

Report on including the governance of AMP tools in the scope of the advice on the MPC's remit

To	Hon Grant Robertson Minister of Finance	Date	22/09/2022
Authorised by	Adrian Orr	Report no	#5968
Prepared by	Katy Simpson	Security	Sensitive

Action Sought

Action sought	Deadline
<p>Note the contents of the paper.</p> <p>Respond to the memorandum through written communication.</p>	3 October 2022 (formal response)

Reserve Bank Contact for Telephone Discussion (if required)

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Actions for the Minister's Office Staff

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Note any feedback on the quality of the report.

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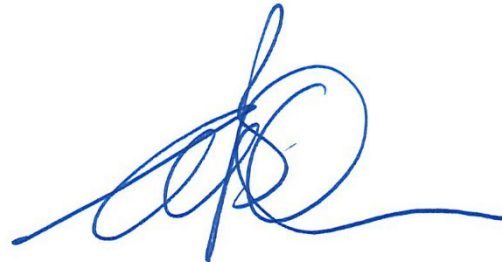
Report on including AMP tools in the scope of the advice on the MPC's remit

Recommendations

We recommend you:

- a. **note** the contents of this report
 - b. **note** that the Reserve Bank of New Zealand intends to include advice on options related to the remit's and charter's roles in governance of Additional Monetary Policy tools within the scope of the advice on the remit
 - c. **agree** to respond to this report through a formal written communication to the RBNZ
- agree / disagree

Hon Grant Robertson
Minister of Finance



RBNZ Governor Adrian Orr
Governor
Reserve Bank of New Zealand

22/09/2022

Report

Purpose

1. The Reserve Bank (RBNZ) will provide advice to you early next year on possible changes to the Monetary Policy Committee's (MPC) remit, as required every five years under the Reserve Bank of New Zealand Act 2021 ('the Act'). The RBNZ provided a memorandum on 29 August setting out the proposed scope of the review informing such advice (refer #5963). Following your meeting with RBNZ and Treasury officials on 5 September, this memorandum consults you on including a further issue in the scope of the Remit Review.

Background

2. With the Official Cash Rate (OCR) already at low levels, additional monetary policy (AMP) tools were first used by the MPC in response to the economic shock caused by the COVID-19 pandemic in March 2020. The MPC used Large Scale Asset Purchases (LSAPs) and the Funding for Lending programme (FLP), and has other tools available to support the response to future downturns – such as negative interest rates.
3. The MPC remit governs how the MPC should formulate monetary policy to achieve its stated objectives. The Act defines the high-level 'economic objectives' that monetary policy should endeavour to achieve (maintaining price stability and supporting Maximum Sustainable Employment). For monetary policy to achieve these general objectives, the MPC remit provides more narrow 'operational objectives' (such as keeping inflation within the one to three percent band) for the MPC to focus on in the formulation of monetary policy.
4. The RBNZ has tool independence, and therefore the remit does not specify what tools the MPC should use to achieve its operational objectives – such as the OCR or AMP tools. The use of AMP tools is not currently discussed in the remit or charter.
5. The RBNZ has the responsibility of implementing monetary policy decisions formulated by MPC and should be done in a financially responsible manner.

AMP tools and their current governance arrangements

6. Over the pandemic, all of the monetary policy tools used by the RBNZ – the OCR, LSAP, and FLP – worked to lower interest rates. AMP tools can provide a range of economic benefits: from supporting financial stability in times of market dysfunction to lowering interest rates and loosening overall monetary conditions, even when the OCR is at the effective lower bound.
7. AMP tools can impact the RBNZ's balance sheet. The RBNZ is part of the Crown, so any gains or losses on the Reserve Bank's balance sheet affect the balance sheet of the public sector. The MPC considers risks to the public sector balance sheet as one of the operational principles related to the use of AMP tools, which are published on the RBNZ's website. These principles are not part of the remit or charter.
8. Balance sheet risk arising from the actions of the MPC is primarily managed through the RBNZ's financial arrangements, which can be influenced or determined by the

Minister of Finance. In implementing the decisions of the MPC, the Reserve Bank Board must ensure that the Reserve Bank acts in a financially responsible manner (s47 of the Act). The Minister can also set a minimum capital level for the RBNZ (s208 of the Act), or indemnify the RBNZ against losses that arise from the use of AMP tools. The combination of the RBNZ's financial risk management and financial resources will determine how much balance sheet risk can be taken on by the MPC.

9. The financial arrangements of the RBNZ are currently under review as part of the implementation of the Act. As part of this review, the RBNZ will provide advice on how to best manage governance and the financial risks associated with AMP tools while preserving the operational independence of the MPC. This advice is expected to be delivered to you in early 2023.
10. The broader governance of AMP tools is set out in the '*Memorandum of Understanding between the Minister of Finance and the Reserve Bank of New Zealand regarding the use of alternative monetary policy tools*', agreed in March 2020. This sets out the purpose and authority to use AMP tools, as well as the process for requesting an indemnity and requirements around reporting and accountability.
11. The RBNZ is also undertaking a review and assessment of the formulation and implementation of monetary policy (RAFIMP). This will include an assessment of how AMP tools have been used and operated over the last five years. Our consultation paper and subsequent advice will draw on those lessons and consider any implications for the remit. The RAFIMP report will be delivered to you in November 2022 and will be published by the RBNZ shortly afterwards.

The coverage of AMP tools in the Remit Review

12. The RBNZ provided a memorandum on 29 August setting out the proposed scope of the Remit Review and advice (refer #5963). This recommended covering a range of topics, but did not recommend covering the use of AMP tools.
13. During the meeting between yourself and officials from the RBNZ and Treasury, you requested that advice on the Remit Review consider the experience of operating AMP tools and whether this would justify any adjustments to the MPC's remit or charter.
14. Following this discussion, the RBNZ would like to add the remit's and charter's role in governance of AMP tools to the scope of the Remit Review to ensure the final advice on the remit can support the best decision making and outcomes. Our advice will consider the appropriate role of the Remit and Charter in the governance of future use of these tools.
15. This would result in a scope of the Remit Review as set out in Table 1 below.

Next steps

16. Our preference is for you to respond to this memorandum and the previous one (#5963) through a formal written response. We intend to publish both reports and your response in due course.

Table 1: Summary of issues for the remit advice

Issue	Notes (RBNZ preliminary positions in <i>italics</i>)
Governance of AMP tools (NEW)	<p><i>The remit and the charter are not well suited to providing for the governance of AMP tools, and this is best addressed as part of the review of financial resources for the RBNZ.</i></p> <p>The RBNZ will be reviewing the operation of AMP tools as part of the Review and Assessment of the Formulation and Implementation of Monetary Policy. Reflecting on this experience, remit advice will consider the appropriate role of the remit and charter in the governance of future use of these tools.</p>
Alternative monetary frameworks	<p><i>The current regime ('flexible inflation targeting') remains the best framework.</i></p> <p>Alternative frameworks have been explored in detail by other central banks. This includes Price-Level Targeting, Average Inflation Targeting and Nominal GDP Targeting. These alternative frameworks can mitigate some of the risks posed by the Effective Lower Bound of monetary policy.</p>
Target level for price stability	<p><i>There is not enough evidence to suggest changing from the 2 percent target (1 - 3 band).</i></p> <p>The main imperative for increasing the inflation target is to address concerns around the Effective Lower Bound of monetary policy. Literature that focuses on the broader welfare costs generally suggest a lower inflation target may be better.</p>
Definition of the prices measure	<p><i>CPI remains fit-for-purpose and the best price measure.</i></p> <p>There have been some concerns in the public around how housing costs are reflected in the CPI and this matter featured in many submissions from the general public. However, alternative measures have significant drawbacks.</p> <p>Any improvements to the CPI itself would need to be addressed by Stats NZ (through a CPI Advisory Committee).</p>
Weighting or preference between objectives	<p>Introducing a hierarchy of objectives (i.e. stating that the MPC should put greater focus on either price stability or maximum sustainable employment) could mitigate risks around competing price stability and MSE objectives.</p>
Guidance for price stability	<p>Guidance for achieving price stability could provide more (or less) flexibility for MPC strategy to manage the trade-off between objectives. We will consider matters such as the width of the target band, whether an explicit midpoint should be retained, the horizon of the price stability target, and the treatment of transitory events.</p>
House price sustainability	<p><i>The Remit Review should focus on whether the requirement to assess the impact of monetary policy on house price sustainability should be included or not (or reflected in an alternative channel, such as the letter of expectations).</i></p> <p>Remit clauses 2(2)(d) and 2(3) were introduced in March 2021. This requires the MPC to 'assess' the impact of its decisions on house price sustainability. It may be more appropriate to incorporate concerns around house price sustainability into an alternative document, such as the letter of expectations.</p>
MPC charter	<p>The RBNZ is to consult the public on matters that will inform the MPC and the Minister on whether the existing charter should be replaced.</p>

Issue**Notes (RBNZ preliminary positions in *italics*)**

The RBNZ intends to explore the current consensus-building model alongside alternative models, as well as considering how well the current charter supports the consensus-building model.
