approach in terms of maintaining and enhancing institutional legitimacy (again Options 3 and 4 are better than Options 1 and 2 in this regard). However, the Minister-focussed appointments approach will likely result in marginally higher transition and ongoing costs than the mixed appointments approach as it will require Ministerial appointments for the full six MPC members rather than only the external members. This means that Options 3 and 4 are likely to be worse than Options 1 and 2 in this regard).

It is necessary to be specific about how the appointment process for internal members would work in a practical sense given that the internal MPC members would also be Reserve Bank staff. Two options exist. First, the "*ex officio* option" would be for internal MPC members to be members of the MPC by virtue of being appointed to their position in the Reserve Bank. The alternative is for the control of internal appointments to be limited to MPC membership. This would mean retaining the existing processes for filling positions, with MPC members chosen from within the Reserve Bank's staff. Both options have advantages and disadvantages.

Of the two options, the *ex officio* option is more likely to reduce the risk of the Reserve Bank's hierarchy influencing its decisions. This is because the Governor would have less influence over the other internal members. This option would also increase the democratic legitimacy of the MPC as decision-makers would be directly appointed by a democratically-elected Minister.

A disadvantage of the *ex officio* option is that it would reduce flexibility within the Reserve Bank's senior management. It would also mean that the Governor would have far less control over the choice of senior managers (who will often have responsibilities beyond monetary policy), and would make it more difficult to reallocate portfolios between them. Conversely, having the Minister appoint staff to the MPC only would the Reserve Bank considerable flexibility in terms of its organisational structure.

The Treasury recommends that the Governor and the Reserve Bank's Deputy Chief Executive be *ex-officio* members of the MPC. This would mean the Governor and the Deputy Chief Executive would be appointed to their positions in the Reserve Bank by the Minister on the recommendation of Board, and would automatically join the MPC. The Treasury recommends that the other internal members are not *ex-officio*, with the current processes for appointing them to their internal roles within the Reserve Bank being retained.<sup>14</sup> The Treasury recommends that Board should also be required to consult with the Governor when nominating all internal members (other than the Governor) to the MPC. These recommendations reflect the desire to maintain a degree of flexibility in the Reserve Bank's senior management structures.

The Reserve Bank's preferred approach is the mixed approach, where the Governor, the Deputy Chief Executive, and the Chief Economist would be *ex-officio members* of the MPC and that the other internal members would not be *ex-officio*. Under this approach, the Board would appoint internal members (other than the Governor) on the recommendation of the Governor (and the Minister would appoint the Governor on the Board's recommendation).

### **Communications Approach**

There is a choice about how to communicate the decisions of the MPC, particularly where MPC members hold different views. A consensus model presents decisions as the views of the whole MPC. An Individualistic model aligns public and private expression of views, even where those views conflict with the MPC's ultimate decision.

Options 1, 3 and 4 in this RIS include a broadly balanced communications approach and Option 2 includes a broadly individualistic communications approach. None include a strict consensus communications approach.

There are a range of communications approaches that could be implemented, and the individualistic, balanced, and consensus design choices are representative examples along this continuum (i.e. there are a fluid range of approaches along this continuum).

The Reserve Bank currently uses a consensus model for all decisions. This is consistent with the Reserve Bank's consensus decision-making model, and allows the Reserve Bank to speak with a single voice on decisions. In the context of a committee composed of only Reserve Bank staff, such a model is also pragmatic. This is because publicly airing internal dissent could create unwarranted market volatility. It is important to recognise that deviation from the consensus model would have operational consequences for monetary policy. The Reserve Bank uses forward guidance to help inform market expectations, and the approach to giving forward guidance is calibrated to a model where the Reserve Bank expresses a single view.

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<sup>14</sup> The Governor has the power to appoint all staff directly except for Deputy Governors, where the current process is for the Board to appoint based on a recommendation from the Governor.

An individualistic model can be expected to enhance the performance of MPC members and reduce group think. This is because a member of the MPC would expect public scrutiny for the positions they take on the MPC, which would in turn encourage greater care when coming to a position. Individualistic behaviour in monetary policy would complicate the Reserve Bank's message, but it would also reassure the public by demonstrating that diverse views were brought to bear in the decision-making process. However, a counter-argument is to favour an individualistic model precisely because of the communication implications. That is, moving away from a position of apparent unanimity shows the inherent uncertainty underlying decision-making, and does so while being honest about the predictive powers of the MPC. The argument continues that such an approach would therefore increase the trustworthiness, and therefore effectiveness, of the Reserve Bank's communications over time.

Practical issues arise under either approach. It is easy to see a consensus model breaking down when there are sharp differences of view, and external members in particular may insist on having their alternative views made public. Conversely, an individualistic model risks different views being expressed to the market in communications, potentially creating unwarranted market volatility and uncertainty. Communication challenges can be managed to an extent through rules, such as blackout periods before and after decisions, and ensuring that only the Governor can speak for the whole of the MPC. Detailed records of meetings that attribute reasoning can also allow a dissenter's views to be presented in a way that does not undermine clarity. However, as discussed below, such an approach to transparency could undermine the way people work together.

The Reserve Bank is seen as highly transparent among central banks internationally in terms of explaining its decisions. This recognises the various transparency measures that the Reserve Bank has in place, including numerous legislated accountability documents, regular press conferences at the release of each MPS and Financial Stability Report (FSR), FEC appearances and numerous speeches and public engagements throughout the year. All of these efforts are welcome and should be continued, given the importance of transparency for supporting accountability.

However, in the context of committee decision-making there is a limitation to the Reserve Bank's approach to transparency. This is because while the Reserve Bank's efforts support institutional accountability, they do little to support the accountability of individual committee members. As such, the Treasury considers the treatment of records of meetings as a potential means of enhancing individual accountability.

Various approaches are used by central banks internationally. Many release committee records of meetings publicly, either relatively quickly after a policy announcement or with a lag. Some central banks have gone so far as to release full transcripts of committee meetings. Other central banks limit the release of records of meetings to their monitoring agent.

The key benefit of releasing records of meetings is the influence it has on behaviour. Specifically, by making the contributions of individual committee members transparent, an incentive is created for MPC members to take care in their deliberations, while also reducing the ability for MPC members to free-ride on the contributions of others. There is an argument that by releasing records of meetings publicly, accountability would be enhanced further. Releasing records of meetings would also fit with the preference towards disclosure encapsulated in New Zealand's Official Information Act 1982.

The biggest concern with releasing records of meetings and transcripts are the effect they can have on committee dynamics and behaviour. The US Federal Reserve's move to publish transcripts of meetings with a five-year lag had the effect of inhibiting debate and the free flow of ideas. As participants became aware that anything they said would be analysed in detail in five years' time, participants began reading lengthy statements during each round of discussion, which ensured they tightly controlled the recording of their views. While attributed records of meetings are not the same as transcripts, the impact on incentives could be similar. This risk may eventuate even if records of meetings are released only to the Board.

A balanced communications model is a middle-ground option that balances transparency of the decision-making process with clarity and coherence of the Reserve Bank's communication of decisions.

The Treasury considers that a broadly individualistic approach is likely to result in greater accountability of the MPC and its members than a broadly balanced or strictly consensus approach (hence Option 2 is better than Options 1, 3, and 4 in this regard). However, a broadly individualistic approach is also likely to result in greater transition costs than a broadly balanced approach as it is a larger step away from the status quo (and hence Options 1, 3 and 4 are better than Option 2 in this regard). On balance, the Treasury prefers a broadly balanced communication's approach initially, but with the Charter allowing the model to evolve to become more individualistic over time.

The Treasury is not proposing that the communications approach be specifically set out in legislation. Rather legislation would specify a minimum level of transparency required and the detailed requirements will be left to be set out in the MPC's Charter.<sup>15</sup> This is to provide for a degree of flexibility in some of the MPC's procedures. The MPC is likely to learn from experience, so the ability for the MPC to evolve its practices without requiring legislative change is valuable. Such flexibility is likely to be particularly important for the MPC's approach to communications. To enable flexibility, the Treasury recommends that primary legislation require the publication of a record of the MPC's meetings and a Charter (or similar mechanism) that covers a defined set of issues, to be agreed by the Minister and the MPC. The Charter would then set out specific requirements for that defined set of issues, which could include what is published and the timeframes for publication, as well as the protocol for individual members to publicly express views that are inconsistent with the views of the MPC as a whole.

While there is merit in enabling the communications approach to evolve, the Treasury does not think it should be left entirely to the MPC to determine. This is because the communications approach is an integral part of the overall accountability framework. Consequently, the Treasury recommends that the MPC agree the Charter with the Minister. If the Charter is agreed by the MPC only, the Treasury would recommend making the legislation far more prescriptive.

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<sup>15</sup> The Charter could also be used to agree the approach to other issues where the Minister 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. For example, while legislation should set out issues that disqualify external members from being appointed, any qualifications required and their terms of engagement should be set in the Charter. Specifically, the Charter could set out the expected time commitment for external members and their level of support. While these matters could be left to individual contracts, these terms of engagement are likely to effect the ability of external members to offer robust challenge to the internal members, so a Minister may wish to set a minimum.

The Reserve Bank recommends that the Charter be agreed by the MPC itself, and that the MPC's Code of Conduct forms 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. The Reserve Bank believes that this arrangement would help ensure that the Reserve Bank retains its 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.

### *The Role of the Treasury*

Options 2 and 4 in this RIS include a non-voting Treasury representative on the MPC, and Options 1 and 3 provide for no representative from the Treasury.

The other design choices for the MPC are not dependent on whether or not a representative from the Treasury is on the MPC (i.e. whether or not a representative from the Treasury is on the MPC can be considered in isolation from the other design choices).

The Treasury recommends 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 MPC's decisions, which would in turn 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 would be discussed by the MPC, such as the labour and housing markets, would also be strengthened.

The inclusion of a Treasury representative on the MPC should also marginally enhance decision-making by the MPC by ensuring it is fully informed about government economic and fiscal policy decisions (hence Options 2 and 4 are better than Options 1 and 3 in respect of this). Moreover, if conventional monetary policy is constrained (for example if the OCR were to approach the effective lower bound), representation from the Treasury would be likely to support macroeconomic stabilisation given the possible need for more active fiscal policy.

There are risks associated with the inclusion of a Treasury representative on the MPC. It could lead to a perception that the Reserve Bank's operational independence has been weakened, and the Treasury representative would 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 would alleviate the risk that of Reserve Bank's operational independence being perceived as compromised. This has been the approach of the Bank of England, where the Treasury attends as an observer with no vote. Furthermore, procedural arrangements, which would be necessary for external members regardless, could manage the risks of sharing market sensitive information.

It could be argued that other mechanisms exist to ensure the necessary coordination between the Reserve Bank and the Treasury, including:

- The MPC directing well-structured questions to the Treasury before each MPC round to ensure their decisions are well informed. This would ensure those questions are answered in a considered way, and that the most appropriate information is used in the forecasts and associated analyses that are provided to the MPC;
- The establishment of a regular, formal consultation process between the Minister of Finance,

the Governor and the Secretary to the Treasury, specifically focused on the coordination of monetary and fiscal policy.

However, the Treasury does not consider that these other mechanisms provide all of the benefits of a non-voting presence on the MPC, primarily a richer understanding of the debate and issues behind the Reserve Bank's decisions. By contrast, the Independent Expert Advisory Panel and the Reserve Bank – while supportive of the aim to co-ordinate monetary and fiscal policy – did not consider a Treasury representative to be the best means of achieving that aim.

# Section 3c: Options identification – consequential changes to the governance and the role Board

## 3c.1 What options are available to address the problem?

As discussed above, the Minister has also asked for the Review to consider whether changes are required to the role of the Reserve Bank Board as a consequence of the changes to the decision making model (i.e. the introduction of the MPC). In light of this, the Treasury has only considered the ‘least change’ options that it considers is necessary to the governance and role of the Board following the move to an MPC. Phase 2 of the Reserve Bank Act Review is likely to consider broader changes to the governance and role of the Board.

The introduction of an MPC would have implications for the governance model and the role and composition of the Board. In particular, the following need to be considered in light of this proposed change:

- The role of the Board in performance monitoring
- The appointment of the Chair and Deputy Chair of the Board

Different options for each of these are set out below.

### *The role of the Board in performance monitoring*

The following two options are considered in this RIS for the role of the Board in performance monitoring:

1. Removal of the Board’s performance monitoring role entirely.
2. Retention of the Board’s performance monitoring role, but with the Board becoming 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, including as the Chair of the MPC and the chief executive of the Reserve Bank.<sup>16</sup>

In each case, the Board’s monitoring activities should have more of a medium-term perspective, in order to recognise that it takes some time for monetary policy to be effective, and place more emphasis on the quality and effectiveness of decision-making processes.

The strengths, weaknesses, and trade-offs of these options are discussed below in section 4c.

<sup>16</sup> To be clear, the Board would continue monitoring the performance of the Reserve Bank and the Governor in respect of all of the other functions of the Reserve Bank beyond monetary policy.



### *The appointment of the Chair and the Deputy Chair of the Board*

The following two options are considered in this RIS for the appointment of the Chair and the Deputy Chair of the Board:

1. The Board appoints its own Chair and Deputy Chair
2. The Minister appoints the Chair and the Deputy Chair of the Board

The strengths, weaknesses, and trade-offs of these options are discussed below in section 4c.

### **3c.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?**

The following criteria have been developed for the purpose of assessing the likely impacts of the options under consideration:

1. **Accountability** – The MPC, the Governor (as Chair of the MPC and Chief Executive of the Reserve Bank), and the Board should be held to account. This will contribute to the capability and performance of the Reserve Bank and maintain and build the Reserve Bank's institutional legitimacy.
2. **Functionality and coherency** – The governance model and role of the Board should be practical, coherent with the institutional framework and suited to the roles the Reserve Bank performs and the tools it uses to perform those roles.

### **3c.3 What other options have been ruled out of scope, or not considered, and why?**

There are many different options for each of the matters discussed above. Therefore, there is a very large number of potential options that could be considered. The Treasury has limited the potential options discussed in this RIS to a range of options that it considers workable and will meet the criteria.

## Section 4c: Impact Analysis – consequential changes to the governance and the role Board

**Marginal impact:** How does each of the options identified at section 3.1 compare with the counterfactual, under each of the criteria set out in section 3.2? *Add, or subtract, columns and rows as necessary.*

### The role of the Board in performance monitoring

	No action (status quo) (no monitoring of MPC or members of MPC, but maintain other existing monitoring responsibilities)	Remove performance monitoring role entirely	Keep performance monitoring role, but change to reflect monitoring MPC, members, and Governor
Accountability	0	--	++
Functionality and coherency	0	--	++
Overall assessment	0	--	++ (Preferred Option)

### The appointment of the Chair and the Deputy Chair of the Board

	Board appoints	Minister appoints
Accountability	0	+
Functionality and coherency	0	0
Overall assessment	0	++ (Preferred Option)

#### Key:

- ++ better than status quo/no change
- + somewhat better than status quo/no change
- 0 about the same as status quo/no change
- somewhat worse than status quo/no change
- worse than status quo/no change

All options are considered on the assumption that an MPC has been established, as recommended earlier in this RIS.

### ***The role of the Board in performance monitoring***

The Board's current monitoring responsibilities include the requirement to keep the performance of the Reserve Bank and the Governor under constant review.

A committee decision-making model that includes external members (which is the Treasury's recommendation) may justify changing the way the Board monitors performance. For example, the Board could be removed entirely from monitoring, with the media and markets providing the necessary monitoring based on the Reserve Bank's public communications (particularly commentary about the different views of MPC members).

However, the Treasury does not consider that moving to a committee decision-making model for monetary policy removes the need for these monitoring and accountability functions. There is still a need for the Minister to have an independent assessment of the Reserve Bank's performance.

Furthermore, the Treasury does not consider that a broadly balanced communication model (as recommended above in this RIS) will provide a sufficient level of focus on individual performance of MPC members to ensure adequate accountability. Removing the Board entirely could therefore increase the risk of group think and social loafing.

Therefore, not having the Board be responsible for monitoring the MPC or its members (option 1) would be worse in this respect than if the Board was responsible for doing so. Removing the Board's performance monitoring role entirely would be significantly worse from an accountability perspective and would be incoherent with the institutional framework of the Reserve Bank.

The Treasury recommends that the Board becomes responsible for keeping under constant review the performance of the MPC in discharging its responsibilities for monetary policy (including acting in a manner consistent with the PTA) and the individual MPC members in discharging their statutory responsibilities, in addition to its existing duties to monitor performance of the Governor and the Reserve Bank (option 2). The Board's monitoring activities should take more of a medium-term perspective, in order to recognise that it takes some time for monetary policy to operate, and more emphasis on the quality and effectiveness of decision-making processes. The Treasury considers that the Board continuing to have such a role in respect of monetary policy would fit well and be coherent with the institutional framework of the Reserve Bank. The Treasury believes this will result in much greater accountability than if the MPC and its members were not monitored by the Board.

Further details about the Board's monitoring role, including the Board's powers and the statutory duties of the MPC members, will be developed as part of detailed work on the implementation of the MPC.

### ***The appointment of the Chair and the Deputy Chair of the Board***

At present, the Board appoints its own Chair and Deputy Chair (option 1), which is unusual in the wider New Zealand state sector. Having the non-executive directors elect their own Chair was intended to reduce the risk of politicisation of the Board. It also ensures that the Chair and the Deputy Chair have the confidence of the Board.

However, having the Minister appoint the Board Chair and Deputy (option 2) should bring the Minister closer to the Board and increase Ministerial engagement, which the Treasury considers to be important. This would also increase the accountability of the Chair and the Deputy Chair to the Minister and raise the institutional legitimacy of the Board.

Accordingly, to strengthen the link between the Board and the Minister, the Treasury recommends that the Minister appoint the Board Chair and Deputy Chair (whether directly or by the Governor-General by Order in Council on the recommendation of the Minister).

# Section 3d: Options identification – secondary instrument for monetary policy

## 3d.1 What options are available to address the problem?

The Act currently requires that the Minister of Finance agree a PTA with the Governor, which represents a secondary instrument that sets out the “policy targets” for carrying out monetary policy during the Governor’s term of office. These policy targets are in effect the operational objectives for monetary policy that accord with the high-level mandate or primary objective provided in the Act.

Amending the Act to provide for an MPC requires reconsideration of the current PTA approach, as the MPC will be responsible for all monetary policy decisions and strategy rather than the Governor being the sole decision-maker.

In light of the codification of the MPC, the Treasury has considered the following three options as to how the operational objectives for monetary policy could be set:

1. Option 1: The status quo, where the Governor would continue to enter into a PTA with the Minister that sets out the operational objectives for monetary policy.
2. Option 2: The MPC would enter into a PTA with the Minister that sets out the operational objectives for monetary policy.
3. Option 3: The Minister sets the operational objectives for monetary policy following the receipt of non-binding public advice from the Reserve Bank. These would be set in a document similar to the PTA but, as it would no longer be an agreement, the name of the PTA under this option would likely change.

## 3d.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The Treasury considers that the mechanism to set the operational objectives for monetary policy should:

1. *Ensure a transparent allocation of responsibility for setting the operational objectives:* The mechanism should ensure stakeholders can easily determine who sets the operational objectives, in the interests of clear public accountability.
2. *Maintain a role for government in making substantive policy decisions:* The mechanism should recognise that setting the operational objectives for monetary policy is a significant policy decision.
3. *Provide clear and effective operational objectives for the MPC:* The mechanism should ensure a clear set of responsibilities for the MPC and capture technical knowledge.
4. *Promote sound monetary policy decisions:* The mechanism should support the dynamic consistency of monetary policy and avoid inflation bias.
5. *Promote a robust review process:* The mechanism should support regular reviews of the operational objectives, ones that would capture both technical expertise and public input, so that sound decisions can be made in setting the operational objectives.

6. *Be consistent with the package of reforms recommended.*

There is a trade-off between the criteria of ensuring that the government is involved in substantive policy decisions and ensuring that the setting of operational objectives takes account of the Reserve Bank's technical knowledge.

**3d.3 What other options have been ruled out of scope, or not considered, and why?**

In some countries (such as the United States and Sweden) the central bank sets the policy target themselves without input from government. However, this would not be compatible with the criteria to ensure that the mechanism to set objectives provides a role for government in making substantive policy decisions. For this reason, this option was not considered in further detail in this RIS.

## Section 4d: Impact Analysis- secondary instrument for monetary policy

**Marginal impact:** How does each of the options identified at section 3.1c compare with the counterfactual, under each of the criteria set out in section 3.2c? *Add, or subtract, columns and rows as necessary.*

	Option 1: Status quo, where Governor and Minister enter into agreement	Option 2: MPC and Minister enter into agreement	Option 3: Minister sets operational objectives
1. Ensure a transparent allocation of responsibility for setting the operational objectives	0	-	+
2. Maintain a role for Government in making substantive policy decisions	0	0	+
3. Provide clear and effective operational objectives for the MPC	0	0	0
4. Promote sound monetary policy decisions	0	0	0
5. Promote a robust review process	0	0	0
6. Consistent with reform package	-	-	+
Overall assessment	-	-	+
			<b>(Preferred Option)</b>

### Key:

**++** better than doing nothing/the status quo

**+** somewhat better than doing nothing/the status quo

**0** about the same as doing nothing/the status quo

**-** somewhat worse than doing nothing/the status quo

**--** worse than doing nothing/the status quo



All options are considered on the assumption that an MPC has been established, as recommended earlier in this RIS.

Once the MPC has been introduced, the MPC would be collectively responsible for monetary policy decisions and strategy. The Treasury considers that it would not be appropriate for the Governor, as just one member of the MPC, to agree the operational objectives with the Minister (i.e. option 1). This is primarily because under option 1 the Governor as signatory to the agreement would effectively be acting individually in making decisions and setting strategy for monetary policy, which would be inconsistent with the collective responsibility element of the MPC model.

The Treasury considers that there are some practical difficulties with option 2. First, it raises issues with the nature of the instrument used to set the operational objectives as an agreement given the “agreement” would be with a revolving MPC membership. This would either require new agreements to be negotiated every time a new member joined the MPC, or for new members to be bound by (and accountable against) the agreement of previous members until it was time for a periodic renewal (e.g. every five years). Second, low public visibility of the negotiation process would make it difficult to determine how the operational objectives were decided (making it weaker against criteria 1), and the mechanism to set the objectives would not be conducive to an open review process that includes public input (criteria 5).

In addition, the Treasury puts weight on the significance of the operational objectives for monetary policy. The significance of the operational objectives suggests a larger role for the Minister in making the decision on the operational objectives. It also suggests that there should be avenues for public input, whilst at the same time recognising the need for capturing the Reserve Bank’s technical expertise in the design of the operational objectives. Compared to options 1 and 2, option 3 provides a greater role for the Minister and, in moving away from a negotiated agreement model, could better support an open review process with clear avenues for public input. On balance, this means that option 3 is preferable under criteria 2 and 5 than option 2.

Therefore, the Treasury favours a model where the Minister sets the operational objectives following the receipt of non-binding advice from the Reserve Bank (i.e. option 3). This balances the Government’s right to set economic policy against the need to ensure technical expertise is captured and will provide clear responsibilities for undertaking a review. The Reserve Bank’s advice on the setting of the objectives will be public, as will the advice the Minister receives from the Treasury in its role as advisor to the Minister, thereby ensuring that there is discipline on the Ministerial decisions. Having the Minister set the operational objectives is consistent with the Reserve Bank retaining operational independence for achieving the objectives.

Further details about the process for agreeing the operational objectives for monetary policy (for example, the process for amending if required them outside of the regular cycle) will be developed as part of detailed implementation work.

# Section 5: Conclusions

## 5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

### *Monetary policy objectives*

Internationally, there are a range of ways that central bank objectives are specified in order to recognise the dual objectives of maintaining price stability over the medium term and also recognising the role of monetary policy in stabilising the real economy. Despite this variation in legislative specification, the practice of monetary policy internationally has coalesced around flexible inflation targeting. Therefore there is more than one way that the monetary policy objective could be specified to achieve similar outcomes. The Treasury would support both of the following options, although at the margin prefers the second specification:

- 1) *monetary policy is directed to the economic objectives of achieving and maintaining stability in the general level of prices over the medium term **and** supporting maximum sustainable employment.*
- 2) *monetary policy is directed to the economic objectives of achieving and maintaining stability in the general level of prices over the medium term, **while** supporting maximum sustainable employment.*

The second option has the advantage of providing a clearer medium term price stability anchor, as the employment objective is subject to the constraint that it should only be pursued to the extent medium term price stability is maintained. The first option may, however, be more durable over time as it allows more scope for the weighting of objectives to be provided for in a secondary instrument. Which of these two options is chosen therefore depends on the weight put on these two factors.

### *Instituting a committee-based decision making model for monetary policy*

The Treasury is recommending option four as the preferred decision making model. The key features of this model are:

- The committee would be a legislated monetary policy committee with 5 to 7 members, with a majority of those members being internal members at the Reserve Bank.
- The committee would have 2 to 3 external members, who would be appointed for their expertise, and work in their roles on a part time basis.
- All MPC members would be nominated by the Board and appointed by the Minister, with the Governor consulted on internal appointments. The Governor and Deputy Chief Executive will be ex-officio members.
- External members would have four-year terms. Internal members will have five-year terms. Terms will be renewable once. Appointments will be staggered over time.
- While making decisions, the Committee would aim for consensus, but vote where no consensus can be achieved.

- The committee would operate under a balanced communications model that balances transparency about the decision-making process with clarity and coherence of the Reserve Bank's communication of decisions. A record of MPC meetings that reflects the range of views and the balance of any votes (without attribution of individual views or votes) would be published. Members could express individual views in public but would be required to consult with their colleagues on the MPC before they did so. The communications model would be determined through a Charter, agreed periodically between the Monetary Policy Committee and the Minister.
- A non-voting Treasury representative would be present on the Committee.

#### ***The role of the Board in performance monitoring***

The Treasury is recommending the Board retain its performance monitoring role, but changing the Board's role in respect of monetary policy as follows:

- The Board would become responsible for keeping under constant review the performance of the MPC in discharging its responsibilities for monetary policy (including acting in a manner consistent with the PTA) and the individual MPC members in discharging their statutory responsibilities.
- The Board would become responsible for keeping under constant review the performance of the Governor in discharging the Governor's responsibilities in respect of executing monetary policy.
- The Board would be expected to take a medium-term perspective in assessing monetary policy.

The Treasury is recommending that the Minister appoints the Chair and the Deputy Chair of the Board.

#### ***Secondary Instrument for Monetary Policy***

The Treasury is recommending a model where the Minister sets the operational objectives for monetary policy in the PTA (or its replacement) following the receipt of non-binding public advice from the Reserve Bank.

## 5.2 Summary table of costs and benefits of the preferred approach

<b>Affected parties:</b> <i>(identify)</i>	<b>Comment:</b> <i>nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks</i>	<b>Impact:</b> <i>\$m present value, for monetised impacts; high, medium or low for non-monetised impacts</i>	<b>Evidence certainty:</b> <i>(High, medium or low)</i>
<b>Additional costs of proposed approach, compared to taking no action</b>			
Regulated parties		\$0	
Regulators	Annual costs created for the Reserve Bank, involving recruitment, pay and expenses, and staff support for external members. This is based on an assumption of 3 external MPC members.	\$200,000 to \$400,000 per year	High
Wider government		\$0	
Other parties		\$0	
<b>Total Monetised Cost</b>	Costs associated with external MPC members	\$200,000 to \$400,000 per year	High
<b>Non-monetised costs</b>		The Independent Expert Advisory Panel suggested that the employment objective could be aided by the production of additional labour market data by Statistics NZ. These have not been costed but would likely be designed to fit within existing data collection frameworks.	Low

### Expected benefits of proposed approach, compared to taking no action

Regulated parties		\$0	
Regulators		\$0	
Wider government		\$0	

Other parties		\$0	
<b>Total Monetised Benefit</b>		\$0	
<b>Non-monetised benefits</b>	The main non-monetised benefits are to support better monetary policy decision making, which in the long term should improve economic growth and the wellbeing of New Zealanders and to provide for monetary policy to play a greater economic stabilisation role, in addition to achieving medium-term price stability.		High

### 5.3 What other impacts is this approach likely to have?

The policies are intended to result in better decision making by the Reserve Bank and ensure that consideration is given to supporting maximum sustainable employment.

The inclusion of employment in the objectives of monetary policy brings a number of risks to the Reserve Bank that will need to be managed carefully during the transition:

**Inflation bias** – There is a risk that market participants may interpret the Reserve Bank’s new employment objective as weakening its focus on inflation. If the Reserve Bank is perceived to be putting more weight on stabilising employment and less on stabilising inflation than has historically been the case, then inflation expectations may rise as a result. This risk should be mitigated by the precise wording used to describe the Reserve Bank’s new objective. The wording would highlight that price stability remains the focus of monetary policy in the medium term. The Reserve Bank can also mitigate this risk by publicly communicating that the inclusion of the new employment objective is consistent with the existing inflation targeting framework.

**Reduced credibility** – By having two objectives, which sometimes conflict with one another, there is a risk the Reserve Bank’s credibility may be undermined. In the event of a supply shock that causes the path of employment and inflation to diverge, the Reserve Bank would not be able to stabilise inflation and employment at once. The MPC would then face a choice as to whether to miss one or both objectives to varying degrees. Missed objectives could result in public criticism and loss of trust in the Reserve Bank. The Reserve Bank could mitigate this risk by clarifying in public communications that monetary policy often faces trade-offs and that monetary policy is not the sole determinant of employment outcomes. Moreover, by avoiding specifying a specific numerical target for the employment objective, the proposed legislation should minimise the focus on achieving specific employment outcomes at any point in time.

**Political interference** – By highlighting the potential trade-off between employment and inflation more explicitly in the legislation, the Reserve Bank may face political calls to place more weight on one objective over the other for political motives. Taken to the extreme, if the Reserve Bank responded to these calls, it could undermine the Reserve Bank’s operational independence.

The transition towards a codified Monetary Policy Committee also brings risks:

**Sub-optimal decisions during transition** – There is a risk in the near term that new members of the MPC would take some time to get up to speed with the technicalities of their new roles. This could result in sub-optimal decisions during the learning phase. This risk should be mitigated by having a majority of internal members with existing experience on the Committee and by Reserve Bank staff playing an active role in bringing new MPC members up to speed. Nevertheless, this learning phase could still potentially disrupt and delay MPC deliberations for a period.

**Co-ordination challenges** – There is a risk that significant divergences in view could develop between MPC members such that it becomes impractical to reach a consensus on

monetary policy decisions. Although narrow decisions such as the setting of the OCR could still be achieved by majority vote, other more complex monetary strategy decisions such as how to communicate forward guidance and what OCR track to publish may become more difficult. In the extreme, the Reserve Bank may be forced to remove some well-known communication devices (such as the OCR track) from its MPS. The Reserve Bank could mitigate such outcomes by exploring alternative communication devices to convey differences in view.

**Political influence** – By having the Minister appoint all MPC members and have a role in setting the MPC’s communication model through the MPC Charter, there is a risk that the Minister is seen to have undue influence on monetary policy decisions. Such a risk could result in increased market attention to Ministerial statements related to monetary policy, which could generate unwelcome market volatility. In the longer term, there is also a risk that the new model could undermine the Reserve Bank’s operational independence. The Minister’s expanded role in the new MPC model may strengthen democratic accountability, but it also increases the risk that MPC members become political appointments. These risks are mitigated to an extent, by having a double-veto system for appointments where the Reserve Bank Board must nominate candidates to the MPC, and by staggering the terms of MPC appointments.

**5.4 Is the preferred option compatible with the Government’s ‘Expectations for the design of regulatory systems’?**

The Reserve Bank Act only regulates the Reserve Bank. There are no areas of incompatibility with the Government’s ‘Expectations for the design of regulatory systems’.



## Section 6: Implementation and operation

### 6.1 How will the new arrangements work in practice?

#### Legislative process

The changes discussed in this RIS will be given effect through legislation, subject to Cabinet agreement. Legislation is intended to be introduced in the second half of 2018. Once legislation is enacted, a transition period of several months will be needed before the committee can come into effect. This will be needed in order to allow for the time to recruit external members onto the committee and to put in place decision-making procedures.

#### Communication

These changes were publicly foreshadowed through Labour Party policy prior to the 2017 election. They also reflect commitments made in the Coalition Agreement between New Zealand First and the Labour Party and are consistent with the Terms of Reference of the Review of the Reserve Bank Act. Changes will be announced in the usual way when agreed by Cabinet.

#### Other agencies

Other agencies that may be impacted by these changes include Statistics New Zealand, as discussed below, and the Treasury.

#### Transition to the new regime

##### *The new mandate*

The MPC will be responsible for the formulation of monetary policy consistent with the new mandate, supported by staff from the Reserve Bank. The inclusion of employment in the monetary policy objective will require some development of an analytical and decision making framework by the Reserve Bank:

- Reserve Bank staff will need to assist the MPC in defining “maximum sustainable employment” and has commenced research in this regard.
- Reserve Bank staff will need to provide the MPC with a framework to help them assess the relevant trade-offs in making monetary policy decisions, particularly where the employment and price stability objectives may come into conflict. The Reserve Bank will undertake research into decision making approaches, and some changes are likely to be required to the Reserve Bank’s modelling framework.
- More timely and detailed labour market statistics would aid decision making. The Treasury and the Reserve Bank have begun discussions with Statistics New Zealand about what would be possible within current data collection frameworks.

Generally, the research required to define the new mandate, and to support the MPC, is expected to be able to be met through the reallocation of existing research resources. However, if major changes to the modelling framework are required, this will require additional funding.

### ***The Monetary Policy Committee***

In order to establish an MPC, members will need to be recruited, remunerated and receive ongoing support.

There will be an initial recruitment effort for external members managed by the Board, which would carry associated costs. External MPC members will need to be appropriately remunerated, including travel, accommodation and disbursements. External MPC members will need to have access to desk space and technology while at the Reserve Bank, and also access to Reserve Bank staff for liaison and support.

The existing monetary policy process will also require some amendment. For example, the process for communicating monetary policy decisions will need to be re-considered. The timely preparation of the minutes and other MPC secretarial matters will require additional resourcing.

### ***Resultant Board changes***

The Board will have an enhanced role in recruitment, specifically of the external MPC members. This will place some initial time pressure on the Board for the recruitment of the foundation external MPC members, although once the staggered appointments are in place this will become more manageable. The Board will need to be allocated some financial resources to assist in this process.

The Reserve Bank Board will have to develop a new framework for assessing whether the MPC has acted in keeping with its employment objective and will have to adapt its processes to these new monitoring duties. The next stage of the Reserve Bank Act Review will consider the specification of the Board's duties and powers. Depending on the outcomes of this stage of the review, the Board may need further financial resource.

## **6.2 What are the implementation risks?**

The new employment objective will require the Reserve Bank to develop an operational framework and communications strategy in order to illustrate it is conducting monetary policy in a manner consistent with its new objective. Given the inherent difficulties in estimating the maximum sustainable level of employment and the uncertainties in how monetary policy contributes to that aim, there is a risk that the Reserve Bank will struggle to convey how its actions are consistent with its new employment objective thereby undermining the Reserve Bank's credibility.

This risk can be mitigated by actively undertaking an analysis of New Zealand's labour market ahead of the change in mandate. Nevertheless, there will be an element of learning by doing, which carries some transitional risk.

As discussed previously, there is also a risk that the market may see the employment objective as a weakening of the commitment to price stability in the medium term, causing inflation expectations to rise. This risk can be mitigated by maintaining a numerical target for inflation as an intermediate objective.

Shifting to a new MPC structure with three external members will require recruitment. There is a risk that New Zealand's small labour market has insufficient candidates that are both qualified and free from conflict of interest to fill such roles. This could result in candidates without the relevant expertise being appointed, which could reduce the efficacy of monetary policy decision making, or result in ongoing vacancies. This risk could be mitigated by recruiting members from overseas and, if this were to also prove insufficient, allowing the initial size of the MPC to be determined by the available pool of proficient external candidates.

# Section 7: Monitoring, evaluation and review

## 7.1 How will the impact of the new arrangements be monitored?

Under the Act, the Reserve Bank is required to publish an MPS which sets out the policies and means by which the Reserve Bank intends to achieve its objectives. These MPSs are referred to the House of Representatives (Finance and Expenditure Committee). The MPS provides a key means for the public and Members of Parliament to assess whether the Reserve Bank is meeting its objectives.

The Reserve Bank Board will retain their role as monitoring agent. The Board's role will be adapted such that it keeps the performance of the MPC, members of the MPC and the Governor under constant review.

The Treasury will monitor the arrangements of the new model and will continue its role in providing advice to the Minister of Finance on the Act. It is expected that the performance of the framework would be routinely reviewed alongside the periodic renewal of the operational objectives.

The Reserve Bank is required, under the Reserve Bank of New Zealand Act 1989, to provide an Annual Report (an annual accountability document) to the Minister of Finance no later than 3 months after the end of the financial year. The Annual Report contains a signed statement from the Governor, as well as the Board's assessment of the performance of the Reserve Bank's functions and the exercise of its powers. It also contains a summary of key activities, and presentation of the Reserve Bank's financial statements.

## 7.2 When and how will the new arrangements be reviewed?

There are currently no plans for a formal review of these changes, outside the commitment to periodic review alongside the renewal of the operational objectives. However, further review and consultation will occur as part of the phase 2 of the Reserve Bank Act Review.