

# Supporting New Zealand's economic stability Toitū te Ōhanga

The five-year review of the Remit that guides monetary  
policy decisions: Advice to the Minister

Te arotake ā-rima tau o te Rīmiti e ārahi nei i ngā  
whakataunga kaupapahere moni: He Kupu Tohutohu  
ki te Minita

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Reserve Bank  
of New Zealand  
Te Pūtea Matua

## Contents

|                                                                            |           |
|----------------------------------------------------------------------------|-----------|
| <b>Foreword</b>                                                            | <b>2</b>  |
| <b>Executive summary</b>                                                   | <b>4</b>  |
| <b>1 Background</b>                                                        | <b>8</b>  |
| 1.1 The monetary policy framework                                          | 8         |
| Box A: A history of New Zealand's monetary policy framework                | 10        |
| 1.2 The current Remit Review                                               | 12        |
| Box B: Preferences across demographic groups in New Zealand                | 15        |
| 1.3 Principles to support the design of the <i>Remit</i>                   | 20        |
| 1.4 Challenges facing the economy and monetary policy                      | 23        |
| Box C: The Effective Lower Bound                                           | 25        |
| <b>2 Primary objectives</b>                                                | <b>28</b> |
| 2.1 Guidance for managing the trade-offs between objectives                | 29        |
| Box D: How MSE has been incorporated into MPC strategy                     | 38        |
| 2.2 Specification of the inflation target                                  | 40        |
| Box E: Potential enhancements of the All Groups Consumers Price Index      | 49        |
| 2.3 Recommendation to maintain an inflation targeting regime               | 51        |
| <b>3 Additional considerations and broader context for monetary policy</b> | <b>54</b> |
| 3.1 Financial stability                                                    | 58        |
| 3.2 Avoiding unnecessary instability                                       | 59        |
| 3.3 Governance of additional monetary policy tools                         | 60        |
| 3.4 House price sustainability                                             | 63        |
| 3.5 Monetary and fiscal policy coordination                                | 64        |
| 3.6 Accompanying text to the operational objectives                        | 65        |
| <b>4 The MPC Charter</b>                                                   | <b>69</b> |
| 4.1 Decision-making procedures in the <i>Charter</i>                       | 69        |
| Box F: How the MPC makes decisions under the 2021 <i>Charter</i>           | 70        |
| 4.2 Communications requirements in the <i>Charter</i>                      | 73        |
| <b>Glossary</b>                                                            | <b>76</b> |
| <b>References</b>                                                          | <b>77</b> |
| <b>Annex 1: 2021 MPC <i>Remit</i></b>                                      | <b>86</b> |
| <b>Annex 2: 2021 MPC <i>Charter</i></b>                                    | <b>90</b> |

## Foreword

This document presents the Reserve Bank's advice to the Minister of Finance on the future *Remit* for the Monetary Policy Committee (MPC). This follows the inaugural review of the MPC *Remit* as required by the Reserve Bank of New Zealand Act (2021).

Monetary policy plays an important role in the economic wellbeing of New Zealanders by maintaining price stability and supporting maximum sustainable employment. Underpinning this role is the operational independence of the MPC to pursue the operational objectives set out by the Government.

The *Remit* plays an important role in this framework in setting out the operating guidelines from the Government for the MPC to achieve price stability and support maximum sustainable employment, and in defining other considerations for the MPC to take into account when formulating monetary policy. The Remit Review is a welcome opportunity to review the framework to ensure that it remains robust and fit for purpose.

As part of the Remit Review, the Reserve Bank has undertaken extensive consultation with various stakeholders, including the public, the Minister of Finance, and the MPC.

The Reserve Bank undertook an initial public consultation in June 2022, seeking feedback on the scope of the Review. The Minister of Finance was also consulted on the scope of the Review following the public consultation. A second public consultation in November 2022 sought feedback on specific options for changes to the *Remit* and *Charter*.

These consultations covered a wide range of important issues for the monetary policy framework. These included underlying principles for *Remit* objectives: their legitimacy; their clarity to the public; and the credibility of monetary policy to achieve them.

The Reserve Bank also engaged with the public through surveys and workshops. These have supported our understanding of what matters to the public regarding monetary policy.

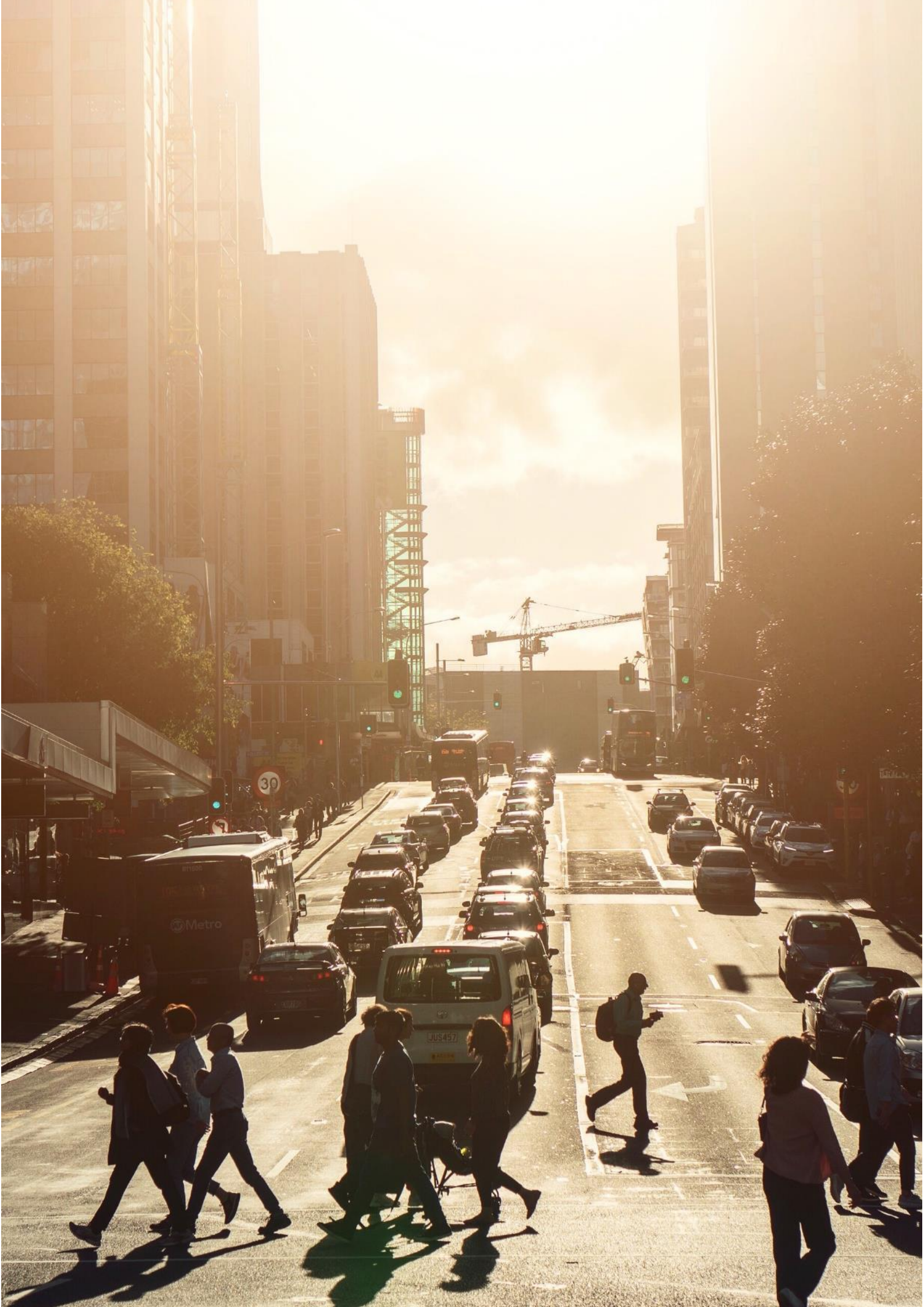
The Reserve Bank consulted the MPC on the recommended changes to the *Remit*. The summary record of this meeting will be published alongside this document, presenting the MPC's position on the Reserve Bank's proposed changes.

The recommendations to the Minister of Finance represent the Reserve Bank's view on which options are likely to best contribute to the wellbeing and prosperity of New Zealanders. The final decision for any changes to the *Remit* is the responsibility of the Minister of Finance.

I would like to thank all those who provided feedback on our consultations. The Reserve Bank has considered and taken into account all feedback in providing advice to the Minister of Finance on the proposed changes to the *Remit*.



Professor Neil Quigley  
Chair Reserve Bank of New Zealand





## Executive summary

The Reserve Bank has undertaken its inaugural review of the Monetary Policy Committee (MPC) *Remit* and *Charter* as required by the Reserve Bank of New Zealand Act (2021) (the 'Act').

Overall, the Remit Review (the 'Review') has found that the current framework of flexible inflation targeting – enabled through the *Remit* – remains appropriate. The recommended changes focus on providing greater clarity to the public on the monetary policy objectives and are not expected to change monetary policy strategy. Similarly, the MPC has suggested amendments to the *Charter* to support transparency and public accountability, such as clarifying the requirements for MPC members speaking externally.

As the first review under the Act, the Review traversed a wide range of issues that are relevant to the monetary policy framework. It included discussions on how the *Remit* could best contribute to the economic wellbeing of New Zealanders, the trade-offs between flexibility and credibility in the *Remit*, and the implications for monetary policy from the housing market, distributional outcomes and climate change.

The Review also considered the constraints that low long-term interest rates – a global phenomenon – has placed on conventional monetary policy, the importance of central bank independence and credibility, and the resilience of the framework to an economy facing more frequent supply shocks. These issues were taken into account alongside the broader welfare implications of monetary policy, such as from the level of inflation and how quickly the MPC should seek to restore inflation to target following a shock.

Throughout this process, the Reserve Bank has engaged with the public. There were two public consultations, deliberative workshops, surveys, public briefings and webinars. There was a wide range of views on key issues, including the extent to which the *Remit* should focus on the inflation objective over the maximum sustainable employment (MSE) objective and other considerations. On balance, the public engagement suggested that there was a slight preference for a greater emphasis on achieving low and stable inflation.

The Reserve Bank does not consider that significant changes are needed to the current monetary policy framework. The flexible nature of inflation targeting allows the MPC to consider and adapt its strategy to economic conditions. Amendments that provide greater clarity on how monetary policy will respond to economic shocks can enhance the credibility of the framework. This can provide some of the same benefits that would be achieved through a greater emphasis on inflation.

A *Remit* that more clearly describes how the MPC is expected to respond to different economic circumstances can support a better public understanding of how interest rates, inflation and the economy more generally will evolve in response to external shocks. To the extent that this provides more confidence that the MPC will achieve low and stable inflation in the medium term, households and businesses may be more likely to expect lower inflation in their future costs when thinking about what their current incomes and prices need to be today. This can, in itself, support more stable price-setting behaviour and inflation dynamics.

The recommendations from the Review are unlikely to materially change monetary policy strategy. However, in providing more clarity to the public, they will address some of the concerns raised by public submissions.

**The Reserve Bank considers flexible inflation targeting to be the most appropriate framework for New Zealand.** A flexible inflation targeting framework allows the MPC to support maximum sustainable employment (MSE) and consider other important issues, such as reducing volatility in the economy. This is the most common framework among advanced economies and it has become well-established and understood by the public.

**The Reserve Bank recommends retaining the flexibility provided by a 'medium term' time horizon for achieving the inflation target.** This medium-term focus on inflation targeting will provide the MPC with the flexibility to consider other objectives by taking longer to return inflation to target – within a reasonable interpretation of the medium term.

To support the clarity of the inflation objective, **the Reserve Bank recommends that the requirement to discount transitory inflation be retained and redrafted.** This clause communicates to the public how the MPC is likely to respond to different economic shocks under flexible inflation targeting.

The Reserve Bank also considered whether the *Remit* should incorporate a hierarchical ordering of objectives: that the MPC should support MSE subject to achieving the inflation objective. This would clarify that achieving price stability is an important prerequisite to pursuing other objectives in the *Remit*. It would also place more emphasis on an objective that is better measured – the inflation target – which can reduce policy errors from measurement issues associated with targeting less well-measured objectives. That said, there has been little practical experience in managing trade-offs between the inflation and MSE objectives since the dual mandate was introduced.

**The Reserve Bank considers that a hierarchical ordering of objectives would be beneficial.** There was a range of views among members of the MPC on this matter. Most members supported introducing a hierarchical ordering of objectives on balance as it would provide greater clarity of how the MPC is likely to act in some conditions. These members were also comfortable with the approach in the 2021 *Remit*. One member who supported a hierarchical ordering also noted that inflation was significantly easier to measure in real time. One member was strongly opposed to incorporating a hierarchical ordering with the view that it would reduce the flexibility for the MPC to use discretion when a trade-off arises between the two objectives.

**The Reserve Bank also considers that an inflation target centred on 2 percent remains appropriate.** Determining the optimal inflation target with accuracy is difficult, and there are arguments from research supporting both higher and lower targets. Furthermore, the 2 percent focus of the inflation target is well-established and there are costs in transitioning to a new inflation target.

Other specifications of the inflation target also remain fit for purpose. **The Reserve Bank recommends that the key aspects of the inflation target remain as defined in the 2021 *Remit*.** These include: defining the inflation target in terms of a target range with a midpoint focus; the two percentage point width of the target range; and using the 'All Groups Consumers Price Index' as the measure of prices for the inflation target.

In pursuing the inflation and MSE objectives, the MPC may also consider other matters that are important to economic wellbeing. The *Remit* specifies these additional considerations, which include having regard to financial stability, as well as avoiding unnecessary instability in output, interest rates, and the exchange rate. The scope of additional considerations for monetary policy to take into account has expanded over time. Most recently, the MPC has been required to assess the effects of its decisions on the Government's policy to support more sustainable house prices in the 2021 *Remit*.

While it is important that there are additional considerations specified for the MPC to take into account, a large number can cloud the focus of the MPC. Too many additional considerations creates a more complex *Remit* that may undermine public clarity and erode the perception of Reserve Bank independence.

**The Reserve Bank recommends that the additional considerations in the *Remit* only include requirements to avoid instability in the economy and to have regard to financial stability.**

This would retain the current requirements in clauses 2(2)(a), with some minor redrafting, and 2(2)(b). These are long-standing requirements in the framework. **The Reserve Bank recommends removing from the *Remit* the requirement to assess the impact of monetary policy on the Government's policy to support more sustainable house prices.** This requirement has been misinterpreted by some commentators and retaining it carries an ongoing risk of this misinterpretation. Removing the clauses – or addressing house price sustainability through other avenues – would also reduce the overall complexity of the *Remit*, supporting greater public clarity.

Similarly, **the text preceding the operational objectives of the 2021 *Remit* should be reduced to support clarity.** This would reduce perception risks for the Reserve Bank's operational independence. This recommended change would simplify the *Remit* document and place greater emphasis on the operational objectives for the MPC. The Reserve Bank does consider that retaining some text outlining the overall purpose of monetary policy, such as that defined in the Act, could support the legitimacy of the *Remit*.

An alternative option is to incorporate matters relating to house price sustainability into the text preceding the operational objectives. This text could also incorporate context relating to other issues that were discussed in the Review, such as the financial risks of some monetary policy tools and fiscal and monetary policy coordination. While this is not the Reserve Bank's recommended option, it carries less risk than incorporating these matters directly into the operational objectives.

The MPC has also made a number of suggestions for the *Charter* that would support greater transparency and accountability in the framework. These changes would provide greater clarity on the expectations on MPC members when they speak externally. Overall, the MPC considers that the consensus decision-making model remains appropriate.

# 1

## Background





# 1 Background

Monetary policy is a powerful economic tool that central banks use to maintain price stability and stabilise the economy. For monetary policy to best support the wellbeing of New Zealanders, it is important that the monetary policy framework remains robust to the challenges facing the economy and incorporates the latest developments in monetary policy research.

This Review is the first since the Reserve Bank of New Zealand Act (2021) was implemented. This document describes the Reserve Bank's recommendations to the Minister of Finance on potential changes to the *Remit*. It also presents the Monetary Policy Committee's (MPC) views on potential amendments to the *Charter*.

This chapter lays out the legislative framework underpinning the *Remit* and the broad approach taken for this Review. Key economic challenges facing economies and monetary policy, such as the global decline in long-term interest rates, are also discussed.

The second chapter outlines the recommended changes to the primary objectives in the *Remit* of achieving the inflation target and supporting maximum sustainable employment (MSE). It includes the role of the *Remit* in providing guidance – and by extension clarity to the public – on how the MPC should manage trade-offs between the inflation and MSE objectives. The main proposed changes to the primary objectives are focused on clarifying to the public the expected MPC response to economic shocks and are unlikely to materially change monetary policy strategy. The Reserve Bank is not recommending changes to the overall framework of flexible inflation targeting.

The other considerations that are specified in the *Remit* are discussed in the third chapter. They include the role of the current requirements relating to financial stability, avoiding unnecessary instability, and assessing the effect of monetary policy on house price sustainability, as well as other matters that may be considered through the *Remit*. Overall, the Reserve Bank is recommending changes that reduce the complexity of the *Remit* and provide greater clarity to the MPC on which matters to consider when setting policy. This includes recommendations to not include operational objectives related to: house price sustainability; the role of additional monetary policy (AMP) tools and financial risks from monetary policy; and fiscal policy and monetary policy coordination.

The fourth chapter discusses potential changes to the *Charter*. As the *Charter* is an agreement between the Minister of Finance and the MPC, the views of MPC members are presented. The MPC considers the current consensus decision-making model remains appropriate and has suggested amendments that focus on improving the transparency and accountability of decisions through other avenues.

## 1.1 The monetary policy framework

The Act provides the Reserve Bank with operational independence to pursue the economic objectives of achieving and maintaining price stability and supporting MSE. The Act also establishes the MPC as the decision-making body within the Reserve Bank that is responsible for formulating monetary policy to achieve these objectives.

To operationalise these high-level objectives, the *Remit* specifies ‘operational objectives’ that direct the MPC on how it should achieve price stability and support MSE under [Section 123](#) of the Act. It also specifies that the *Remit* may include guidance on how to manage trade-offs between these two objectives and additional matters that should be considered when setting monetary policy, such as financial stability.

The *Remit* is issued by the Minister of Finance. As a representative of the elected Government, the Minister of Finance can reflect the concerns of the members of the public when considering any changes to the *Remit*.

Alongside the *Remit*, the *Charter* sets the decision-making process, expectations supporting transparency and accountability, and reporting requirements for the MPC. Under [Section 102](#) of the Act, the *Charter* must include requirements for summary *Records of meetings* and guidelines on external communications from individual MPC members. The *Charter* may also include broader reporting requirements, decision-making processes and other matters. A key purpose of the *Charter* is to promote transparency and accountability in MPC decision-making.<sup>1</sup>

The *Charter* is as an agreement between the Minister of Finance and the MPC. When the Reserve Bank undertakes a review of the *Remit*, the Minister and the MPC must also consider whether changes are required to the *Charter*.

While the Review is limited to the *Remit* and *Charter*, the frameworks for monetary policy are broader. This broader context can be relevant for the design of the *Remit* and the *Charter*. In particular:

- The Reserve Bank regularly reviews recent economic cycles and the performance of monetary policy. These provide useful insights into and lessons on how monetary policy should be conducted in the future, which may include the design of the *Remit* and the *Charter*. The most recent review, the [Review and Assessment of the Formulation and Implementation of Monetary Policy \(RAFIMP\)](#), was completed in November 2022.
- The governance of the implementation of monetary policy and the management of the associated financial risks of monetary policy tools are the responsibility of the Reserve Bank Board. In contrast, the MPC is responsible for the formulation of monetary policy – determining the monetary policy settings that are most appropriate for given economic conditions and that are consistent with the *Remit*.
- The Reserve Bank often publishes research on important economic issues and shares relevant information with other public agencies. These aspects of the Reserve Bank’s work can support the Government in understanding and setting policy in some areas, such as housing.<sup>2</sup>

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<sup>1</sup> [Section 101](#) states that “(2) The purpose of the charter is to provide for the following to the extent that those matters are not otherwise provided for in this Act: (a) requirements to promote transparency and accountability in connection with the performance of the MPC’s functions; and (b) decision-making procedures.”

<sup>2</sup> Information sharing between agencies can be formalised through *Memorandum of Understanding*, or may occur through more informal channels, such as working-level groups. The Minister of Finance is also able to influence the Reserve Bank’s research agenda through the annual *Letter of Expectations*.

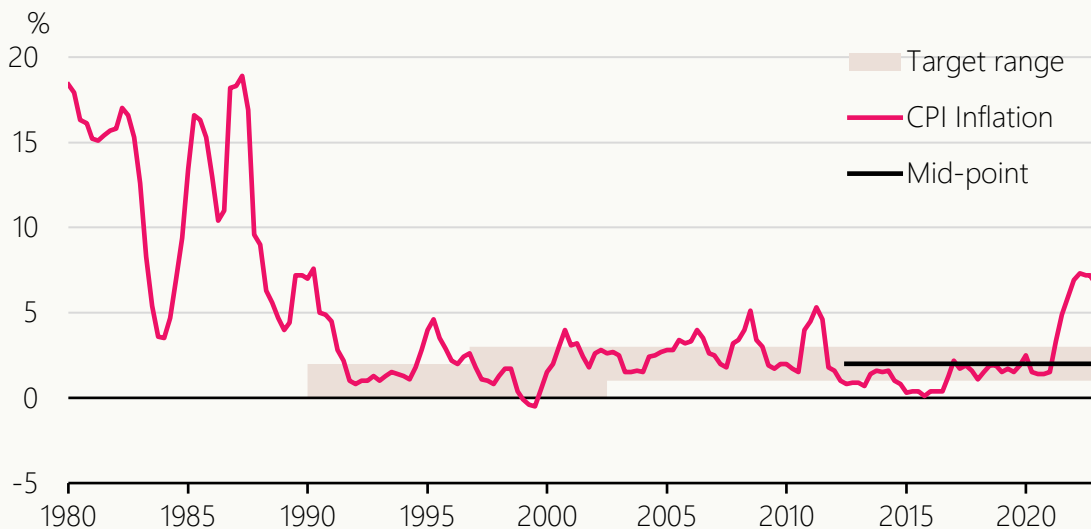
## Box A: A history of New Zealand's monetary policy framework

New Zealand's inflation-targeting monetary policy framework was formally established through the first *Policy Target Agreement (PTA)* in 1990.<sup>3</sup> This framework was introduced on the back of the high inflation experienced in the 1980s, with the earliest *PTAs* setting relatively strict expectations for inflation to be brought under control. The inflation rate fell quickly within the inflation target less than two years after the first *PTA* was introduced (see Figure 1).

The Reserve Bank of New Zealand Act (1989) also established the operational independence of the Reserve Bank to conduct monetary policy. This ensured that short-term political pressures – often related to election cycles – did not influence monetary policy decisions or result in an emphasis on near-term economic activity at the expense of price stability and long-term welfare.

Alongside this operational independence, the introduction of an inflation-targeting framework provided the Reserve Bank with a means to establish a credible commitment to the public that monetary policy would act to maintain low and stable inflation.

**Figure 1: Annual All Groups Consumers Price (CPI) inflation since 1980**



Source: Stats NZ

### Changing the calibration of the inflation target

The Reserve Bank initially adopted a 0 to 2 percent inflation target range in 1990. The width of the target band was then widened to 0 to 3 percent in 1996. This change was partly in response to the difficulty in maintaining inflation within the narrower band and concerns that pursuing a narrow target band could result in an undesirably high amount of volatility in the real economy.<sup>4</sup>

In the early 2000s, there was some public concern that the economy's growth rate had been unnecessarily constrained by a target that was too low and monetary policy that was too aggressive. In response to those concerns, the band was narrowed to 1 to 3 percent in 2002. Since then, inflation has remained mostly within this range and deviations from the range have mostly been driven by temporary shocks. Inflation was generally within the target band prior to COVID-19, albeit often below the midpoint.

<sup>3</sup> For a selection of papers on New Zealand's monetary policy framework, see [Buckle \(2019\)](#), [McDermott and Williams \(2018\)](#), [Grimes \(2014\)](#), [Bollard and Karagedikli \(2006\)](#) and [Reddell \(1999\)](#).

<sup>4</sup> See [Brash \(2002\)](#).

## Introducing more objectives for monetary policy strategy

As low and stable inflation became established in New Zealand, wages and prices increased at more stable and predictable rates. This made it easier for the Reserve Bank to continue to achieve stable inflation and, as a result, monetary policy could consider a broader range of economic factors. Over time, the framework progressively incorporated more of these additional considerations for monetary policy.<sup>5</sup>

The 1999 *PTA* instructed the Reserve Bank to “avoid unnecessary instability in output, interest rates and the exchange rate”. In 2012 the Reserve Bank was required to also “have regard to the efficiency and soundness of the financial system”, which aligned with a broader emphasis on financial stability following the Global Financial Crisis. The 2018 *PTA* introduced a second primary objective that requires the MPC to support MSE, and this was reflected in the first *Remit* in 2019.

The 2021 *Remit* introduced a requirement for the MPC to assess the effects of monetary policy on the Government’s policy to support more sustainable house prices. Although the clauses do not directly affect monetary policy decisions, the MPC discusses house price sustainability as part of monetary policy deliberations.

## Incorporating flexibility into inflation targeting

These additions created potential tensions with the inflation target as monetary policy cannot consider them while achieving the inflation target all the time. As a result, in order for monetary policy to be able to take into account these additions, inflation targeting became more ‘flexible’. This was possible in the first instance because high inflation had been brought under control and the credible inflation target supported more stable price-setting behaviour.

Implicitly, the introduction of the additional considerations themselves introduced a degree of flexibility in the regime. They created an expectation that monetary policy should consider broader economic issues – such as financial stability – and provided decision-makers with scope to take into account these additional considerations alongside inflation.

Flexibility was also introduced through clauses that allowed inflation to deviate outside the target range due to events that caused temporary price fluctuations. These clauses initially focused on specific events, but were widened over time to incorporate a broader range of reasons for inflation deviating from the target range. The 2002 *PTA* also redefined the inflation target as between 1 and 3 percent on average “over the medium term”, which provided more scope to incorporate additional considerations into monetary policy strategy.

An exception to the general shift to more flexibility was the introduction of a midpoint to the inflation target in 2012. Prior to this, inflation expectations had been drifting towards the upper end of the target band (see Figure 4 on page 24). The inclusion of the midpoint reinforced public and market confidence that longer-term inflation would average around 2 percent.<sup>6</sup>

The 2021 *Remit* reflects the evolution of the monetary policy framework in New Zealand as the structure of the economy, and our understanding of monetary policy, have developed. The Remit Review formalises the process for amending and updating the framework to ensure that it remains robust to the challenges facing the economy over the next five years and continues to best contribute towards the wellbeing of New Zealanders.



## 1.2 The current Remit Review

The *Policy Target Agreements (PTAs)* – the predecessors to the *Remit* – were often reviewed and renewed when there was a change in the Minister of Finance or the Governor of the Reserve Bank. These processes did not involve any engagement with the public and did not necessarily involve in-depth reviews.<sup>7</sup>

The Remit Review is the first review under the new process in the 2021 Act. In contrast to the previous reviews of the *PTAs*, the reviews of the *Remit* will occur on a more regular cycle: the next review will be within five years as prescribed by the Act.<sup>8</sup> This document and the associated Ministerial report provide the Reserve Bank's advice to the Minister of Finance on recommended changes to the *Remit*.

The process for this review, outlined in the Act, requires that the Reserve Bank seek views from the public on matters relevant to this advice and have regard to those views.<sup>9</sup> The Reserve Bank undertook public consultations on such matters from November 2022. The accompanying *Summary of submissions* outlines views provided in this consultation. The Reserve Bank also consulted the MPC, with their views reflected in the *Record of meeting*.

The Minister of Finance is responsible for making decisions on changes to the *Remit*. The Reserve Bank's advice documents also present MPC members' views on potential changes to the *Charter*. The *Charter* is an agreement between the Minister of Finance and the MPC, and both parties must consider whether any changes to the *Charter* are desirable when a new *Remit* is issued.

The advice to the Minister of Finance, the *Summary of submissions*, and other supporting documents are made publicly available once the Minister sets the new *Remit*.

### Process for Remit Review advice and decisions



### Initial public consultation

The Reserve Bank began engaging with the public on the Review in June 2022. The initial consultation document discussed the issues that should be in the scope of the Review and covered a broad range of topics. This consultation also included a discussion on the underlying principles for designing monetary policy objectives, which are described in the next section.

<sup>5</sup> See [Table 1.1](#) of the second public second public consultation document for a summary of the different changes to the *PTAs* from 1990 to 2018.

<sup>6</sup> See [Kendall and Ng \(2013\)](#).

<sup>7</sup> See [Svensson \(2001\)](#) as an example of an in-depth review of the framework prior to the Reserve Bank of New Zealand Act (2021).

<sup>8</sup> See [Section 2 of Schedule 3](#) of the Act (2021).

<sup>9</sup> These requirements are outlined in [Section 5 of Schedule 3](#) of the Act (2021).

One question from the consultation focused on the weight placed on the inflation and MSE objectives respectively. A large number of submitters supported a stronger emphasis on the inflation target. Some submitters also suggested that the *Remit* be amended so the MSE objective is subject to achieving the inflation objective. This specific policy option was considered in the second consultation.<sup>10</sup>

The first public consultation also discussed the interactions between the housing market and monetary policy. As an important component of the New Zealand economy, the forecasts used for formulating monetary policy incorporate the effects of house prices, construction costs and rents on the economy. The housing market can also pose macroeconomic risks that may be taken into account in monetary policy strategy. Since 2021 the *Remit* has required the MPC to assess the impacts of its decisions on house price sustainability.

The distributional outcomes of monetary policy and the effects of climate change were also discussed. These are important for the economic wellbeing of New Zealanders, and the Reserve Bank has undertaken research exploring them.<sup>11</sup> However, while these are important, it is not clear that monetary policy can meaningfully address the underlying drivers of these issues. There are other avenues – such as the *Letter of Expectations* – that are better-placed to influence the Reserve Bank’s research agenda and contribute to a better understanding of these issues.

Most public submissions supported the Reserve Bank’s position that distributional matters and climate change should not be incorporated into the *Remit*. A majority supported removing the clauses relating to house price sustainability from the *Remit*.

## Deliberative workshops and survey findings

Alongside these consultations, the Reserve Bank engaged with the public through a number of other forums. They included deliberative workshops, surveys, and public briefings.

These revealed that, while members of the public had a significant interest in the state of the economy, there was a limited understanding of some key aspects of monetary policy. The common economic terms: ‘Gross Domestic Product’, ‘Consumers Price Index’, and ‘Official Cash Rate’ were familiar to many people, but few had heard of ‘Maximum Sustainable Employment’.<sup>12</sup> Similarly, a large portion of respondents to the surveys were familiar with the Reserve Bank’s roles in managing cash, keeping inflation low and stable, and influencing interest rates, but were not familiar with its role of supporting MSE.

Deliberative workshops found that some members of the public confused the role of the Reserve Bank with the broader responsibilities of the government and had difficulty distinguishing between monetary policy and fiscal policy. Participants also did not expect to learn the details of monetary policy, but did expect to be made aware of how policy decisions would affect them in their everyday lives.

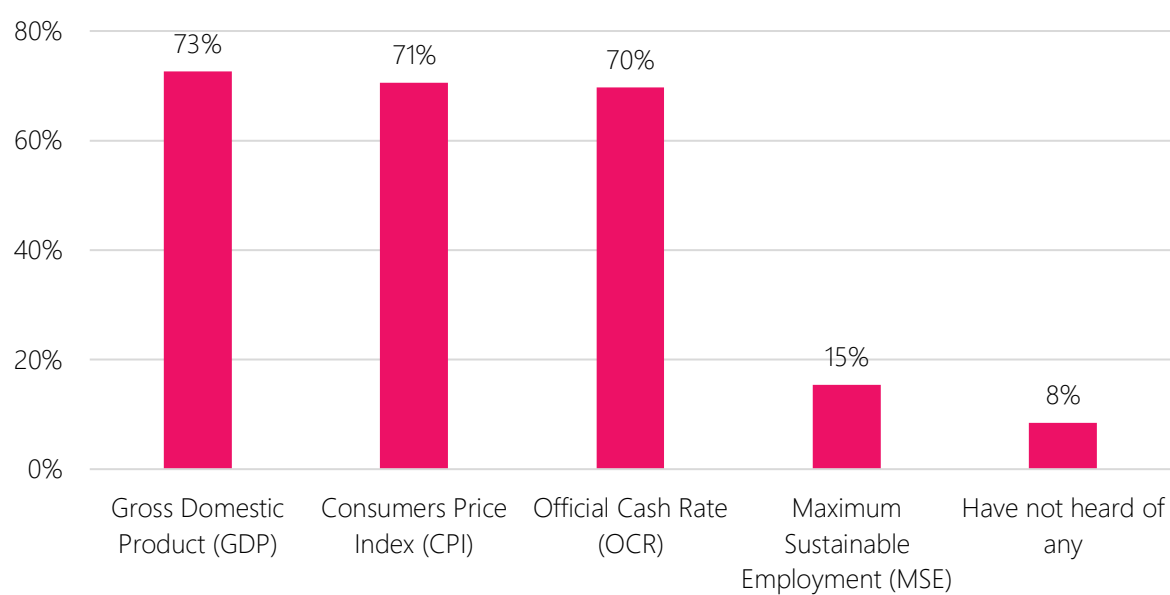
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<sup>10</sup> See the *Summary of submissions* from the first public consultation.

<sup>11</sup> For examples of Reserve Bank staff research on and analysis of the interaction between monetary policy and distributional issues, see [Chipeniuk and Nolan \(2022\)](#), [Leong \(2021\)](#), [Nolan \(2021\)](#), and [Markham, Özbilgin, and Robinson \(2022a,b,c\)](#). Additionally, the Reserve Bank has committed to understanding the impacts of climate change through its climate strategy; see *Climate Changed 2021 and Beyond: The Reserve Bank Climate Change Report*.

<sup>12</sup> These findings are based on a representative sample of 1000 New Zealanders. They do not include the results of a separate survey process that allowed members of the public to undertake the survey through the Reserve Bank’s website.

Figure 2: Share of respondents who had heard of each economic concept



Source: Reserve Bank.

Note: See footnote 13.

The deliberative workshops also provided insights into New Zealanders’ preferences between inflation, unemployment and other important economic factors. In general, participants were uncomfortable choosing between inflation and unemployment, but tended to prioritise inflation after considering the severity and extent of potential harm.

The Reserve Bank also conducted a survey that compared preferences for various unemployment and inflation outcomes, revealing the extent to which households would accept increases in unemployment in order for inflation to decline.<sup>14</sup> More respondents placed a greater emphasis on reducing inflation when the initial inflation rate was elevated; most were willing to accept a two percentage point increase in the unemployment rate in return for reducing inflation from five to two percent.<sup>15</sup>

These findings did vary when other considerations were introduced, such as the number of years in recession and the number of years required to save for a house deposit. There were also differences across demographic groups, although these were relatively small in the broader context of the overall diversity of views (see Box B).

<sup>13</sup> These results are from a representative survey of 1,000 New Zealanders. The results are derived from the questions: “Which of these terms have you heard before today?” and “Have you heard of maximum sustainable employment (MSE) before today?”. The ‘Have not heard of any’ category represents those respondents that had not heard of any of these economic concepts, including MSE, or responded that they did not know.

<sup>14</sup> This survey was conducted through the 1000 minds program.

<sup>15</sup> There is a range of results from literature on the effects of inflation and unemployment on household. There are also different results across countries and across demographic groups within research papers. For a selection of research in this area see [El-Jahel et al. \(2022\)](#), [Blanchflower et al. \(2014\)](#), [Scheve, K. \(2004\)](#) and [Di Tella et al. \(2001\)](#).

## Box B: Preferences across demographic groups in New Zealand

Monetary policy contributes to the wellbeing of New Zealanders by maintaining a stable general level of prices and supporting MSE. However, different segments of the population are affected by monetary policy differently and there may be different views across demographic groups on how monetary policy should manage different trade-offs.

The effects of monetary policy on issues that are important to different groups of society is complex. In part, this reflects the wide range of issues that people are concerned about, including the cost of living, unemployment, inequality, housing security and material hardship. The public's views on how monetary policy should consider and trade-off these matters is therefore likely to vary significantly.

The Reserve Bank has sought to better understand the range of public preferences for trade-offs, particularly with respect to inflation and employment. Alongside other considerations, understanding the public's preferences can help to inform the most appropriate strategies. A central bank's communication strategy can also be enhanced if the central bank better understands the range of preferences and concerns with respect to monetary policy outcomes.

### Range of preferences from public engagement

The Reserve Bank's public engagement highlighted that there is a wide range of views in New Zealand society. One survey sought to better understand the public's views on the trade-offs between inflation and employment, and assess how these preferences may change across different economic circumstances.

Respondents were, on average, equally averse to a one percentage point increase in the inflation rate and the unemployment rate. However, there was a considerable diversity in preferences. Depending on the specific circumstances posed to respondents, approximately a third were very averse to high inflation, a third were very averse to high unemployment; and the remaining third were equally concerned about inflation and unemployment but thought that other factors such as housing affordability or higher incomes were more important.<sup>16</sup>

The survey also provided insights into preferences across demographic groups. Young and low-income people had less tolerance for inflation; older and retired people had less tolerance for higher unemployment; and working-age people, people from Auckland, and people in households earning between \$100,000 and \$150,000 were more concerned about real income growth and housing affordability than others and less concerned about unemployment and inflation. However, these differences were small and not strongly correlated with observable characteristics such as age, gender, income, work-status, home-ownership status, education, or ethnicity – even when those differences were statistically significant.

For example, there were statistically significant differences responses between Māori and non-Māori respondents. Māori respondents, on average, were willing to accept a 1.28 percentage point increase in inflation in order to obtain a 1 percentage point reduction in unemployment.

<sup>16</sup> For between 28 and 52 percent of respondents a 0.5 percent increase in inflation was as bad as a 1 percent increase in the unemployment rate, whereas between 23 and 40 percent of respondents a 2 percent increase in inflation is as bad as a 1 percent increase in unemployment. The last group of people made up between 26 and 43 percent of respondents.



Meanwhile, non-Māori respondents were willing to accept a 1.12 percentage point increase in inflation in order to obtain a 1 percentage point reduction in unemployment.<sup>17</sup> However, the size of this difference is not large relative to the wide range of views and preferences among Māori respondents.

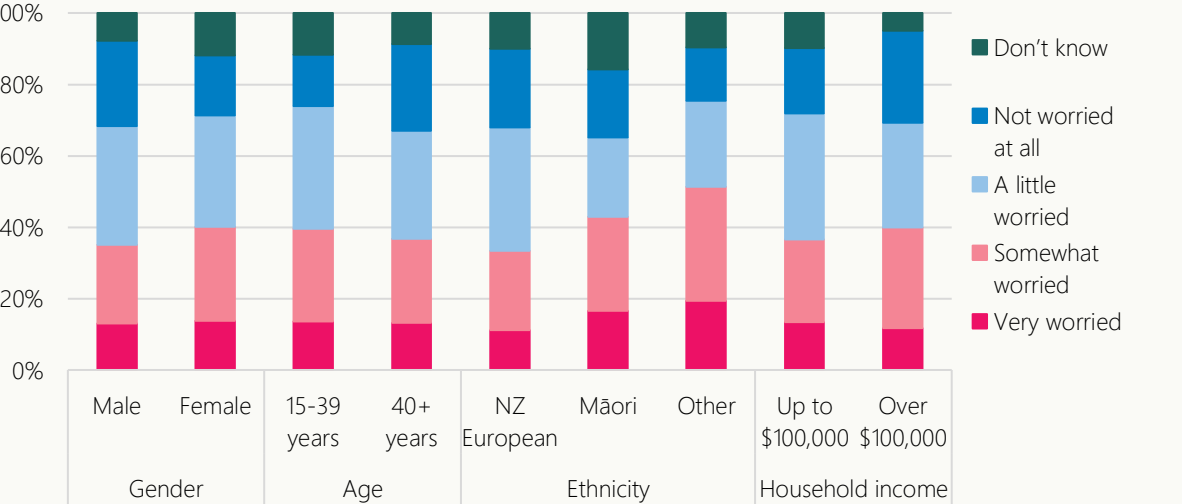
Similarly, another survey asked respondents to report on how concerned they were about unemployment increasing above 3.2 percent, which was the unemployment rate at the time. Figure 3 shows some notable differences in the extents to which people in New Zealand were worried about the unemployment rate being higher than 3.2 percent.

The most significant differences were across ethnicities. While 33 percent of respondents who identified as New Zealand European were somewhat or very worried about employment rising above 3.2 percent, the equivalent share for Māori respondents was 43 percent, and for respondents with other ethnicities it was 51 percent.<sup>18</sup> While the survey did not explore the direct trade-offs between inflation and unemployment, it does reveal the demographic groups that were most concerned about specific consequences of monetary policy decisions.<sup>19</sup>

There were also differences in views across other demographic characteristics. A higher proportion of males than females reported that they were “not worried at all” about unemployment increasing above 3.2 percent. Similarly, a higher proportion of younger New Zealanders appeared to be “somewhat worried” or “very worried” about rising unemployment.

Monetary policy decisions affect different demographic groups in complex ways. It is important that the Reserve Bank understands the preferences across society to inform our understanding of the trade-offs between the inflation and MSE objectives.

**Figure 3: Responses to the question “The current unemployment rate is 3.2%. How much do you worry about unemployment being higher than this?”**



Source: Reserve Bank.  
 Note: See footnote 20.

<sup>17</sup> These results comparing preferences between Māori and non-Māori come from questions where respondents chose between a reduction in inflation from 5 percent to 3 percent and a reduction in unemployment from 7 percent to 5 percent.

<sup>18</sup> These results may be explained by other demographic factors, such as age and income. Further research would be required to assess the statistical significance of these factors.

<sup>19</sup> The Dynata survey data does not provide data on respondents’ trade-offs between unemployment and inflation. For example, Māori respondents may be on average more worried about unemployment than New Zealand European respondents, but they may also be on average more worried about inflation.

<sup>20</sup> The gender category does not include respondents who selected “another gender” or “prefer not to say” given the small sample size (four respondents). Respondents could select multiple ethnicities. Some respondents’ responses are therefore included in multiple categories. For example, if someone reports as Māori and New Zealand European, their response regarding the unemployment rate is captured in both of these groupings.

## Findings from the *Review and Assessment of the Formulation and Implementation of Monetary Policy*

The Reserve Bank undertakes regular reviews of monetary policy and recent economic cycles. The focus of and processes for these reviews were updated in the 2021 Act.<sup>21</sup> The first review under this new process, the *Review and Assessment of the Formulation and Implementation of Monetary Policy (RAFIMP)*, was completed in November 2022.

The RAFIMP provided several learnings from the past five years that are relevant for monetary policy frameworks and strategies. It found that monetary policy had been undertaken in a manner consistent with the objectives in the *Remit*, although in hindsight monetary policy should have been tightened sooner in 2021.

The RAFIMP noted that, from 2017 to 2022, the inflation and MSE objectives had not come into conflict. This meant that the ability for the monetary policy to manage trade-offs between these objectives has largely not been challenged. If shocks that affect the productive capacity of the economy ('supply shocks') – such as extreme weather events – become more frequent, this could test how the framework addresses such trade-offs.

Another conclusion was that providing credible and clear communications is critical in monetary policy implementation. The design of the operational objectives in the *Remit*, and the reporting requirements and expectations around external communications for MPC members in the *Charter*, can support such communications.

The RAFIMP also noted that prudential policy is the best way to limit financial stability risks resulting from the housing market. As the Reserve Bank has a suite of macroprudential policy tools, this reduces the need for monetary policy to explicitly address risks in the housing market.

Other findings from the RAFIMP, such as the need to develop better measures of neutral interest rates, were not directly related to the recommendations around the design of the *Remit* or *Charter*. However, future Reserve Bank research and analysis in this area will support monetary policy strategies and subsequent reviews of the framework.

## Consultation with the Minister of Finance on the scope of the Review

Following the initial consultation and public engagement, the Reserve Bank consulted the Minister of Finance in September 2022 on the scope of the policy options to consider in the second consultation. The Minister of Finance agreed with the Reserve Bank's recommendation that distributional outcomes and climate change – while important to the wellbeing of New Zealanders – should not be included directly in the scope of policy options. The role of the housing market was also limited to focus on the current requirement around assessing house price sustainability.

The Minister of Finance agreed that the definition of MSE did not need to be further specified as part of the Review. The Minister also considered that the governance of AMP tools should be included in the Review.<sup>22</sup> See Section 3.3 in this document for a discussion on this issue.

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<sup>21</sup> See Section 131 of the Act.

<sup>22</sup> See Report on additional monetary policy tools in the scope of advice and Letter from the Minister of Finance to the Governor.

On the back of this, the Reserve Bank publicly consulted on specific policy options and changes to the *Remit* and *Charter* from November 2022. While the second consultation had a narrower focus than the first consultation, it included a broad range of issues relevant for monetary policy frameworks. Table 1 provides a brief summary of each policy issue.

The Reserve Bank's positions in the public consultation were largely focused on improving the clarity of the framework and were unlikely to change monetary policy strategy materially. These included reducing the complexity of the *Remit* and mitigating risks relating to the perception of the Reserve Bank's operational independence.

**Table 1: Policy issues in the second public consultation**

| Issue                                                      | Summary                                                                                                                                                                                                                                                                                                                                                                                     |
|------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Guidance for managing trade-offs between objectives</b> |                                                                                                                                                                                                                                                                                                                                                                                             |
| Hierarchical preferences for inflation and MSE objectives  | The <i>Remit</i> can define a weighting scheme to guide how the MPC manages trade-offs between the inflation and MSE objectives. The second public consultation discussed whether hierarchical preferences – a form of weighting scheme where the inflation objective is emphasised under certain conditions – should be introduced to provide greater clarity on monetary policy strategy. |
| Time horizon for the inflation target                      | The 2021 <i>Remit</i> defines the inflation target as 1 to 3 percent “over the medium term”. This time horizon is not defined and allows the MPC to adapt its strategy for returning inflation to target, providing much of the flexibility in the framework. A specified time horizon may support greater clarity but limit flexibility.                                                   |
| Discounting transitory inflation                           | The 2021 <i>Remit</i> requires the MPC to “discount events that only have a transitory effect on inflation”. This requirement does not have a material effect on strategy as the MPC already has a medium-term focus, but can provide further clarity to the public.                                                                                                                        |
| <b>Specification of the inflation target</b>               |                                                                                                                                                                                                                                                                                                                                                                                             |
| The level of the target                                    | There are arguments for both raising and lowering the 2 percent inflation target. There are also costs associated with changing the inflation target, particularly in the current environment of heightened inflation.                                                                                                                                                                      |
| The type of inflation target                               | The inflation target has been defined as a target range with a midpoint focus since 2012. The types of targets – a range target, a point target, and a range target with a midpoint focus – vary across countries. Literature is mixed on which approach is best.                                                                                                                           |
| The width of the target range                              | The target range is one percentage point above and below the midpoint focus in the 2021 <i>Remit</i> . The main reason for having a target range in the current framework is to convey to the public the degree of uncertainty in inflation targeting.                                                                                                                                      |
| Measurement of prices                                      | The CPI has been the measurement of prices for the purposes of inflation for almost the entire period of inflation targeting. Alternative measures were assessed against a range of criteria in the second consultation.                                                                                                                                                                    |

| Issue                                                                                               | Summary                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
|-----------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Alternative frameworks for defining price stability</b>                                          |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |
| Flexible inflation targeting compared with alternatives                                             | Academic research and central bank reviews overseas have explored alternative monetary policy frameworks. These alternative frameworks can address some of the challenges facing monetary policy, particularly around the Effective Lower Bound (ELB). However, there is little experience with the real world application of these frameworks. <sup>23</sup>                                                                                                                                                                                                                                                |
| <b>Additional objectives for the MPC to consider in the pursuit of inflation and MSE objectives</b> |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |
| Avoiding unnecessary instability                                                                    | Requirements for decision-makers to avoid causing unnecessary instability in the economy are longstanding in the New Zealand framework. It is generally accepted that placing at least some weight on macroeconomic stabilisation in monetary policy decisions is welfare enhancing. The 2021 <i>Remit</i> specifies that the MPC shall “avoid unnecessary instability in output, interest rates and the exchange rate”.                                                                                                                                                                                     |
| Financial stability                                                                                 | Many central banks have incorporated requirements for monetary policy to consider financial stability, particularly following the Global Financial Crisis. The 2021 <i>Remit</i> defines this requirement in terms of the language used in the 1989 Act. The second consultation focused on redrafting this requirement to align with <a href="#">Section 119</a> of the Act.                                                                                                                                                                                                                                |
| Assessing house price sustainability                                                                | The 2021 <i>Remit</i> introduced a requirement for the MPC to assess the effect of its decision on the Government’s policy to support more sustainable house prices. This requirement has been misinterpreted by some commentators as being a requirement to ‘have regard to’ house price sustainability. Rather, this is an assessment requirement for the MPC and does not directly interact with the formulation of monetary policy. The Reserve Bank consulted on the removal of these clauses from the <i>Remit</i> .                                                                                   |
| The role of AMP tools and financial risks                                                           | The role of AMP tools and financial risks associated with monetary policy was also explored in the second consultation. It focused on whether there was a role for the <i>Remit</i> to incorporate requirements relating to these issues. The Reserve Bank raised a number of concerns with such a requirement, including in relation to unintended consequences and risks to the perception of central bank independence. The Reserve Bank also viewed the broader frameworks in place as adequate in that staff already considered the key issues and risks associated with the use of AMP tools.          |
| Fiscal policy and monetary policy coordination                                                      | The second public consultation provided an opportunity for the public to discuss the role of fiscal and monetary policy coordination. While this is an important issue for the Reserve Bank, other avenues, such as <i>Memoranda of Understanding</i> , are better placed to support coordination between agencies.                                                                                                                                                                                                                                                                                          |
| Text accompanying the operational objectives                                                        | The 2021 <i>Remit</i> is preceded with text that is not directly related to the operational objectives. The text communicates the broader context within which monetary policy operates, drawing a connection between the operational objectives and the overall purpose of monetary policy to support the prosperity and wellbeing of New Zealanders. At the same time, the broad nature of the Government’s objective in the 2021 <i>Remit</i> document may create risks to the perception of the Reserve Bank’s operational independence and cloud the public’s understanding of what the MPC’s focus is. |

<sup>23</sup> The only real-world examples of these frameworks are the US adopting flexible average inflation targeting in 2020, and Sweden briefly adopting price-level targeting in the 1930s.

### 1.3 Principles to support the design of the *Remit*

While the Act outlines the purpose of the *Remit* and provides guidance on its content, the design of the *Remit* should take into account several other important considerations. These include the need to support the public legitimacy of the framework, balance the role of maintaining price stability and considering other objectives, and support the accountability of the MPC.

#### Operational independence and public legitimacy

As the Reserve Bank has operational independence, it is important that the monetary policy framework maintains public legitimacy. The Reserve Bank engages with the Minister of Finance, who – as an elected representative – decides on the specific objectives in the *Remit*. An important aspect of central bank independence is that the targets set for monetary policy broadly align with outcomes that best support the long-term wellbeing and prosperity of New Zealanders. The operational independence of the Reserve Bank allows the MPC to pursue these objectives without facing pressure to emphasise short-term economic gains at the expense of longer-term outcomes.

In this context, operational independence is best supported when there are clear, transparent, achievable and measurable objectives for monetary policy. Without a clear objective that can be monitored in a transparent manner, a central bank's legitimacy could become precarious as it would be left with a wide scope to set policy and define its own success criteria.<sup>24</sup> Clear and measurable targets also ensure that the public can hold central banks accountable for their roles. This would support public confidence in the integrity and effectiveness of monetary policy decisions, and also ensure that decision-makers remain focused on the stated objectives.

Having a *Remit* with many broad and imprecise objectives increases the risk that the objectives will come into conflict and the risk that the MPC will have to make value judgements on trade-offs between objectives. In such cases it becomes less clear how the MPC would respond in any particular scenario, and whether its value judgements would be the same as those society at large. This could undermine the public legitimacy of the Reserve Bank's operational independence over time.<sup>25</sup>

#### Balancing price stability with other considerations

In the long run, monetary policy's best contribution to wellbeing is maintaining price stability, which creates the conditions for high productivity and employment. Monetary policy also affects the real economy in the shorter-term. Taking this into account when formulating monetary policy can improve wellbeing.<sup>26</sup>

A key challenge when designing monetary policy frameworks is balancing the need to support a central bank's commitment to maintaining price stability with providing enough flexibility for the decision-maker to adopt strategies that can consider these short-run effects on the economy. This is complicated by the fact that the extent to which monetary policy can sustainably consider these short-run effects depends on the credibility of the decision-maker's commitment to the inflation objective.

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<sup>24</sup> See Tucker (2018) for a discussion on this point as well as other considerations that support the legitimacy of central bank independence.

<sup>25</sup> Issing (2019) discusses how central bank communications affects the effectiveness of monetary policy, and notes that communications should not become blurred by additional tasks.

<sup>26</sup> Woodford (2003) and Rotemberg and Woodford (1999) suggest that reducing interest rate and output volatility, at the expense of higher inflation volatility, can improve welfare.



If the MPC's commitment to price stability is not perceived as credible, households and businesses may adapt their price- and wage-setting behaviour in anticipation of higher future inflation. This makes it more difficult for the MPC to achieve the inflation objective and can require larger monetary policy moves to keep inflation expectations anchored to the inflation target, which would come at the cost of other short-term considerations. Overall, it reduces the scope for monetary policy to consider other objectives while maintaining price stability.<sup>27</sup>

This tension between supporting stable price and wage-setting behaviours and taking into consideration the benefits of macroeconomic stabilisation is a long-lasting challenge for monetary policy. The extent to which the monetary policy framework in New Zealand has emphasised the objective to maintain low inflation has changed over time (see Box A on page 10). This has, in large part, reflected changes in the structure of the economy. In particular, the Reserve Bank established a credible commitment to the public that monetary policy would act to maintain low and stable inflation in the 1990s. This allowed subsequent changes to the framework to incorporate additional considerations, such as avoiding unnecessary instability in output, interest rates, and the exchange rate.

## The role of clarity for the public

The *Remit* should also support public accountability for monetary policy decisions by providing clear objectives for monetary authorities to achieve. This supports the ability of the public to monitor the performance of monetary authorities and ensures that decision-makers remain focused on the stated objectives of the framework. It can also support the overall legitimacy of monetary policy by supporting the public's understanding of the framework.

The clarity of the *Remit* can also contribute to the beliefs that households and businesses have in relation to the MPC's commitment and ability to achieve its objectives. A *Remit* that is complex and has many additional considerations for the MPC may undermine those beliefs and possibly lead to a misinterpretation of the *Remit* objectives. In this way, clarity to the public matters for supporting the perceived credibility of the MPC's commitment to low inflation. A clearer *Remit* can therefore better support well-anchored inflation expectations.

## Incorporating these considerations in the Review

To support the process of designing a *Remit* that incorporates these considerations, the Reserve Bank established a set of principles that could be used to guide the design of the *Remit* in the first public consultation. These are restated below:

- **Legitimacy:** the *Remit* aligns with the MPC's economic objectives of achieving and maintaining price stability and supporting MSE.

The MPC's economic objectives are set out in the Act, and the *Remit* must align with these legislated objectives. This maintains the legitimacy of the framework by ensuring that the MPC is working towards the objectives that Parliament has tasked it with achieving. Additions to the *Remit* must not compromise or hinder the MPC's ability to achieve the economic objectives.



<sup>27</sup> See [Box C](#) of the second public consultation for a discussion on this point. Also see [Kydland and Prescott \(1977\)](#) for a seminal paper on time-inconsistency matters.

Furthermore, the purpose of the Act is to promote the prosperity and wellbeing of New Zealanders and to contribute to a sustainable and productive economy. Designing a framework that – in keeping with the purpose of the Act – best promotes wellbeing also supports the broader democratic legitimacy of the framework.

- **Credibility:** the public holds a durable belief that the MPC can achieve the objectives in the *Remit*.

Credibility is important for effective monetary policy. If the public expects that the MPC will achieve its inflation target, this ‘anchoring of expectations’ makes it more likely that prices and wages will be set in a manner consistent with the inflation target, even in the face of shocks to the economy. This makes it easier for the MPC to achieve price stability and provides greater scope for the MPC to stabilise short-run economic activity and support MSE.



- **Achievability:** monetary policy has a clear and measurable effect on every objective in the *Remit*.

Some objectives may be influenced by other factors more than by monetary policy, meaning that using monetary policy to achieve such objectives may impose economic and wellbeing costs that outweigh the benefits. An unachievably large number of objectives, conflicting objectives, or objectives that are outside the control of monetary policy, can pose risks to the credibility of the MPC’s commitment to price stability and supporting MSE.



- **Flexibility:** targets for the economic objectives are not so strict as to adversely impact overall wellbeing.

Instead of responding to all changes to inflation in the same way, a flexible inflation target allows the MPC to distinguish between temporary and persistent changes to inflation. Moreover, flexibility allows the MPC to maximise its contribution to supporting MSE and stabilising economic output, subject to ensuring that inflation remains well-anchored at the target midpoint.



The flexible inflation targeting framework can be considered as monetary policy’s best long-term contribution to the wellbeing of New Zealanders, as reflected in the economic objectives of the *Remit*. The specification of the economic objectives in the *Remit* also empowers the MPC with the flexibility to take into account other considerations, such as the effect of monetary policy on short-term economic activity.

- **Clarity and transparency:** the public can monitor the performance of the MPC against the *Remit*.

The *Remit* should provide the MPC with clear guidance for its objectives and the strategies it can use to achieve them. The MPC’s operational independence rests on sustained public confidence in the integrity and effectiveness of its decisions. Transparency includes the need for the MPC to explain its decisions to the wider public, and ensures that the public can hold the MPC accountable. The objectives in the *Remit* should support transparency and accountability.



## 1.4 Challenges facing the economy and monetary policy

Monetary policy frameworks have faced various challenges in history. The 1970s and 1980s, for example, were characterised by high inflation and central banks had to establish their public credibility as inflation targeters to stabilise pricing dynamics in the economy.

A key challenge that has emerged for central banks has been the persistent decline in 'neutral' rates since the 2000s. This contributed to the low-interest-rate environment that followed the Global Financial Crisis, and continues to pose risks around the ability of monetary policy to provide stimulus in the face of an economic downturn.

More recently, the past few years have seen price shocks from disruptions to supply chains from the COVID-19 pandemic and the war in Ukraine. This has contributed to rising inflation globally and contrasts with the period before COVID-19, which was dominated by demand-driven shocks to the economy.

### **The decline in neutral rates, the Effective Lower Bound and additional monetary policy tools**

The steady decline in neutral interest rates in the past two decades has increased the risk that monetary policy could become constrained by the ELB. That is – in the face of large deflationary shocks – conventional monetary policy may be unable to support economic activity and the ability of the MPC to achieve the inflation target or support MSE could be severely hindered.

This has been a common focus in reviews of monetary policy frameworks overseas and has been considered through a number of channels: increasing inflation targets; ensuring there is flexibility to pursue a range of monetary policy strategies; and adopting alternative monetary policy frameworks.<sup>28</sup>

Central banks, including the Reserve Bank of New Zealand, have also developed AMP tools. These tools provide stimulus through channels that are different from conventional monetary policy, expanding the total amount of stimulus the MPC can provide when interest rates are very low.

While these AMP tools are useful in providing additional monetary policy stimulus, they are not perfect substitutes for conventional monetary policy tools. In particular, some AMP tools can have a material effect on the consolidated Crown balance sheet by shifting risk in government funding.<sup>29</sup> See Box C for a more detailed discussion on the implications of the ELB.

### **More frequent supply-side shocks following the COVID-19 pandemic**

The 2021 *Remit* does not provide any guidance to the MPC on how to balance its inflation and MSE objectives, and in most circumstances there is no conflict between these objectives.

However, the onset of COVID-19 and the war in Ukraine have seen more frequent shocks to the cost of supplying goods for businesses, which have increased prices without increasing economic activity. While the two objectives have not been in conflict for much of the period following 2020, these types of shock can accentuate the trade-offs between the inflation and MSE objectives for the MPC.

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<sup>28</sup> For examples of recent reviews of monetary policy frameworks overseas, see [Federal Reserve \(2020\)](#), [Bank of Canada \(2021\)](#), and [European Central Bank \(2021\)](#).

<sup>29</sup> See [Chapter 3](#) of the RAFIMP for a discussion on the estimated macroeconomic impacts of AMP tools and the effects of AMP tools on the Crown balance sheet.

In the context of more frequent extreme weather events caused by climate change and a potential shift in the global economy towards regionalisation, there is a risk that such shocks will occur more frequently.<sup>30</sup> In such instances the MPC could face greater trade-offs between maintaining price stability and supporting MSE, and may have less scope to take into account other considerations such as seeking to avoid instability in interest rates and output.

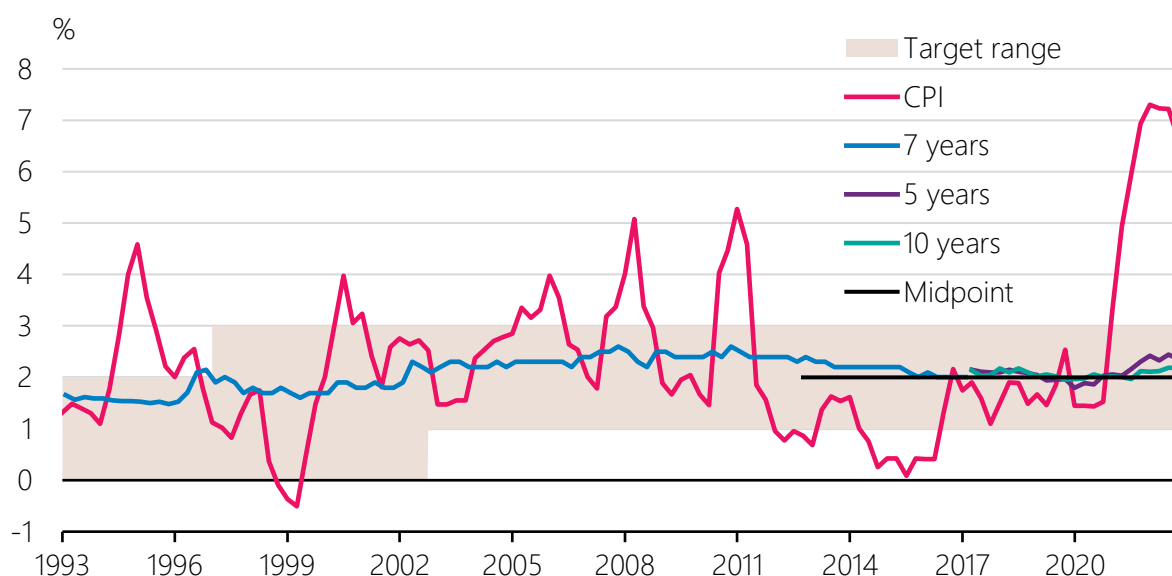
Furthermore, if monetary policy strategies become unclear to the public in the face of such shocks, this may pose challenges to the credibility of the MPC's commitment to return inflation to target. At the same time, the nature of these shocks is more likely to cause the MPC to use the flexibility afforded in the framework to manage these trade-offs.

## Heightened inflationary environment

The high level of inflation experienced in the past two years has seen the public's expectation of future inflation drift up from the 2 percent midpoint. The average of businesses' expectations for inflation in five and ten years' time reached 2.4 and 2.2 percent respectively in March 2023. Given the importance of households' and businesses' beliefs around future inflation, less well-anchored expectations could create challenges for the credibility of the framework.

A loss in central bank credibility can have enduring effects on the conduct of monetary policy, making it more difficult for monetary policy to support MSE and take into account other considerations.<sup>31</sup> It can also be difficult to regain such credibility once it has eroded.

**Figure 4: Businesses' expectations for annual CPI inflation (%)**



Source: Reserve Bank's *Survey of expectations*, Aon Hewitt Economists' Survey, Stats NZ

Note: See footnote 32.

<sup>30</sup> For a discussion on how climate change may affect inflation in New Zealand, see *Monetary Policy Statement November 2021*. Also see [Brainard \(2022\)](#) and [Lagarde \(2022\)](#) for discussions by other central banks on the implications of deglobalisation and supply shocks for monetary policy.

<sup>31</sup> See [Borio et al. \(2023\)](#) for an example of how price-setting dynamics change when entering into a high inflation environment.

<sup>32</sup> The 7 year inflation expectations represents data from the Aon Hewitt: Expected CPI inflation - 7 years ahead. This data comes from the Aon Hewitt Economists' Survey. The survey was a small, select group of around seven New Zealand banks and economic agencies. The data show Expected CPI inflation - 7 years ahead from 1993-2017. The 5 and 10 year inflation expectations data is from the Reserve Bank's Survey of expectations (M14) which is a survey of forecasters, economists and industry leaders. The survey is conducted quarterly by the Nielsen Company on behalf of the Reserve Bank.

## Box C: The Effective Lower Bound

When central bank policy rates reach low levels, the amount of stimulus provided by lowering policy rates further begins to diminish. This can eventually reach the point, known as the 'Effective Lower Bound' (ELB), where central banks are unable to meaningfully provide stimulus through conventional policy.

The ELB occurs due to the effect of very low or negative interest rates on people's behaviour. When nominal interest rates are negative, bank customers have to pay to deposit their money at a bank. As a result, negative interest rates incentivise people to withdraw their cash as the cost of paying interest on bank deposits may outweigh the 'cost' of holding physical currency. This reduces the effectiveness of monetary policy as people can circumvent the banking system and are therefore less sensitive to further reductions in saving rates.

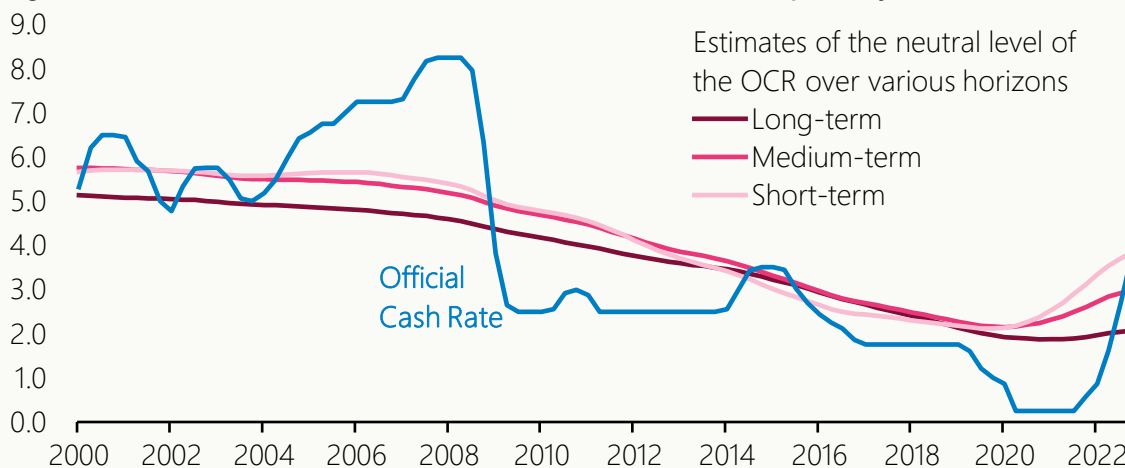
As it becomes more difficult to lower deposit rates, the spread between deposits and lending rates also becomes compressed. This can limit how much lending rates are reduced in response to policy rate cuts. By extension, this reduces the amount of new lending in response to a lower central bank policy rate, and hence the flow-through of monetary policy to the economy.

There can also be technological constraints in implementing interest rates that are very low or negative: some computer systems may not be able to transact negative interest payments.

### The decline of neutral rates and how central banks have responded

Neutral interest rates have declined in the past 20 years to historically low levels due to structural factors such as global saving and investment patterns, declining productivity growth, and aging populations. Monetary policy is unable to meaningfully influence these factors. This means that interest rates must be lower today than they were in the early 2000s in order to provide the same amount of monetary stimulus. That is, the level of the Official Cash Rate (OCR) that could be considered 'expansionary' is lower today due to these structural changes in the economy. This has increased the risk of monetary policy becoming constrained by the ELB.

**Figure 5: Decline in interest rates in New Zealand since 2000 (% , quarterly data)**



Source: Data is from the February 2023 MPS.

Note: See footnote 33.

<sup>33</sup> Estimates of the neutral OCR are uncertain as it is not directly observable. The relevant measure for the neutral OCR can also vary over time horizons. See chapter 4 of the [November 2022 MPS](#) for further information on estimates of the neutral interest rate.



## How central banks have sought to mitigate risks from the ELB

Comparable central banks have considered the growing risks posed by the ELB when reviewing their monetary policy frameworks. Most consider an inflation target around 2 percent to be appropriate, but some have adapted other aspects of their frameworks to mitigate ELB risks.

The US Federal Reserve adopted ‘flexible average inflation targeting’ in August 2020, in part due to the proximity of interest rates to the ELB. This introduced ‘history dependence’ to the framework, whereby previous shortfalls in meeting the inflation target require higher-than-otherwise inflation in the future.<sup>34</sup> Introducing history dependence can support higher expected future inflation, effectively reducing real interest rates to produce additional stimulus.

The Bank of Canada’s 2021 review of monetary policy frameworks suggested that introducing history dependence could reduce the severity of ELB episodes, but could also lead to greater volatility in the real economy relative to flexible inflation targeting when monetary policy is not constrained by the ELB. The review suggested that similar benefits could be captured through “an enhanced form of flexible inflation targeting with state-contingent forward guidance”.<sup>35</sup>

The European Central Bank’s 2021 review also described how the ELB may affect its monetary policy strategy.<sup>36</sup> As part of its “symmetric” approach to the risks of over- and under-shooting the inflation target, the European Central Bank noted it may need to take “especially forceful or persistent action” to avoid low inflation expectations becoming entrenched. That is, given the heightened risks of undershooting the target in a low-interest-rate environment, a transitory period in which inflation is moderately above target may be warranted.

## Actions the Reserve Bank of New Zealand has taken to manage risks from the ELB

Prior to 2020, the Reserve Bank undertook a work programme to overcome some of the challenges posed by the ELB. Many of the technological problems with implementing negative interest rates through the Reserve Bank’s clearing systems had been overcome by early 2020, however commercial banks still faced challenges with their computer systems. The Reserve Bank had also undertaken work assessing the implications of different AMP tools.<sup>37</sup>

Due to the ongoing challenges of implementing negative interest rates in early 2020, the Reserve Bank was unable to lower the OCR as much as required to stimulate the economy in a time of unprecedented uncertainty. Instead, the Reserve Bank deployed AMP tools to provide monetary stimulus and assist with financial market functioning during this period. While these tools provided additional stimulus and supported market functioning, they are not perfect substitutes for conventional policy and the OCR remains the preferred monetary policy tool to smooth fluctuations in economic cycles.

In contrast to the low interest rate environment going into 2020, the MPC has been increasing interest rates since the latter half of 2021 and the Reserve Bank is currently in a position to be able to lower the OCR further than at the start of the COVID-19 pandemic. However, in the event that the OCR is at the ELB and cannot be lowered to provide additional monetary stimulus, the Reserve Bank is also well positioned to respond with its suite of AMP tools.<sup>38</sup>

<sup>34</sup> See [Powell \(2020\)](#) and [Federal Reserve \(2020\)](#). Similarly, previous overshoots of the inflation target require lower-than-otherwise inflation under history dependence.

<sup>35</sup> See [Bank of Canada \(2021\)](#).

<sup>36</sup> See [European Central Bank \(2021\)](#).

<sup>37</sup> See [Drought, Perry and Richardson \(2018\)](#).

<sup>38</sup> See [Kengmana \(2021\)](#) for further information on the Reserve Bank’s AMP toolkit.



A woman with dark hair, wearing a bright yellow coat and a patterned scarf, is standing in a supermarket's produce section. She is reaching out to touch a green apple on a shelf. The shelves are stocked with various fruits, including apples, oranges, and grapes, many of which are packaged in clear plastic containers. A shopping cart is visible in the foreground, partially filled with produce. The scene is brightly lit, typical of a supermarket environment.

# 2

## Primary objectives



## 2 Primary objectives

The economic objectives of achieving and maintaining price stability and supporting maximum sustainable employment (MSE) are defined in the Act. The *Remit* provides guidance for achieving these economic objectives by setting specific targets or goals for the Monetary Policy Committee (MPC), known as the ‘primary objectives’.

Through the Review, the Reserve Bank has considered a wide range of potential changes to the primary objectives. This has included the guidance provided on how to manage trade-offs between the two primary objectives, the time horizon to achieve the inflation objective, and whether the inflation target is defined as a range, a target point, or a combination of the two. The Reserve Bank has also considered how the primary objectives are calibrated in terms of the level of the inflation target and which price measure to use. Alternative frameworks and definitions of price stability – such as price-level targeting – have also been considered and compared with inflation targeting.

Overall, the primary objectives in the *Remit* appear fit for purpose. The Reserve Bank does not see a strong case for moving away from the 1 to 3 percent inflation target band with a 2 percent midpoint focus and with inflation measured by the All Groups Consumers Price Index (CPI). The flexible inflation targeting framework, including the undefined medium-term focus of the inflation target, also allows the MPC to consider and adapt its strategy to economic conditions accordingly.

However, the Reserve Bank believes that improvements can be made to the specification of the primary objectives in order to support the overall clarity of the *Remit*. These changes would focus on better explaining to the public how monetary policy is expected to respond to shocks or given economic conditions, which may also better enable the public to monitor the MPC’s performance. This greater clarity can also support more stable price-setting behaviour and inflation dynamics.

The Reserve Bank recommends two amendments to the primary objectives in the 2021 *Remit*. The first is to redraft the requirement to discount transitory inflation and incorporate it directly into the inflation objective.<sup>39</sup> This would provide clarity on the nature of flexible inflation targeting with a medium-term time horizon. The second recommendation is to introduce a hierarchical ordering of the primary objectives by redrafting the objective of supporting MSE to be subject to achieving the inflation target. This would clarify that achieving price stability – by determining a monetary policy strategy that achieves 1 to 3 percent inflation over the medium term – is an important prerequisite for supporting MSE.

As part of the earlier consultation process on the scope of the Review, changes to the definition of MSE in the operational objectives were ruled out of scope for this Review. Policy options were therefore not considered. The 2021 *Remit* does not define MSE in the primary objectives, and instead directs the MPC to consider a range of labour market indicators. See [Section 7](#) of the first public consultation for a discussion on this issue.

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<sup>39</sup> The 2021 *Remit* specifies that “The MPC shall discount events that have only transitory effects on inflation, setting policy with a medium-term orientation” through clause 2(c). The inflation objective is defined through clause 2(1)(a) of the 2021 *Remit*.

## 2.1 Guidance for managing the trade-offs between objectives

The dual mandate – defining two primary objectives for the MPC to pursue – was formally established in 2018 with the introduction of a requirement to support MSE to the Act.<sup>40</sup> In the long-run, no trade-off exists between these objectives; returning inflation to target is consistent with employment operating at MSE.

Since the introduction of the dual mandate, the shorter-term implications of monetary policy from each objective have generally aligned. That is, the dual mandate has not tended to create trade-offs between the two primary objectives for the MPC to weigh in its monetary policy decisions. This reflects the fact that a labour market operating above MSE – likely to be a tight labour market – will contribute to upward inflation pressures, and vice versa for a weak labour market.

However, trade-offs can arise between the objectives when there is a shock that affects employment and prices in opposite directions, such as a ‘supply’ or ‘cost-push’ shocks. Pursuing one objective can cause a greater deviation from the other objective. Trade-offs can also arise when inflation expectations are inconsistent with the inflation target. In this case, monetary policy settings that keep inflation on target may result in employment falling below or rising above the level of MSE.

Since the introduction of inflation targeting in 1990, it has been acknowledged – through various requirements in the *Policy Target Agreements (PTAs)* and *Remits* – that it is not always possible or desirable for monetary policy to fully offset every shock to prices. *PTAs* and *Remits* have also required monetary policy to consider the short-term consequences for important matters, such as output volatility. The main mechanism for monetary policy to consider such matters is to take longer than otherwise to reach the inflation target. In doing so, monetary policy can reduce volatility in the real economy, which by extension can generally support more stable dynamics in the labour market. See Box A for more details on how the monetary policy objectives have evolved with respect to these considerations.

A key challenge for the MPC is to manage situations where there are trade-offs between the inflation and MSE objectives, or between these primary objectives and additional considerations (also referred to as ‘secondary objectives’) in the *Remit* that the MPC must consider. The *Remit* can provide guidance on how the MPC should manage these trade-offs and how much emphasis the MPC should place on some objectives or considerations.

With respect to how quickly inflation should be returned to target, the *Remit* can specify the time period in which the MPC should be aiming to achieve the inflation target. Alternatively, it can provide the MPC with flexibility to determine this time period, as it does in the 2021 *Remit*. Similarly, the *Remit* can specify the types of shocks to inflation on which the MPC should not place much emphasis on – such as a one-off price spike from a change in GST – when seeking to return inflation to target. The Act also allows the *Remit* to include a formal framework for weighting the economic objectives.

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<sup>40</sup> See the [Reserve Bank of New Zealand \(Monetary Policy\) Amendment Act 2018](#).

A *Remit* that provides specific guidance on these matters would more clearly define the monetary policy strategies that the MPC should formulate. This would support greater clarity in the framework and supports the credibility of the MPC's commitment to these strategies. However, such specific guidance could preclude the MPC from adopting some monetary policy strategies.

Conversely, the *Remit* could be less specific to provide more flexibility for the MPC to adapt its strategies if needed. The most appropriate monetary policy strategy can depend on a wide range of factors: the costs of inflation; the costs of economic and employment volatility; the uncertainty facing decision-makers; risks around the Effective Lower Bound (ELB) and the nature of shocks facing the economy.<sup>41</sup> The benefits of providing clearer guidance by specifying how the MPC should respond to particular economic conditions should be weighed against the need to provide the MPC with flexibility to adapt its monetary policy strategy to a wide range of circumstances.

The 2021 *Remit* does not provide explicit guidance on how to balance price stability and supporting MSE, and the meaning of 'medium term' is left undefined. This allows the MPC to adapt its approach to achieving the price stability and MSE objectives over time. The MPC sets out its strategy through the *Statement of the MPC's monetary policy strategy*, which is provided with each *Monetary Policy Statement (MPS)*, and the MPC provides forecasts that show when inflation is expected to return to target. *The Monetary Policy Handbook* also outlines general approaches that can be adopted for managing such trade-offs. The *Remit* does include a clause that requires the MPC "to discount events that have only transitory effects on inflation, setting policy with a medium-term orientation".

## The Reserve Bank's recommendations

The Reserve Bank views the current degree of flexibility afforded to the MPC through the 2021 *Remit* as appropriate. The Reserve Bank therefore recommends that the *Remit* retain the current undefined medium-term time horizon. This is an important source of flexibility for monetary policy as adapting the time taken to return inflation to target enables the MPC to consider other objectives.

The Reserve Bank also recommends retaining the requirement for the MPC to discount transitory inflation. This clause provides clarity to the public on what inflation targeting with a medium-term horizon may mean for monetary policy strategy. However, this requirement should be redrafted and incorporated directly into the inflation objective.

The Reserve Bank considers that introducing a hierarchical ordering of objectives to the *Remit* would, on balance, be beneficial. A hierarchical ordering of objectives – effectively a type of weighting scheme – would enhance the clarity of the *Remit* and support the MPC's credibility in inflation targeting. The Reserve Bank does not view this as likely to materially affect the flexibility of the framework in a practical sense, although there is only a limited experience of the primary objectives coming into conflict since the dual mandate was introduced. There were a range of views on this matter among MPC members.

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<sup>41</sup> [Woodford \(2003\)](#) and [Rotemberg and Woodford \(1999\)](#) show that reducing interest and output volatility, at the expense of higher inflation volatility, can improve welfare outcomes. Literature also generally suggests that a more gradual approach to changing interest rates is appropriate in the face of uncertainty, particularly when risks are skewed to the downside ([Orphanides, 2003](#); [Sack, 1998](#)). Furthermore, the most optimal strategy to deal with ELB is likely to be through stimulating the economy more than otherwise so that inflation expectations are in a stronger starting position if there is a shock ([Orphanides and Wieland, 2000](#)). In this context, there a more gradual approach to reducing stimulus to likely reduce the risk of the ELB ([Evans et al., 2015](#)). However, there may be circumstances where more aggressive monetary policy response may be more appropriate. For example, the [Drew and Plantier \(2001\)](#) notes that "without a good track record, gradualism may be interpreted by agents in the economy as the Bank being 'soft' on inflation. That would no doubt damage the Bank's ability to influence inflation expectations and actual inflation." [Brainard \(1967\)](#) also provides a seminal paper that explores how uncertainty affects policy choices more broadly.

1

**Recommendation**

The time horizon for the MPC to achieve their inflation objective should remain as the 'medium term'.

2

**Recommendation**

The *Remit* should retain the requirement to discount transitory inflation, but the requirement should be redrafted and incorporated directly into the inflation objective.

3

**Recommendation**

On balance, the *Remit* should incorporate a hierarchical ordering of primary objectives.

The second consultation paper included a request for feedback on whether the *Remit* strikes the right balance between credibility – that the MPC can meet its objectives and keep inflation expectations anchored – and flexibility to support MSE and consider other objectives.

A majority of public submissions – around 60 percent – argued for a greater focus on credibility, generally through more emphasis on the inflation objective. A smaller proportion believed either that the approach in the 2021 *Remit* struck the right balance between credibility and flexibility, or that there should be greater emphasis on further flexibility.

The Reserve Bank recommendations for the primary objectives intend to achieve greater decision-making clarity, while still maintaining enough flexibility for the MPC to take into account its MSE objective and other considerations. These recommendations largely align with the broad support for emphasising credibility from responses to the second consultation.

**Time horizon**

The *Remit* can provide more guidance on managing trade-offs between objectives through the time horizon for achieving the inflation target. The MPC does not attempt to return inflation to target immediately because the inflation process is persistent and there are lags in the effect of monetary policy on inflation. Furthermore, a key mechanism for the MPC to consider other objectives, such as supporting MSE and reducing volatility in the real economy, is to take longer than otherwise to reach the inflation target. In this sense, the time horizon for achieving the inflation target is a core aspect of the flexibility in the framework that allows the MPC to pursue other objectives.

Research suggests that the appropriate time horizon for monetary policy – when other important economic factors such as output volatility are also considered – can be substantially longer than the 12 to 24 months it takes for monetary policy to transmit through the economy.



Some research suggests the optimal time horizon may be around four years in some cases. Furthermore, the appropriate time horizon is state-contingent, depending on the shocks facing the economy and other contextual issues, and will vary over time. For example, supply or ‘cost-push’ shocks create a trade-off between output and inflation, meaning the optimal time horizon for returning inflation to target may be longer than when responding to a demand-side shock.<sup>42</sup> Overarching all of these considerations is also the relative preference for price stability compared with output stabilisation.

The target horizon is defined as the “medium term” in the 2021 *Remit*, but its exact meaning is undefined. The Reserve Bank has historically interpreted the medium term as the second half of a three-year forecast horizon.<sup>43</sup> This interpretation reflects the fact that monetary policy affects the real economy and inflation with a lag. However, the use of the phrase ‘medium term’ – rather than a defined period – allows for the time horizon to be adapted if needed and provides flexibility for the MPC to respond to wide range of economic circumstances.

An alternative option explored in the second consultation was to specify the time required for forecast inflation to return to target in the *Remit*. In contrast to the 2021 *Remit*, the MPC would have less scope to amend its strategy to take longer to return inflation to target under some circumstances.

A specified time horizon – defined within a reasonable time frame – may better anchor inflation expectations and support MPC credibility. This would also reduce the overall flexibility of the *Remit*, limiting how much the MPC could support MSE and consider other objectives. However, if a specified time horizon were too short, it could risk the MPC missing the inflation target more frequently. This would likely undermine the public’s belief in the MPC’s ability to achieve the inflation target and could have a perverse effect on credibility.

There is a range of time horizons for inflation targets overseas. The Bank of Canada, for example, “seeks to return inflation to target over a horizon of six to eight quarters. However, the most appropriate horizon for returning inflation to target will vary depending on the nature and persistence of the shocks buffeting the economy”.<sup>44</sup> It is important to note that direct comparisons of central banks are difficult given the different legal arrangements underpinning monetary policy frameworks.

The Reserve Bank recommends that the *Remit* retains the undefined medium-term time horizon for achieving the inflation target. This provides the MPC with much of their flexibility to support MSE and consider other important matters in the decisions.

Of the submissions that engaged with this issue in the second public consultation, the majority supported retaining an undefined medium-term time horizon. Several highlighted the necessary flexibility of an undefined term due to the lagged influence of monetary policy. Some suggested that some level of extra detail should be added, for example by requiring the MPC to occasionally outline how it views the medium term in practice.

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<sup>42</sup> For example, [Smets \(2003\)](#) analyses the factors that determine the length of the medium-term horizon and finds that the optimal time horizon depends on the structure of the economy and becomes longer when the central bank places a greater weight on other objectives like minimising output gap and interest rate variability. [Akram \(2010\)](#) also notes that the optimal time horizons should consider the time lags of monetary policy and should not exceed the life spans of the effects of shocks due to nominal rigidities. Otherwise, monetary policy would be counterproductive and prolong the economic disequilibrium caused by shocks beyond their own ‘life spans’. The [European Central Bank \(2021\)](#) also notes that supply-side shocks typically imply much longer horizons than demand-side shocks, stating that “in order to mitigate volatility in economic activity, supply shocks usually require a smoother and more protracted policy response and some tolerance for temporary deviations of inflation from its target. How smooth and protracted the response should be depends on the relative weight attached to inflation volatility on the one hand and output volatility on the other.”

<sup>43</sup> See [Bollard and Ng \(2008\)](#).

<sup>44</sup> See the Bank of Canada’s strategy in their [Monetary Policy Report](#).

Some submissions disagreed with retaining the unspecified definition of medium term. Most of the arguments centred on the idea that defining an explicit medium-term horizon could increase the accountability of monetary policy. Most did not suggest a specific definition, but those that did suggested a one year, a two to three year or a five year time horizon. One submitter suggested a two year horizon for bringing inflation within the target band, but retaining an undefined horizon for returning inflation to the midpoint of the target.

## Discounting transitory effects on inflation

Since the introduction of inflation targeting in 1990, the *PTAs* and *Remits* have set out how monetary policy should respond to shocks that cause inflation to temporarily deviate from target. This is reflected in clause 2(c) of the 2021 *Remit*. These requirements have also been associated with a requirement for decision-makers to explain why inflation outcomes are outside the target range.<sup>45</sup>

### ***Excerpt from the 2021 Remit***

- (2) In pursuing the operational objectives, the MPC shall:
- (c) discount events that have only transitory effects on inflation, setting policy with a medium-term orientation

The Reserve Bank recommends retaining this requirement and redrafting clause 2(c) of the 2021 *Remit* to clarify its intent. In reaching this recommendation, the Reserve Bank has identified two aspects of the clause in the 2021 *Remit* that could be redrafted to add clarity.

First, the requirement could be redrafted to shift the focus to the ‘transitory effects of inflation’ of an event, rather than the events themselves. Recent experience has emphasised that events that initially have only transitory effects on inflation can have second-round effects that are more persistent. The wording of clause 2(c) of the 2021 *Remit*, taken literally, directs the MPC to discount events that have *only* a transitory effect on inflation.

Second, the requirement could be redrafted to introduce language that more clearly qualifies the requirement in terms of the medium-term inflation target. The transitory effects clause is intended to complement the medium-term concept in the *Remit* by elaborating on the likely monetary policy responses to particular economic shocks.

The Reserve Bank also recommends shifting the redrafted requirement to the part of the *Remit* text related to the inflation objective, rather than having it sit alongside additional objectives as it does in the 2021 *Remit*. The requirement relates to how the MPC should go about achieving its inflation objective, whereas other requirements in clause 2 of the *Remit* set out additional considerations that the MPC must have regard to or seek to achieve. Moving this requirement would help to improve the delineation between the primary objectives and additional considerations in the *Remit*.

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<sup>45</sup> Previously these requirements were part of the *PTAs*. These reporting requirements now sit within the *Charter*, with clause 2(b)(ii) of the 2021 *Charter* requiring the MPC to explain when inflation outcomes, or expected inflation outcomes, are outside the target range through the *Monetary Policy Statement*.

Alternatively, the 2021 *Remit* could be amended to remove the transitory effects clause. Targeting inflation over the ‘medium term’ already implies that monetary policy should not respond to temporary shocks to inflation beyond how such shocks affect medium-term inflation. Removing the wording could support a more succinct *Remit*. However, the Reserve Bank considers that retaining a redrafted transitory-effects clause provides clarity to the public on when monetary policy will not respond to changes in inflation. While this may be captured through the medium-term focus of the price stability objective, it may not be obvious to a non-technical audience.

On balance, there was more support among consultation respondents for either retaining or rewording the transitory effects clause than there was for removing it from the *Remit*. One submitter noted that the transitory effects clause complemented the ‘medium-term’ aspect of inflation targeting, in the context of the medium term being an unclear concept. Similarly, another submitter argued that the clause provided an important “balance” to the medium-term specification of the price stability objective.

Many submitters who argued for removing this clause from the *Remit* did not elaborate on their reasoning. However, several submissions argued that the clause was less significant, or even redundant, due to flexible inflation targeting.

## Hierarchical ordering

The *Remit* can incorporate a weighting scheme to provide guidance on how the MPC should manage trade-offs between the inflation and MSE objectives. The second public consultation considered two options around this:<sup>46</sup>

- The status quo of not specifying any guidance for managing trade-offs between price stability and supporting MSE in the *Remit*.
- A hierarchical ordering of objectives that requires the MPC to support MSE subject to the price stability objective being achieved.

Both of these approaches are seen in other countries. Some advanced-economy central banks – including the US Federal Reserve – have employment as a primary objective of monetary policy alongside price stability.<sup>47</sup> Others – such as the Bank of Canada, the Sveriges Riksbank, the Norges Bank and the European Central Bank (ECB) – have secondary employment stabilisation objectives that tend to be conditional on not compromising their primary objectives of maintaining price stability. A common element among all central bank mandates that stipulate employment stabilisation as an objective is the absence of formal numerical targets.

The key consideration for managing trade-offs between the inflation and MSE objectives is the degree to which the *Remit* allows the MPC to adapt strategies. A more flexible *Remit* can better facilitate changes in how the MPC manages these trade-offs. Conversely, a *Remit* that specifies or provides guidance on how the MPC should manage such trade-offs can provide greater public clarity and credibility to the framework, which is important in supporting the underlying flexibility afforded to the MPC.<sup>48</sup>

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<sup>46</sup> The option of removing MSE as a primary objective was out of scope of the Review as supporting MSE is an economic objective defined in the Act.

<sup>47</sup> Note, the Reserve Bank of Australia’s approach is “to focus on price stability... while taking account of the implications of monetary policy for activity and levels of employment in the short term”. However, in April 2023, a review Reserve Bank of Australia was published which included the recommendation for a dual monetary policy objectives of price stability and full employment, with equal consideration given to each. See [Australian Government \(2023\)](#).

<sup>48</sup> Box A describes how credibility established in the 1990s allowed for the incorporation of flexibility in the New Zealand monetary policy framework.

In this context, it is useful to understand the most appropriate monetary policy strategies for different circumstances. When no trade-off exists, monetary policy can achieve both objectives simultaneously.<sup>49</sup> However, trade-offs between price stability and output or employment arise when a more realistic range of shocks and real-world frictions are considered.<sup>50</sup> When deviations from each objective move in opposite directions – for example when inflation increases while employment falls – the MPC faces a trade-off between objectives: achieving one objective necessarily creates a movement away from the target level of the other. This often arises when the economy is facing more frequent supply or ‘cost-push’ shocks. The appropriate weighting of objectives in these cases is less clear.

Much of the academic literature in this space focuses on specified weightings for objectives that optimise social welfare. This research generally suggests that it is welfare-enhancing to have at least some weighting on objectives other than inflation.<sup>51</sup> However, the literature is less clear on the benefit of specifically considering employment in a central bank’s mandate. Some key research papers suggest that adding any weight to employment adds very little to total welfare.<sup>52</sup> In contrast, other literature suggests that under certain economic conditions it is optimal to put some weight on the unemployment objective.<sup>53</sup>

Reserve Bank research using a theoretical macroeconomic model calibrated to New Zealand data has found that, in most realistic situations, welfare outcomes are broadly similar across different weightings on inflation and MSE objectives. In part, this reflects that the two objectives have generally aligned over time and that there have not been many trade-offs between inflation and employment. However, under a counterfactual case where the economy is facing more powerful cost-push (supply) shocks, this research suggests it is better for monetary policy to focus only on the inflation target.<sup>54</sup>

One important limitation of research in this area is the tendency to use simplifying assumptions in order to model the economy. Some of these models implicitly assume that households believe inflation will return to its target rate in the future. The ability of the MPC to consider other objectives is itself dependent on the public’s belief that the MPC is committed to maintaining price stability in the medium term. Policies that optimise output or employment outcomes today, but undermine the MPC’s credibility to maintain stable inflation, can lead to worse long-term outcomes as the MPC will need to respond more aggressively to inflation in the future. Monetary policy strategies adopted by the MPC therefore need to be consistent with achieving the inflation objective and maintaining price stability.<sup>55</sup>

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<sup>49</sup> This is often referred to as the “divine coincidence” and is a feature of some New Keynesian models of the type analysed by [Blanchard and Gali \(2007\)](#).

<sup>50</sup> See [Alves \(2014\)](#) and [Kim \(2016\)](#).

<sup>51</sup> See [Rotemberg and Woodford \(1997\)](#) as a seminal paper in this type of research. See also [Bhandari et al. \(2021\)](#).

<sup>52</sup> See especially [Ravenna and Walsh \(2011\)](#), and also [Walsh \(2014\)](#) and [Campolmi and Gnocchi \(2016\)](#).

<sup>53</sup> See for example [Faia \(2009\)](#), [Faia et al. \(2014\)](#), [Lechthaler et al. \(2013\)](#), [Sunakawa \(2015\)](#) and [Lechthaler et al. \(2019\)](#). While these papers suggest placing some consideration on employment, they generally do not specify a particular weighting. The *Monetary Policy Handbook* also outlines the strategy of [Svensson \(2014\)](#), which is to treat both objectives with roughly the same prominence, better ensuring that one objective is not achieved at the expense of the other.

<sup>54</sup> See [Jacob and Özbilgin \(2021\)](#). This modelling finds that social welfare can be improved by either placing more emphasis on employment when there is not a strong emphasis on inflation or by responding more aggressively to inflation ignoring employment stabilisation. However, the marginal changes to welfare are small and any meaningful increase in welfare requires an unrealistically high emphasis on employment while retaining a relatively low weight on inflation.

<sup>55</sup> See the discussion in Section 1.3 on the role of central bank credibility in the framework.

Another limitation with such modelling are the assumptions around policy-makers having perfect information on both the structure of the economy and the level of unobservable variables such as MSE. In reality, it is difficult to measure and assess 'gaps' between employment and MSE in real time or even *ex-post*. On the other hand, prices have been measured through the CPI for over a century in New Zealand and the CPI follows an international standard, supporting the robustness of the measure.<sup>56</sup> Literature suggests that an increased weight on well-measured objectives reduces the chance of monetary policy mistakes, particularly if there is uncertainty in the relevant data or the economy.<sup>57</sup>

Research also suggests organisations with multiple objectives tend to over-emphasise those that are easier to measure as this more clearly signals the organisation's performance.<sup>58</sup> There are two potential implications from this. First, a central bank may wish to place more weight on the better-measured objective – the inflation target – to prove their effectiveness and maintain their credibility. This would also align with the need to maintain a credible commitment to achieving the inflation objective for anchoring inflation expectations. For example, the MPC Remit for the Bank of Canada states that because "*maximum sustainable employment is not directly measurable*" and "*well-anchored inflation expectations are critical to achieving both price stability and maximum sustainable employment*", "*the primary objective of monetary policy is to maintain low, stable inflation over time*".<sup>59</sup>

Second, and conversely, a central bank may place more weight on the inflation objective than is socially optimal. In this context, redefining the inflation target as a prerequisite – through a hierarchical ordering – may allow for more emphasis on supporting MSE than otherwise during times when inflation is at or near the target. However this has not been extensively explored in literature and more research is required with respect to this aspect of hierarchical preferences.<sup>60</sup>

Together, the considerations from literature suggest that emphasising the inflation objective through a hierarchical ordering is appropriate in many circumstances. Further, if inflation expectations are – or risk becoming – unanchored, it is likely that decision-makers will place a greater emphasis on the inflation target. This will reduce the risk of monetary policy needing to respond more aggressively to inflation to bring inflation expectations back to target, which would come with greater costs to employment than otherwise.

Incorporating a hierarchical ordering of objectives in the *Remit* is therefore unlikely to meaningfully influence monetary policy strategies in practice. However, it can provide greater clarity for the public on how the MPC will consider trade-offs between the two objectives and support the credibility of the MPC's commitment to maintaining price stability.

At the same time, it is important to acknowledge that much of New Zealand's short experience with a dual mandate has been in a period when there have not been trade-offs between the inflation and MSE objectives. In this context, there is little real-world experience of how the MPC would respond to such circumstances in practice. See Box D for an explanation on how monetary policy strategies have considered the MSE objective in the New Zealand context.

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<sup>56</sup> See [Statistics New Zealand \(2015\)](#). The international standard referenced is the *CPI Manual* ([International Monetary Fund, 2020](#)).

<sup>57</sup> See [Poole \(1970\)](#). See also [Orphanides & Williams \(2005\)](#), who suggest that the stagflation of the 1970s may have been caused by setting policy on estimates of employment gaps that were subject to large measurement issues (page 1927).

<sup>58</sup> See for example [Holstrom and Milgrom \(1991\)](#), [Roberts \(2007\)](#) and [Roberts \(2010\)](#).

<sup>59</sup> [Government of Canada \(2021\)](#).

<sup>60</sup> Forthcoming Reserve Bank research examines how a weighting framework can be designed within a multiple-objective remit to solve mismatches between the priorities of a central bank and a government that issues the remit.



The Reserve Bank views hierarchical ordering as maintaining the benefits of the MSE objective while providing additional clarity to the public on how the MPC will respond to situations where monetary policy faces trade-offs between price stability and supporting MSE in the short-term.

The majority of respondents to the second public consultation either supported hierarchical ordering or suggested that MSE should not be a primary objective. The reasons provided for this included: that central banks have greater influence over inflation than other economic factors in the long term and therefore this is the best way they can support wellbeing; that employment concerns are better addressed through government policy; and that the existing approach reduces predictability by making it unclear which objective will take precedence in MPC decisions when they come into conflict.

There were also public submissions that were opposed to placing greater emphasis on the price stability objective at the expense of the MSE objective. These submissions argued that: the MSE objective gives the Reserve Bank licence to discuss employment; that the *Remit* already implicitly treats MSE as a subsidiary objective; and that MSE is a good proxy for excess demand – a key driver of inflation – but is less prone than the inflation measure to ‘noise’ from large transitory movements.<sup>61</sup>

There was also a diversity of views among the members of the MPC on this issue. Most members supported the introduction of hierarchical ordering of objectives on balance. These members considered that it could provide better clarity on how the MPC should manage trade-offs between the inflation and MSE objectives when they arise and support the credibility of the price stability objective. Such ordering would also reflect how the MPC is likely to respond when facing such trade-offs.

MPC members noted that the introduction of the MSE objective had brought about benefits in terms of the Reserve Bank’s and the MPC’s understanding and communication of labour market issues. Members agreed that labour market research is critical and should be promoted on an ongoing basis, regardless of whether hierarchical preferences are implemented.

There was an alternative perspective within the MPC, with one member opposing a hierarchical ordering of objectives. This member viewed it as significantly weakening the MSE objective and would effectively represent a reversion to a single mandate. Further, as much of the experience with the dual mandate has been in a period when the objectives have not been in conflict, there is limited practical experience to demonstrate how the MPC would respond to a trade-off between the inflation and MSE objectives.<sup>62</sup>

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<sup>61</sup> This includes comments made in the first and second public consultation.

<sup>62</sup> See the accompanying *Record of Meeting* from the consultation with MPC members.

## Box D: How MSE has been incorporated into MPC strategy

In April 2018 the Reserve Bank formally moved to a dual mandate with two primary objectives for monetary policy. In addition to achieving and maintaining price stability, the MPC were now also required to support MSE.<sup>63</sup> The *Remit* does not define MSE, but the *Monetary Policy Handbook* describes it as “the highest utilisation of labour resources that can be maintained without creating an acceleration in inflation”.<sup>64</sup>

### Monetary policy decision-making before the dual mandate

Before the MSE objective was introduced, the monetary policy framework was still flexible enough to consider important matters other than inflation. The matters to be considered in monetary policy decisions were defined through the *PTAs*. From 1999 onwards, the *PTAs* included a requirement to “seek to avoid unnecessary instability in output, interest rates and the exchange rate”.

As output and employment tend to move in the same direction – an increase (decrease) in output is associated with an increase (decrease) in employment – considering output stability generally supports more stable employment and implies smaller deviations of employment from MSE.<sup>65</sup> Further, by definition, any deviations above (below) MSE will result in upwards (downwards) inflationary pressure, so monetary policy has always implicitly had to consider deviations from MSE for effective inflation targeting. The *Monetary Policy Handbook* describes the addition of the explicit MSE objective as “likely to be an evolution, not a revolution, of the RBNZ’s existing strategy”.<sup>66</sup>

### Research on MSE and labour market dynamics

While monetary policy in New Zealand did not radically change with the introduction of the MSE objective, the Reserve Bank’s understanding of MSE and the labour market has evolved. This in turn has influenced how MSE is considered in monetary policy strategy.

Labour market factors such as unemployment and labour supply and demand have always been important considerations in MPC policy-making. However, and for the first time, the May 2018 *MPS* included a formal list of labour market indicators for assessing whether employment was at or near MSE. Reserve Bank research also explored the best methods for evaluating MSE. It found that indicators sensitive to business cycle fluctuations were better than other measures at forecasting employment, wage growth and non-tradables inflation, and should be given greater weight in assessing whether the economy was at MSE.<sup>67</sup> The indicator suite was subsequently expanded to include many of them.<sup>68</sup>

As part of its regular assessments of the economy, the Reserve Bank undertakes investigations into relevant trends in the labour market to complement the indicator suite. For example, the uneven employment impacts of COVID-19 were investigated in the November 2020 *MPS*, and the implications for real wages from a tight labour market and increasing costs of living were discussed in the November 2022 *MPS*.<sup>69</sup>

<sup>63</sup> See the [Reserve Bank of New Zealand \(Monetary Policy\) Amendment Act 2018](#).

<sup>64</sup> See [Section 5.5.3](#) of the *Monetary Policy Handbook* (2020).

<sup>65</sup> See [Box C](#) of the May 2018 *MPS*.

<sup>66</sup> See [Section 7.3](#) of the *Monetary Policy Handbook* (2020).

<sup>67</sup> See [Robinson, Culling and Price \(2019\)](#).

<sup>68</sup> The expanded suite was first used in the [August 2019 MPS](#). For a more recent example see [Figure 2.6](#) in February 2023 *MPS*.

<sup>69</sup> See Chapter 4.2 of the [November 2020 MPS](#) and Chapter 4.2 of the [November 2022 MPS](#).

The Reserve Bank has also investigated how labour market cycles have affected different demographic groups, how monetary policy affects regional unemployment, regional labour market spill-overs, and the quality of several individual labour market indicators.<sup>70</sup>

### **The evolution of monetary policy strategy with MSE**

Since the MSE objective was introduced, and on the back of the Reserve Bank research, monetary policy strategy has developed to consider more formally the role of MSE. This has included how to manage trade-offs between the inflation and MSE objectives if they arise, described in the *Monetary Policy Handbook*.

When there is no trade-off between the inflation and MSE objectives, monetary policy strategy is not likely to be substantially different from a framework without MSE. This might occur, for example, when there is a shock that moves inflation and employment in the same direction. This has been the experience for much of the five years since the MSE objective was introduced.

However, the objectives can occasionally come into conflict. In such cases the MPC needs to consider how much it will tolerate one objective deviating from target relative to the other. This is complex because inflation and employment are “fundamentally different concepts” and “assessing MSE involves many judgements” since it cannot be directly observed.<sup>71</sup> The *Statement of the MPC’s monetary policy strategy* notes that – in general – the MPC would let inflation overshoot (undershoot) the target midpoint for a time when employment is projected to be below (above) its long-run sustainable level.<sup>72</sup>

However, it is always important to keep the broader economic context in mind when considering trade-offs between the objectives. For example, in November 2022 the MPC expected employment to fall below MSE alongside inflation remaining above target in 2023. However, in this case where inflation expectations were also rising, allowing inflation to stay so far outside the target range for too long would have risked inflation expectations becoming unanchored. Consequently, the November 2022 MPS noted:

*“Trying to avoid an economic contraction by limiting any interest rate increases in the near term would likely lead to a longer period of high inflation. In turn, this would likely result in higher interest rates and a larger contraction eventually being required to bring inflation and employment back to a more sustainable path.”*

While employment was still relevant to decision-making before the dual mandate, now the Reserve Bank has increased its focus on labour market dynamics. The dual mandate has also seen the further development of strategies for managing trade-offs in the framework. As an economic objective defined in the Act, the MSE objective will continue to play an important role in monetary policy irrespective of the potential changes to the *Remit*.

<sup>70</sup> Markham, Özbilgin and Robinson (2022a, 2022b, 2022c); Markham (2020); Haworth (2020); Robinson (2020); Culling and Robinson (2020); Ball, Richardson and van Florenstein Mulder (2020).

<sup>71</sup> See [Section 7.3.3](#) of the *Monetary Policy Handbook* (2020).

<sup>72</sup> See for example the [February 2023 MPS](#).

## 2.2 Specification of the inflation target

Since 2012, the inflation target has been based on a hybrid regime – a combination of a point target and a range – with a 1 to 3 percent range with a specific focus on the 2 percent midpoint over the medium term. The inflation target has been based on the CPI for almost the entire period since inflation targeting was introduced in 1990.<sup>73</sup> The second public consultation discussed all of these dimensions and explored alternative options for specifying the inflation target.

The optimal level of inflation has received much attention in academic research and other central bank reviews of monetary policy frameworks. The literature provides arguments for both lowering the inflation target, mostly focused on reducing distortions created by inflation, and increasing the target, which focuses on reducing the risk of the Official Cash Rate (OCR) becoming constrained by the ELB.

In terms of the way that the inflation target is specified, a target range ('band') around the midpoint supports the achievability of a target and conveys to the public the message that there is a degree of uncertainty with inflation targeting. The width of the target range should balance the achievability of the target with the need to maintain a credible commitment to stable inflation. A band that is too narrow can result in a perception that the MPC is not achieving its mandate. Conversely, a band that is too wide could lead to less well-anchored inflation expectations.

The measure used for the price stability objective should be influenced by monetary policy, be representative of the inflation rate experienced by households, be produced independently, and be robust by following best practice.

### The Reserve Bank's recommendation

The Reserve Bank recommends retaining the inflation target as defined in the 2021 *Remit*. It is well-understood by the public and changing the target in the current environment of heightened inflation could undermine the credibility of the framework. The focus of the inflation target on 2 percent appears to be in the vicinity of the optimal level and the 1 to 3 percent target range balances achievability and credibility. The Reserve Bank also considers that the CPI remains the best measure of prices for the inflation rate as it is well-established, is produced by an external agency, and can be benchmarked against an international standard.



#### Recommendation

The inflation target should continue to be defined in terms of a target range, with a focus on keeping future inflation at or near the midpoint. The midpoint should continue to be 2 percent and the target range should continue to be 1 to 3 percent. The measure used for inflation should continue to be the All Groups Consumers Price Index.

In general, there was broad support from consultation respondents for the inflation target as defined in the 2021 *Remit*. The most substantial area of engagement was on the 2 percent focus of the inflation target, with other aspects receiving much less attention in submissions.

<sup>73</sup> For two years under the 1997 *PTA*, the inflation target was defined in terms of the 'All Groups Consumers Price Index excluding Credit Services' (CPIX) measure.

## The level of the midpoint of the target

The 'optimal' level of the inflation target can be viewed as the rate of inflation that balances the trade-offs between the costs and benefits of positive inflation and best contributes to overall economic wellbeing.

The arguments for lowering the inflation target tend to focus on avoiding the welfare costs associated with positive inflation. The main costs of positive inflation cited in the literature include:<sup>74</sup>

- Altering household preferences for liquid assets. As the value of real money declines in the face of inflation, households and businesses may be incentivised to invest in assets with expected yields above inflation. This can distort the amount of liquid assets held by businesses and households away from an 'optimal' level.<sup>75</sup>
- Resource misallocation arising from price rigidities. When businesses update their prices infrequently, a positive inflation rate can lead to a distortion between the prices and costs of goods that can lead to inefficiencies.<sup>76</sup>
- Tax system distortions. As nominal interest is taxed in New Zealand, higher inflation lowers real after-tax returns. This can affect people's saving and investment decisions, particularly when deciding between different assets to invest in. For example, compensation for inflation on bank deposits is taxed whereas it is not always taxed on capital gains for property and equities.<sup>77</sup>
- The distributional effects of inflation. If a higher inflation rate is unanticipated, or if the volatility of inflation increases over time, it can reduce the real value of debt, redistributing wealth from savers to borrowers.<sup>78</sup>
- Housing market distortions. The inflation rate can distort the repayment profiles for home-buyers (known as 'mortgage tilt'). A higher inflation rate can increase the real servicing costs relative to income for the first years of a mortgage. Although the real servicing costs relative to income will be lower in later years, the serviceability hurdle for purchasing a house may be higher.<sup>79</sup>

Conversely, the main arguments for raising the inflation target include:

- Reducing the risks created by the ELB. A higher inflation rate lowers the real interest rates that can be achieved before monetary policy is constrained by the ELB, thereby providing (conventional) monetary policy with more scope to support the economy in the face of a disinflationary shock.<sup>80</sup>
- Reducing the effects of nominal wage rigidity on employment. As nominal wages are slow to fall – or do not fall at all – when a negative shock hits the economy, businesses often do not lower wages in line with falls in demand for labour. Instead of lowering wages to cut costs, employers lay off workers, increasing unemployment. A high inflation rate allows for real wages to decline instead of unemployment increasing.<sup>81</sup>

<sup>74</sup> See the Reserve Bank's background note on the optimal level of the inflation target for a more detailed discussion ([Lockyer, 2022](#)).

<sup>75</sup> This concept is frequently attributed to Friedman (1969), who argues that money holdings enable transactions and thus provide societal value.

<sup>76</sup> See [Schmitt-Grohé and Uribe \(2010\)](#) for a discussion of how the introduction of price rigidities may make the Friedman (1969) rule suboptimal.

<sup>77</sup> The issues around inflation and tax system distortions are also discussed in [Bank of Canada \(2011\)](#) and [Røisland \(2017\)](#). [Hargreaves \(2008\)](#) discusses the influence of the tax system distortions on New Zealand's housing market, noting that inflation accentuates these distortions.

<sup>78</sup> [Carey \(1989\)](#) discusses these implications in the New Zealand context, as well as other distortions on the economy caused by inflation, such as through the tax system.

<sup>79</sup> See [Lessard and Modigliani \(1975\)](#).

<sup>80</sup> For example, [Dorich et al. \(2018\)](#) suggest that a higher inflation target substantially improves macroeconomic stability when the real neutral rate is deeply negative. See Box C for a discussion on the ELB and monetary policy frameworks more broadly.

<sup>81</sup> Much of the literature refers to [Tobin \(1972\)](#) as a basis for this discussion, who argued positive inflation was justified in order to facilitate real wage adjustment.



- If negative supply-shocks become more frequent – such as due to climate change – this could lead to more periods of inflation being above the midpoint or the upper band range. To the extent that these shocks may cause second-round inflationary pressures, monetary policy may also need to ‘lean against’ them. Some have argued that a higher inflation target – if calibrated correctly – may make the inflation objective more achievable and credible, as well as reduce the need to lean against these inflationary shocks.<sup>82</sup> However, this is a relatively nascent idea and has not been as robustly tested in research as other considerations.

Alongside this, there is evidence that the level of inflation itself can influence the responsiveness of inflation expectations. The degree of attention that households and businesses devote to changes in the general level of prices can influence their own price- and wage-setting behaviour. When inflation is low and stable, people tend to be relatively indifferent to macroeconomic events and inflation processes. On the other hand, when inflation is high and volatile, it becomes much more salient and households and businesses can become more responsive to general inflation.<sup>83</sup> In this situation, inflation expectations become more easily unanchored and the effectiveness and credibility of monetary policy may be reduced over time.<sup>84</sup>

Higher expected inflation can lead to businesses increasing their prices more frequently due to the expectation of declining relative prices, and due to employees negotiating larger increases in their nominal wages because of declining real wages. Both of these processes can mean that the MPC may be required to adjust interest rates by larger amounts than otherwise to return inflation to target. While the exact level at which households and businesses become more cognisant of inflation may be difficult to determine, this is a risk to consider around increasing the inflation target.<sup>85</sup>

There would also likely be some distributional effects as the economy transitioned to a new level of inflation – although these could in theory be at least partly offset by fiscal policy.

In recent years, several central banks, including the Bank of Canada, the ECB and the Reserve Bank of Australia, have re-evaluated their inflation targets in monetary policy framework reviews.<sup>86</sup> Many central banks have considered that a target around or close to 2 percent continues to strike a good balance between the costs and benefits of positive inflation.

On balance, an inflation target centred on 2 percent is within the range of ‘optimal’ inflation targets suggested in research.<sup>87</sup> It is low enough to avoid many of the costs of high inflation and some of the distributional effects of positive inflation, and, compared with a lower target, it better mitigates the risk of encountering the ELB. The 2 percent target also accounts for the small measurement error in consumer price indices.<sup>88</sup> There are also pragmatic reasons for retaining the existing inflation target: it is well-understood by the public and changing the target in the current environment could undermine the credibility of the framework.

<sup>82</sup> This argument was raised in a few of the public submissions to the second consultation, in particular see the submission from the New Zealand Council of Trade Unions. [Schnabel \(2022\)](#), and [Kabundi et al. \(2022\)](#), also discuss the implications of climate-related price shocks on monetary policy, but conclude that more research is needed.

<sup>83</sup> [Coibion et al. \(2020\)](#) show that households’ and businesses’ are relatively inattentive to monetary policy and inflation in a low inflation environment.

<sup>84</sup> See [Blanchard’s \(2022\)](#) opinion piece as an example of how inflation salience is being considered in discussions about the calibration of inflation targets.

<sup>85</sup> [Chen, Korenok and Munro \(2022\)](#) estimated that, for the United States, people start paying attention to inflation when it is around 3–4 percent.

<sup>86</sup> Note, the Reserve Bank of Australia has a 2 to 3 percent target range. The 2023 review of the Reserve Bank of Australia recommended retaining the flexible inflation target of 2 to 3 percent. The review also recommended that the Reserve Bank of Australia should aim to return inflation to around the midpoint of the inflation target. See [Australian Government \(2023\)](#).

<sup>87</sup> See the Reserve Bank’s background note on the level of the inflation target ([Lockyer, 2022](#)). [Table 1](#) of [Lockyer \(2022\)](#) also includes a summary of other central bank inflation targets.

<sup>88</sup> See the Reserve Bank’s background note on the measurement of price stability ([Brocklesby, 2022](#)). For example, [Lebow and Rudd \(2001\)](#) estimated that the U.S. CPI has a positive measurement bias of approximately 0.6 percentage points annually. The authors attribute most of this to the welfare improvements from item quality changes that are not captured in the index (quality bias), and new items being introduced to market (new goods bias).

The majority of respondents to the second consultation agreed with the Reserve Bank's recommendation to retain the existing inflation target, although there was some support for lowering the target and some for raising it.

Across both public consultations, support for retaining the current target included arguments that it has been shown to be achievable and that a low positive rate is likely to be around the optimal level of inflation. Support for lowering the target tended to focus on the societal and economic costs that occur in an inflationary environment.

There was some support for raising the inflation target in both consultations, largely focusing on the benefit in mitigating the risks created by the ELB. In the second consultation there was also greater emphasis on the current environment of heightened inflation. Some submitters argued that raising the target would ensure that it is more achievable if heightened inflationary pressures continue into the future. Factors they pointed to for why this might be the case included a reduction in globalisation, a shift towards green investment, and more frequent climate-related supply shocks.

## Design of the inflation target

As well as the 'hybrid regime' – a target range with a midpoint focus – the Review considered a single numeric target ('point regime') and a range-only regime ('range regime').

A point regime provides a precise value for central banks to target and can enhance the clarity of the inflation objective. This can support the public's ability to monitor the MPC's performance and can provide a focus for future inflation expectations. However, it also reduces the achievability of the target, and a perception of persistently 'missing' the 2 percent target may undermine credibility.

In contrast, a target range may communicate the imprecise control that central banks have over inflation. A range regime improves the achievability of a target and conveys to the public the degree of uncertainty that exists with inflation targeting. However, a range may also provide less clarity around the future rate of inflation within the range, which can risk inflation expectations becoming less well-anchored.

Some research suggests that a range regime is less likely to be missed and hence is more credible than a point regime.<sup>89</sup> However, there is also evidence to suggest that a pure range regime leads to less well-anchored expectations in turbulent times and offers a worse trade-off between inflation and real economy stabilisation than a point regime.<sup>90</sup> Conversely, there can be communication risks associated with a range regime.<sup>91</sup> It could be interpreted as signalling indifference about inflation outcomes within the range. It can also create a risk that the public expects inflation to remain within the range at all times – whereas they are unlikely to expect inflation to remain precisely at all times in line with a point regime. This may draw the public's focus on the magnitude of inflation deviations, rather than other important aspects of monetary policy deliberations, such as the persistence and source of those deviations.

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<sup>89</sup> See [Ehrmann \(2021\)](#).

<sup>90</sup> See [Grosse-Steffen \(2021\)](#), [Le Bihan et al. \(2021\)](#), [Haavio and Laine \(2021\)](#), and [Cecioni et al. \(2021\)](#).

<sup>91</sup> See [Chung et al. \(2020\)](#).

A hybrid regime can help to mitigate some of the costs of a range-only regime. Hybrid regimes can introduce more complexity than pure point regimes or range regimes. However, the hybrid regime has been in place in New Zealand since 2012, so it is reasonably well-established. The inclusion of the midpoint, aimed at reinforcing public and market confidence that longer-term inflation outcomes will average around 2 percent, appears to have resulted in better-anchored inflation expectations.<sup>92</sup>

As it stands, there is no international consensus on the type of regime that should be used. For example, the Reserve Bank of Australia, the Bank of Israel, and the Swiss National Bank have target ranges, while the Bank of England and the US Federal Reserve have point targets. In all these countries there are also further nuances. The Bank of England has a 'trigger' system for informing the government about deviations from the target and the Federal Reserve has an average-inflation targeting regime incorporating history dependence. Similar to New Zealand, the Bank of Canada has adopted a midpoint target of 2 percent with a 1 to 3 percent range.

As the MPC will generally aim to anchor long-term inflation expectations to the middle of the inflation target, the type of inflation target appears less relevant for providing additional flexibility – particularly when the time horizon for achieving the inflation objective is already defined over the medium-term.<sup>93</sup> The Reserve Bank therefore views point regimes, range regimes and hybrid regimes as comparably flexible under a framework that aims to return inflation to target over an undefined medium-term horizon.

The majority of the second consultation submissions supported the Reserve Bank's recommendation to retain the hybrid approach of defining the inflation target in terms of both a range and a midpoint focus. Some were in favour of moving to either only a range or only a midpoint, but few elaborated on their reasoning. More detailed justifications were given by some supporters of the status quo, including that the current regime is well-entrenched in public expectations and that it provides the necessary flexibility to avoid causing unnecessary instability in the economy.

## The width of the target range

Within a hybrid regime, there are options for the width of the band around the midpoint. The appropriate width of the inflation target range depends on a number of factors. The range needs to balance a reasonable inflation target that anchors expectations with a target that is achievable and conveys the degree of uncertainty in inflation targeting. Both of these considerations interact with the perception of central bank performance and credibility.<sup>94</sup>

A symmetric range of one percentage point above and below the 2 percent midpoint effectively balances the need for credibility and flexibility in the *Remit*. Despite New Zealand – and many other economies – experiencing high and volatile inflation in recent years, the two percentage point range provides sufficient headroom to deal with most economic circumstances. Hence, this target is likely to remain achievable from a monetary policy perspective, as well as being credible, clear, and transparent from the public's perspective. Most advanced economies that have adopted inflation targets with ranges, including hybrid regimes, have chosen ranges that are one percentage point above and below the midpoints.

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<sup>92</sup> See [Kendall and Ng \(2013\)](#).

<sup>93</sup> [Kuttner and Posen \(2012\)](#) compare the Federal Reserve prior to 2012, which had a range regime, with the Bank of England, which had a point regime. The authors find that the two regimes are comparably flexible in terms of the speed of returning inflation to target following a disturbance, and that a point regime does not lead to an excessively inflexible commitment to the inflation objective.

<sup>94</sup> See [Dennis \(1997\)](#) and [DeBelle \(1997\)](#).

The level of uncertainty in which monetary policy operates matters for the calibration of the band width. Aspects of uncertainty include imperfect control of monetary policy over the inflation rate, long and variable lags of monetary policy, and an imperfect ability to forecast future inflation. If an inflation band is narrower than is appropriate for the level of uncertainty, inflation is more likely to move outside of the band and there may be more inflation ‘misses’ from random shocks that are outside the central bank’s control.

Maintaining credibility therefore requires a target range that accounts for the degree of uncertainty in inflation targeting. A tight band could increase the accountability of the MPC for achieving the inflation target, as the *Charter* requires reasons for breaches to be published.<sup>95</sup> However, a band that is too narrow can result in a perception that the MPC is not achieving its mandate. Conversely, a band that is too wide can undermine the signal that keeping inflation in the band provides to the public and weaken the anchoring of inflation expectations, particularly if the midpoint focus is perceived as weak. For example, if the public believes that policymakers view inflation at the top or bottom of the band as just as acceptable as inflation in the middle, it would result in inflation expectations becoming less well-anchored.

For the majority of the period since the 1 to 3 percent target band was adopted in 2002, inflation has remained within this range. This suggests that the inflation band in the 2021 *Remit* has sufficiently reflected the uncertainty in inflation outcomes, and does not appear to have caused significant volatility in interest rates. Additionally, changing the width of the band in the current economic conditions may be perceived as changing the target in response to high inflation, and could undermine the credibility of monetary policy.

Another consideration is the economic instability caused by a narrow band. If the band is too narrow, an increase in interest rates to prevent inflation rising above the band in one quarter may need to be offset by a decrease in the next quarter to prevent inflation falling below the lower limit. A wider band may provide the MPC with more flexibility in the short-term to support MSE, stabilise economic output and distinguish between temporary and persistent changes to inflation. However, the implications for flexibility are likely to be less relevant under a regime that already has flexibility through an unspecified time horizon for achieving the inflation target, as under the 2021 *Remit*.

The Reserve Bank considers that the two percentage point width of the target range remains appropriate. It supports the flexibility of the framework and balances the considerations relating to how the band width interacts with achievability, credibility, clarity and transparency.

The majority of submissions in the second consultation supported the Reserve Bank’s recommendation to retain the width of the current target range, although there was some support for both a narrower and a wider range.

One submitter, arguing for a narrower range, suggested that this was necessary for the MPC to retain accountability with respect to its inflation objective. Reasons provided in support of a wider range included that it allowed the MPC to account for inflationary pressures it could not control, such as external or tradables inflation, and that it would allow the MPC to adjust the OCR at a more gradual pace.

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<sup>95</sup> This is reflected in clause 2(b)(ii) of the 2021 *Charter*.

The measure of prices for the inflation target

The Reserve Bank recommends that the ‘All Groups Consumers Price Index’ (CPI) remain the measure of prices for the inflation target in the *Remit*. It is well established, produced by an external agency, and can be benchmarked against an international standard.

While a central bank could – in theory – target any measure that reflects the general level of prices in the economy, the options considered in the Review focused on a set of existing price measures. Alongside the CPI, the measures considered were the household living-costs price indexes, core inflation, the GDP deflator, and the private consumption expenditure deflator.

Table 2 captures the key characteristics of a credible and reliable price measure underlying monetary policy decisions. As well as being representative of the household inflation experience, the target measure should be robust and reliable throughout time. It should meet statistical best practice and international standards, be comparable across time and countries, be produced in a timely manner, and be published externally by an entity that is independent of the Reserve Bank.<sup>96</sup>

Table 2: Criteria for assessing a suitable inflation measure

| Criterion               | Description                                                                                                                                                                                                                                                                                                                                                                                                                                                              |
|-------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Monetary policy control | The MPC should be able to credibly influence the target measure to ensure that maintaining price stability is an <b>achievable</b> objective.                                                                                                                                                                                                                                                                                                                            |
| Representativeness      | The measure should be representative of the inflation experienced by households. This supports the <b>credibility</b> of the MPC’s actions as they relate to actual price and wage-setting processes. It also supports the <b>legitimacy</b> of inflation as a measure of price changes experienced by New Zealanders.                                                                                                                                                   |
| Independence            | The measure should be produced externally, with a fully documented methodology that provides <b>clarity and transparency</b> for public scrutiny.                                                                                                                                                                                                                                                                                                                        |
| Robustness              | The measure should align with international standards and best practice, be produced in a timely manner, be comparable across time and countries, and not be subject to large and frequent revisions. A robust measure supports <b>credibility</b> in MPC actions by ensuring that the price measure is accurately calculated. It also allows for more appropriate international comparisons and hence greater <b>clarity and transparency</b> of the MPC’s performance. |

The CPI is an index produced by Stats NZ that measures the changes in the prices of a fixed basket of consumer goods and services. It is an appropriate measure as it estimates the prices that are representative of the costs typically experienced by households over time.

<sup>96</sup> This largely follows the framework of Nickel et al. (2021), which reviewed the measure of prices for the ECB’s price stability objective. See also the Reserve Bank’s background note on the best measurement for an inflation target (Brocklesby, 2022), which builds on these principles set out in Nickel et al. (2021).



The CPI has also been used for most of the inflation targets in New Zealand since inflation targeting was introduced in 1990. The Reserve Bank has been able to maintain low and stable inflation in most of this period, suggesting that inflation targets based on the CPI are achievable. While the CPI is subject to volatility through shocks outside of the Reserve Bank's control – such as the increase to GST in 2010 – the underlying drivers of the CPI are influenced by monetary policy. Hence, the MPC can credibly influence it through monetary policy settings. The CPI also adheres to international standards, making it a relatively robust measure of prices, and importantly it is produced independently by Stats NZ. In terms of representativeness, the CPI is broadly reflective of the inflation experienced by households as it is weighted based on a survey of household expenditure.<sup>97</sup> It is also a well-understood measure and appears to move with household inflation perceptions, as seen in its correlation with household inflation expectations. Moreover, the CPI has a longstanding link with important wage-setting processes in New Zealand.

Prices respond to monetary policy with a lag. On this basis, some of the more theoretical literature tends to favour a central bank stabilising a price measure that is more reflective of the lagged influence of monetary policy, such as core inflation measures.<sup>98</sup> In practice, most central bank targets are based on the headline measure of consumer price inflation rather than a core inflation measure, as this is likely to be the most representative measure of the inflation experienced by households.

Table 3 outlines some of the trade-offs between prospective price measures for the inflation.

**Table 3: High-level summary of potential price indices for the inflation target**

| Price measure                             | Monetary policy affectability | Representativeness | Independence | Robustness |
|-------------------------------------------|-------------------------------|--------------------|--------------|------------|
| CPI                                       | ✓                             | ✓                  | ✓✓           | ✓✓         |
| Household living-costs price index        | ×                             | ✓✓                 | ✓✓           | ✓✓         |
| GDP deflator                              | ×                             | ×                  | ✓✓           | ×          |
| Personal consumption expenditure deflator | ✓                             | ✓✓                 | ✓✓           | ×          |
| Internally-produced core measures         | ✓✓                            | ×                  | ×            | ×          |
| Externally produced core measure          | ✓✓                            | ×                  | ✓✓           | ✓✓         |

**Key:** ✓✓ - Strong, ✓ - Somewhat strong, × - Somewhat weak, ×× - Weak

<sup>97</sup> See [Figures 3 and 4](#) in Brocklesby (2022).

<sup>98</sup> See [Mishkin \(2007\)](#).

Other measures of prices tend to perform better than the CPI in one or two criteria, but have significant drawbacks in other areas. For example, the household living-costs price index is more representative of the cost pressures facing households, but includes interest rate costs that would lead to unusual patterns in inflation in response to monetary policy. Core measures of inflation are more influenced by monetary policy, but are less representative of the inflation experienced by households and not as robust as the CPI.

The Reserve Bank recommends that the CPI remain the measure of prices for the inflation rate. The CPI is produced independently by Stats NZ and adheres to a robust international standard. It is broadly representative of the inflation experienced by households and has been shown to be influenced by monetary policy.

Most submissions supported the Reserve Bank's recommendation to continue using the CPI as the measure for the inflation target. Some of these submissions noted that the CPI is well-understood by households and businesses, is reliably measured and credible, and is produced by an independent source.

The most common opposing view to using CPI was that it did not sufficiently incorporate the cost of housing. Others suggested that the CPI did not accurately reflect the inflation that they had experienced.

Box E discusses improvements in the CPI would be helpful for policy decisions – in particular if the CPI were produced on a monthly basis. Submissions that commented on potential improvements to the CPI noted that they would support such changes.

## Box E: Potential enhancements of the All Groups Consumers Price Index

The 'All Groups Consumers Price Index' (CPI) has been used by the Reserve Bank as the measure of inflation for most of the period since inflation targeting was adopted in 1990.<sup>99</sup> It is a cost-of-goods index that measures changes in the prices of a fixed basket of consumer goods and services. The basket of goods is revised regularly to ensure it accurately represents the consumption behaviour of households. The CPI is used in several ways: as a benchmark index for central bank inflation targeting strategies; as a broad measure of the health of an economy; and for compensation indexing purposes in the public and private sectors.

The CPI is well-established, having been used for over a century in New Zealand, and adheres to an international standard for such indices.<sup>100</sup> While the CPI is compliant with these standards, over time many economies have improved their methods and now produce CPI measures with a greater frequency and more frequent reweighting of the basket of goods. New Zealand has not incorporated these improvements to the CPI and has largely become an outlier internationally (see Table 4 below).

Since Australia began publishing a monthly indicator index in September 2022, New Zealand is now the only country in the OECD that does not produce either a monthly CPI or a reliable monthly CPI indicator. Additionally, other countries tend to reweight their CPI baskets more frequently. New Zealand generally reweights its CPI once every three years and this is based on relatively dated data; the most recent reweighting in 2020 was based on spending patterns from the year ending June 2019.<sup>101</sup>

Stats NZ compiles and publishes our CPI. However decision-making in regards to potential CPI improvements may require decisions from both Stats NZ and the Government.

**Table 4: Inflation measures targeted by select central banks**

| Central bank                | Statistical agency               | Central bank target measure         | Publication frequency             | Approximate reweighting frequency |
|-----------------------------|----------------------------------|-------------------------------------|-----------------------------------|-----------------------------------|
| Reserve Bank of New Zealand | Stats NZ                         | CPI                                 | Quarterly                         | Every 3 years                     |
| Reserve Bank of Australia   | Australian Bureau of Statistics  | CPI                                 | Monthly, <sup>102</sup> quarterly | Annually <sup>103</sup>           |
| Federal Reserve             | U.S. Bureau of Economic Analysis | Personal Consumption Expenditures   | Monthly                           | Monthly (with a publication lag)  |
| Sveriges Riksbank           | Statistics Sweden                | CPI with a fixed interest rate      | Monthly                           | Annually                          |
| European Central Bank       | Eurostat                         | Harmonised Index of Consumer Prices | Monthly                           | Annually                          |
| Bank of Canada              | Statistics Canada                | CPI                                 | Monthly                           | Annually <sup>104</sup>           |

The Reserve Bank sees benefits in improving the CPI in these areas.

More frequent CPI publications would support the formulation of monetary policy by allowing the MPC to incorporate more timely information into the monetary policy process, and adapt its strategy more quickly in response to changing economic circumstances. This would reduce the likelihood of policy mistakes, which is particularly relevant for periods when the economy is facing large shocks and heightened uncertainty.

A monthly publication of the CPI would also enhance its international comparability, which is important for central banking research.<sup>105</sup> In this context, it would also improve the robustness of New Zealand's CPI as a measure, giving it increased public credibility. The Reserve Bank made statements to this effect in its submission to the 2013 CPI Advisory Committee.<sup>106</sup>

There are options for how to improve publication frequency. For example, Australia recently introduced a monthly CPI measure based on between 62 and 73 percent of the full quarterly CPI basket.

Similarly, a more frequent reweighting of the CPI would more precisely reflect household consumption patterns. Currently the CPI is reweighted once every three years. While this is in compliance with the IMF's *CPI Manual*, it is the minimum requirement. Reweighting once every one or two years could help to reduce the excess measurement errors present in the CPI, and would align with the features of the CPIs in many other developed economies.<sup>107</sup> This would also support the representativeness of the CPI as a measure that reflects the inflation being experienced by households, making it a better indicator of inflation for the purpose of monetary policy.

<sup>99</sup> For two years under the 1997 PTA, the inflation target was defined in terms of the 'All Groups Consumer Price Index excluding Credit Services' (CPIX) measure.

<sup>100</sup> Several international organizations such as the IMF and the OECD have developed and produced the *CPI Manual (International Monetary Fund, 2020)*, which advises statistical agencies on suitable methodologies for constructing consumer price indices. Another important institution in this space is the *Ottawa Group*, which provides a forum for specialists to discuss challenges and best practice related to measuring prices.

<sup>101</sup> Note that there were some bespoke changes to reduce the weights on international airfares and overseas accommodation in September 2020 due to the COVID-19 pandemic. See *Stats NZ* for more detail.

<sup>102</sup> In September 2022, Australia introduced a revisable monthly indicator which is based on between 62-73 percent of the full quarterly CPI basket. As of March 2023, Australia still publishes its full CPI at a quarterly frequency.

<sup>103</sup> Australia's annual reweight largely draws on its six-yearly household expenditure survey. New Zealand's household expenditure survey is currently three-yearly.

<sup>104</sup> Since 2021, Canada's has reweighted annually. From 2011 until 2021, Canada's reweighting was every two years.

<sup>105</sup> For example, an internationally comparable CPI is useful for studying the real exchange rate.

<sup>106</sup> The Reserve Bank submission to the 2013 CPI Advisory Committee is available [here](#).

<sup>107</sup> The *CPI Manual (International Monetary Fund, 2020)*, for instance, asserts that the upward bias inherent in a Lowe index (or Laspeyres-type index) will likely increase as the time between reweights increases.

## 2.3 Recommendation to maintain an inflation targeting regime

While inflation targeting is the most common framework adopted by advanced economies, it is not the only framework for achieving price stability. Alternative frameworks have been explored in academic research, as well as by other central banks.<sup>108</sup>

The Reserve Bank views a flexible inflation targeting framework as the most robust and suitable option for New Zealand. Inflation targeting is currently the most widely used framework around the world, and offers the benefit of being already well understood and credible in the New Zealand context. In contrast, the magnitude of the benefits of alternative frameworks is uncertain and there is limited real-world experience with these frameworks. However, we expect to learn more about alternative frameworks from academic research and the experiences of other central banks in the years to come.



### Recommendation

New Zealand should retain a flexible inflation targeting regime.

The main alternative frameworks considered as part of the second public consultation were:

- Targeting the *level of prices* ('price-level targeting'), possibly with the target level growing at a steady rate. The central bank would have to make up for previous periods of high or low inflation in order to return to the target level.
- Targeting an *average change in prices over a rolling window* ('average inflation targeting'), which also requires the central bank to make up for recent periods of high or low inflation, although to a lesser extent than in price-level targeting.
- Targeting the nominal value of outputs (or incomes) rather than the price of a representative basket of goods. This can be in two forms: the level of nominal GDP ('nominal GDP targeting'), or the growth rate of nominal GDP ('nominal GDP growth targeting').

Price-level targeting and average inflation targeting incorporate history dependence: the need for the central bank to make up for past over- or under-shoots of inflation. History-dependent monetary policy frameworks have theoretical benefits, particularly in cases where a central bank faces a high risk of the ELB becoming a constraint on monetary policy.<sup>109</sup>

However, in requiring more aggressive monetary policy responses to make up for past over- and under-shoots, this could reduce the scope for the MPC to consider real output and unemployment in the short term. For example, the current environment of high inflation might require deflation to return prices to the targeted price level. It is difficult to determine the extent to which the cost of this may be offset by the theoretical benefits of history dependence.<sup>110</sup>

<sup>108</sup> In particular, support for history-dependent frameworks grew following [Bernanke \(2017\)](#) who proposed a temporary price-level targeting regime that applies when rates were constrained by the lower bound. The strongest recent support came from the Federal Reserve which adopted a flexible average inflation targeting framework in 2020 ([Federal Reserve, 2020](#)). The [Bank of Canada \(2021\)](#) also considered the potential benefits to an average inflation targeting regime. The findings of these monetary policy framework reviews are discussed further in Box C.

<sup>109</sup> For future discussion of the benefits of history dependent monetary policy frameworks, see [Svensson \(1999\)](#), [Hatcher and Minford \(2016\)](#), [Dorich et al. \(2021\)](#), and [Wagner et al. \(2022\)](#).

<sup>110</sup> The Bank of Canada considered the relative theoretical costs and benefits of history dependent monetary policy frameworks in research leading up to their 2021 framework renewal. See [Dorich et al. \(2021\)](#) for further details.



Furthermore, there is a lack of practical experience with history dependent frameworks; the only current example is the adoption of flexible average inflation targeting by the US, but even this regime was only introduced in 2020. In this context, there is substantial uncertainty about the effects on the New Zealand economy and the wellbeing of New Zealanders if a history dependent framework were implemented.

Another set of proposed alternative frameworks targets nominal GDP or income rather than prices. Nominal GDP targeting accounts for the quantity of goods and services traded, not just their price levels. It would result in stronger monetary policy responses to negative demand shocks, as both falling real GDP growth and inflation cause nominal GDP growth to decline. In contrast, the response to supply shocks would be softer as increasing inflation would partly offset the decline in real GDP.<sup>111</sup>

The Reserve Bank does not see a nominal GDP target as appropriate at this time. Benefits are theoretical, with no central bank having implemented such a target. Additionally there are operational challenges, as nominal GDP calculations are subject to significant data revisions and lags. This would delay policy-makers' ability to re-assess policy in light of new information. Further, it can be challenging to calibrate nominal GDP targets. It requires a good understanding of the underlying trends in the productive capacity of the economy, and the target may need to change as those trends develop to maintain price stability.

The majority of respondents in the second consultation supported the Reserve Bank recommendation to retain inflation targeting. Most submissions did not consider the three main alternative frameworks covered above and instead engaged on whether or not flexible inflation targeting was appropriate.

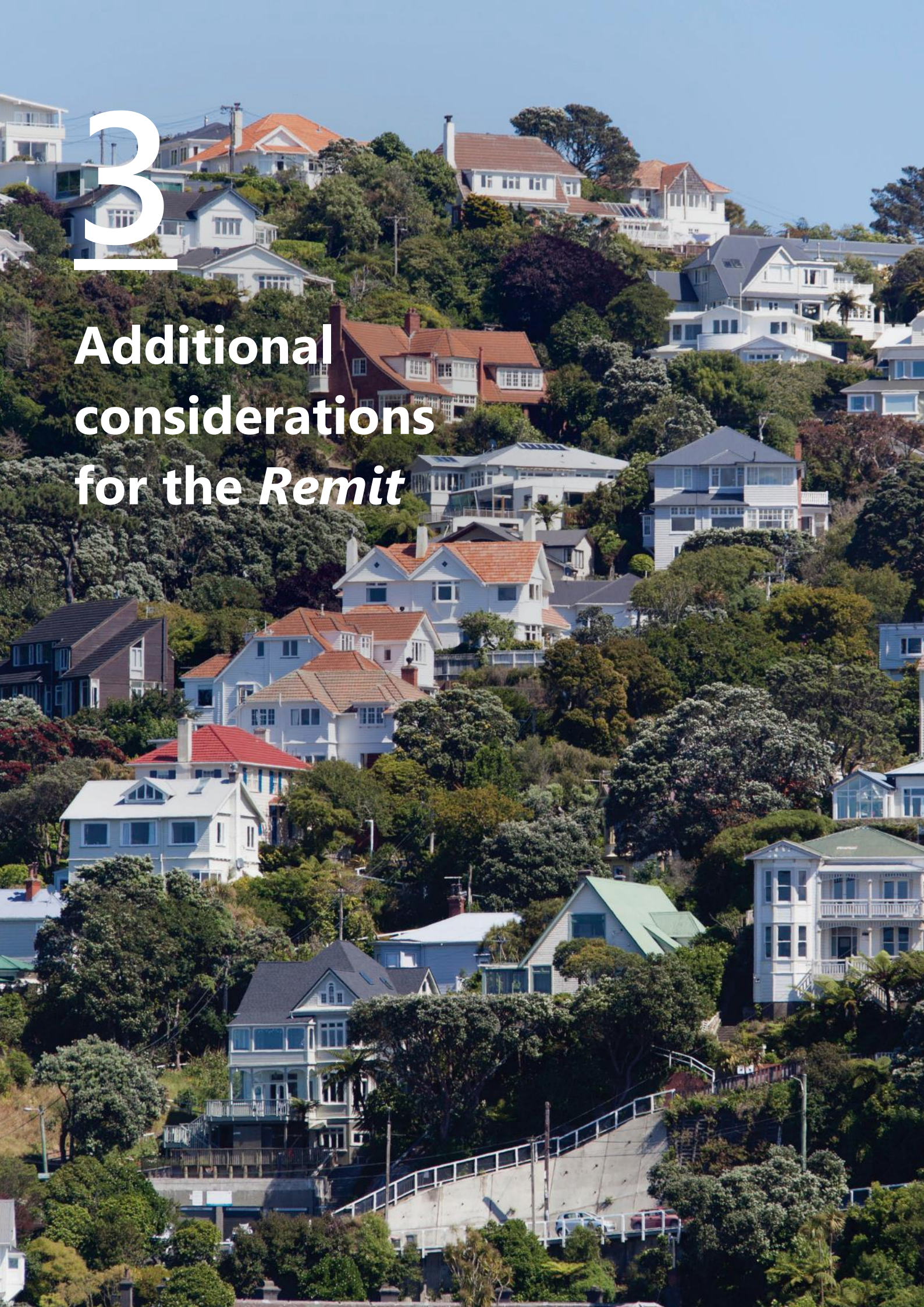
The main reason given in support of inflation targeting was that it balances the flexibility to consider real output and deal with uncertainty, while also providing a specific inflation target to anchor inflation expectations. Some submitters also noted that the current framework has the benefit of being well-understood and seen as credible. Some were in favour of retaining a flexible regime but reducing the level of flexibility, in particular with respect to MSE.

Submissions against retaining the flexible inflation targeting raised concerns that the current framework can decrease accountability due to the discretion allowed within a flexible framework. Others disagreed more broadly with the framework, including with the structures of government and central banks, with some showing distrust in policy-makers' decision-making.

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<sup>111</sup> For discussions on nominal GDP targeting, see [Beckworth \(2019\)](#), and [Ambler \(2020\)](#).





3

# Additional considerations for the *Remit*



### 3 Additional considerations and broader context for monetary policy

Although the main focus of the Monetary Policy Committee (MPC) is to achieve price stability over the medium term and to support maximum sustainable employment (MSE), the 2021 *Remit* document also contains a number of additional matters that are relevant for the MPC. This includes: a clause that further defines the inflation objective by requiring the MPC to discount transitory inflation; additional considerations (often referred to as ‘secondary objectives’) for the MPC to consider in the pursuit of the inflation and MSE objectives; and some accompanying text that outlines the broader context within which monetary policy operates.

These parts of the *Remit* document have different purposes. The operational objectives – which includes both the primary objectives and additional considerations – are better placed to incorporate factors that should be considered in MPC decision-making. Conversely, the text accompanying the operational objectives is best suited to providing the broad context of monetary policy and high-level expectations for the MPC. Any addition to the operational objectives of the *Remit* would place greater requirements on the MPC than changes to the text describing the broader context of monetary policy.

The additional considerations reflect important matters – such as output volatility and financial stability – that the MPC should consider in the pursuit of inflation and MSE objectives. These requirements have changed over time, reflecting and supporting the evolution to the current flexible inflation targeting framework and are reflected through clause 2 in 2021 *Remit*.

As discussed in Chapter 2, the Reserve Bank recommends that the requirement to discount transitory inflation be redrafted and incorporated directly into the inflation objective as this requirement relates more directly to the inflation target.

#### ***Excerpt from the 2021 Remit***

- 2) In pursuing the operational objectives, the MPC shall:
  - a) Have regard to the efficiency and soundness of the financial system
  - b) Seek to avoid unnecessary instability in output, interest rates, and the exchange rate
  - c) Discount events that have only transitory effects on inflation, setting policy with a medium-term orientation
  - d) Assess the effect of its monetary policy decisions on the Government’s policy set out in subclause (3).
- 3) The Government’s policy is to support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers.

The response of monetary policy, in terms of both the magnitude of policy responses and how quickly the operational targets are met, can be influenced by the additional considerations in the *Remit*. For example, in keeping with the requirement in clause 2(b), the MPC may choose to achieve its inflation target over a slightly longer time horizon in order to avoid unnecessary instability in output or interest rates in particular circumstances.<sup>112</sup> In this sense, the additional considerations augment the flexible inflation targeting framework by specifying the matters that the MPC should consider in using its flexibility.

<sup>112</sup> See [Kendall and Ratcliffe \(2019\)](#) for a more detailed discussion on how the trade-offs around additional considerations may be taken into account by the MPC.

Given the broader purpose of monetary policy to support the wellbeing of New Zealanders, these considerations should also reflect issues that, when considered in the pursuit of the inflation and MSE objectives, will improve welfare outcomes. This would also support the legitimacy of the *Remit* and monetary policy more generally.

The additional considerations should also be clear, measurable and achievable. As discussed in Section 1.3, an important aspect of operational independence for central banks is having clear and measurable goals for monetary policy to target. This ensures that monetary policy consistently targets the objectives set out by the Government. Furthermore, ambiguous or conflicting targets may cloud the focus of the MPC and could undermine public support for the framework if the MPC cannot achieve the specified objective. Ambiguity in how the MPC may respond to certain economic shocks could also undermine the clarity that the *Remit* provides to the public.

Additionally, the accumulation of these requirements in the *Remit* over time could be perceived as an erosion of the independence of the Reserve Bank. This is particularly relevant for the clauses in the 2021 *Remit* regarding the Government's policy to support more sustainable house prices, and the potential addition of a requirement for the governance of additional monetary policy (AMP) tools.

Monetary policy can have important effects on the broader economic objectives of the Government. Where it is not intended for the MPC to adjust its monetary policy strategy to account for these factors, broader expectations around communication and information sharing can be incorporated in other aspects of the framework. This could be through documents, such as the *Letter of Expectations* and *Memoranda of Understanding*, or be part of the broader context provided in the text that precedes the operational objectives.

## The Reserve Bank's recommendations

The Reserve Bank's recommendations consider the benefits and risks of additional considerations – both existing and prospective – to monetary policy outcomes.

The Reserve Bank views clauses 2(a) and 2(b) of the 2021 *Remit* – requirements to consider financial stability and avoid unnecessary instability in output, interest rates, and the exchange rate – as providing benefits to the formulation of monetary policy. These are long-standing requirements in the monetary policy framework and reflect the conventional understanding that placing at least some weight on these matters in monetary policy decisions is beneficial to welfare.

The only change that is recommended is to redraft clause 2(a) to require the MPC to “have regard to the importance of protecting and promoting the stability of New Zealand's financial system”. The clause from the 2021 *Remit* reflects the language used in the Reserve Bank of New Zealand Act (1989), and this change would align the requirement with the language used in [Section 119](#) of the 2021 Act.



### Recommendation

Clause 2(a) of the 2021 *Remit* should be redrafted to align with the requirement in Section 119 of the Reserve Bank of New Zealand Act (2021).



### Recommendation

Clause 2(b) of the 2021 *Remit* should be retained.

The second consultation explored whether the *Remit* should incorporate a requirement related to the use of AMP tools, with a focus on financial risks. The existing arrangements already involve Reserve Bank staff considering a range of important matters – including public balance sheet risk – when providing advice to the MPC on the design and use of AMP tools. Furthermore, the Reserve Bank Board has oversight of financial risks and the MPC has an incentive to ensure that its decisions are consistent with the Board’s financial responsibility duties.

There are risks associated with incorporating requirements in the *Remit* that define financial risk or specify AMP tools. These include unintended consequences, such as capturing the effects of Official Cash Rate (OCR) changes on the Crown balance sheet or limiting the Reserve Bank’s ability to adapt policy tools over time. They could also be perceived as limiting the Reserve Bank’s operational independence and could affect the credibility of the MPC’s commitment to achieving its operational objectives.

The Reserve Bank therefore recommends that the *Remit* not include any requirement related to the use of AMP tools or financial risks.



### Recommendation

The *Remit* should not include any requirement related to AMP tools or financial risks.

There are some requirements – both existing and prospective – that would have little or no bearing on the formulation of monetary policy.

For example, some submissions from the public consultation commented on the role of fiscal policy and monetary policy coordination. Incorporating a requirement on such a matter would not directly influence monetary policy strategy and would contribute to the accumulation of objectives, potentially undermining the overall clarity of the *Remit*. Furthermore, the existing arrangements already allow for coordination between fiscal and monetary policy: The Treasury has an observer who provides insights on fiscal policy during MPC deliberations, and the working relationship between the Reserve Bank and The Treasury is formalised through a Memorandum of Understanding.

Similarly, the 2021 *Remit* includes requirements for the MPC to “assess” the effect of its decisions on house price sustainability through clauses 2(d) and 3. As this is – in effect – a requirement for the MPC to consider *ex-post* its decision, it does not have a meaningful influence on monetary policy strategy.

The MPC already considers house prices in its decisions, but this is through the influence that the housing market has on inflation and employment outcomes, and through the requirement for the MPC to consider financial stability.

As *Remit* clauses 2(d) and 3 do not influence the formulation of monetary policy, the Reserve Bank recommends that the requirement relating to assessing house price sustainability be removed from the *Remit*. The Reserve Bank also recommends that the *Remit* not incorporate other requirements that do not directly relate to the formulation of monetary policy.

While these issues are important, they may be better accommodated through other documents, such as *Memoranda of Understanding* or the *Letter of Expectations*.



### Recommendation

The requirement for the MPC to assess the effect of its decisions on the sustainability of house prices – clauses 2(d) and 3 in the 2021 *Remit* – should be removed from the *Remit*.



### Recommendation

The *Remit* should not include requirements that do not relate directly to the formulation of monetary policy. This includes not incorporating a requirement related to fiscal policy and monetary policy coordination in the *Remit*.

The 2021 *Remit* document includes text before the operational objectives. This includes a paragraph describing the Government's objective and another that provides context to the *Remit*, noting the general purpose of the Act.

Such text can contribute to the legitimacy of the *Remit*, by connecting the role of the operational objectives with the broader purpose of monetary policy to promote the prosperity and wellbeing of New Zealanders. However, aspects of the text can affect the perception of the Reserve Bank's operational independence and contribute to a more complex document. This text may also raise practical challenges as the *Remit* may need to be reissued with a change in the Government's objective. This could open up the *Remit* to more frequently changes.

The Reserve Bank recommends that the text relating to the Government's objective should be removed from the *Remit* document. The Reserve Bank also recommends that the context paragraph be redrafted to align with the 2021 Act.



# 11

## Recommendation

The text relating to the Government's objective should be removed from the *Remit*. Other parts in the text preceding the operational objectives should be redrafted to refer to the Reserve Bank of New Zealand Act (2021).

As noted above, the Reserve Bank recommends that the *Remit* not include any requirements for the governance of AMP tools, house price sustainability, or fiscal and monetary policy coordination. One option for these matters is to incorporate them into the text preceding the operational objectives. This text could provide the broader context within which monetary policy operates, noting the importance of these matters to the MPC. It would not place the same strict requirements on the MPC and would reduce some of the risks associated with incorporating these issues into the operational objectives.

However, the Reserve Bank considers that such language may still create risks and recommends that these issues not be included in the *Remit* document. To the extent that they are included in the text accompanying the operational objectives, they should still follow the key principles for designing a *Remit*, outlined in Section 1.3. These include ensuring the expectations are clear and measurable. Such text should also be drafted in a manner that minimises the risk of the Reserve Bank's operational independence being perceived to be constrained.

## 3.1 Financial stability

The requirement for the MPC to have regard to the soundness and efficiency of the financial system originated from the 2012 *Policy Target Agreement (PTA)*. It was introduced following the Global Financial Crisis and is a common feature of overseas frameworks, through either monetary policy strategies or formal governing documents such as the *Remit*. Given the importance to the economy of stability in the financial system, and that the requirement to consider the financial system is well established, the Reserve Bank recommends that the *Remit* retains this clause. However, it should be redrafted to align with language in the 2021 Act.

There are a number of ways in which monetary policy strategies can consider risks to the financial system. Monetary policy actions can alleviate dysfunction in financial markets during turbulent periods. For example, bond-purchasing programmes for monetary policy purposes can also provide liquidity to financial markets when there are few willing buyers in the market otherwise.

Some research also suggests that there may be conditions under which monetary policy should be more contractionary than otherwise to ward off a build-up of risks in the financial system, although there is not a consensus in literature.<sup>113</sup>

Another consideration is the effects of volatility from sharp interest rate changes. Large increases in interest rates can stress household and business debt serviceability and balance sheets. However, more gradual changes to interest rates allow businesses and households time to adjust to changes in their debt-servicing and funding costs.<sup>114</sup>

<sup>113</sup> For a section of literature on this matter, see [Filardo and Rungcharoenkitkul \(2016\)](#), [Gerdrup et al \(2017\)](#), [Guorio, Kashyap and Sim \(2017\)](#), [Classens et al \(2009\)](#), [Yellen \(2009\)](#), [Jordà et al \(2015\)](#), and [Dell'Ariccia et al \(2017\)](#).

<sup>114</sup> See [Bernanke \(2004\)](#).

Clause 2(a) of the 2021 *Remit* does not specify how the MPC should incorporate financial stability into its strategy. However, it does provide scope for the MPC to incorporate these different concerns into its decisions, alongside other relevant matters, when formulating monetary policy.

The wording of clause 2(a) in the 2021 *Remit* is consistent with the Reserve Bank's responsibilities under the repealed Reserve Bank of New Zealand Act (1989). It is slightly different to the requirement in [Section 119](#) of the 2021 Act, which specifies that the MPC must "have regard to the importance of protecting and promoting the stability of New Zealand's financial system" when formulating monetary policy.<sup>115</sup>

Redrafting clause 2(a) to align it with the requirement in Section 119 of the Act would ensure the *Remit* is more consistent with the current legislation. Most public submissions that engaged with this issue in the second consultation supported this position.

### 3.2 Avoiding unnecessary instability

Clause 2(b) of the 2021 *Remit* requires the MPC to seek to avoid unnecessary instability in output, interest rates and the exchange rate. It was introduced in the 1999 *PTA* and was an important development in the move towards flexible inflation targeting. Given the benefits of flexibility in the *Remit*, the Reserve Bank recommends that clause 2(b) of the 2021 *Remit* be retained.

It is generally accepted that volatility in the economy is negative for welfare outcomes and that monetary policy should give at least some consideration to this matter.<sup>116</sup> The extent to which the MPC should place weight on this depends on a range of other considerations, including the need to maintain a credible commitment to return inflation to target.

Retaining this requirement would also provide more context for the general public around how the MPC will use the flexibility embedded in its operational objectives. This would continue to support the clarity of the monetary policy framework.

There may be circumstances where volatility in output, exchange rates or interest rates is an unavoidable consequence of the MPC achieving its inflation and MSE objectives, particularly with respect to interest rates and the exchange rate. However, clause 2(b) of the 2021 *Remit* specifies that the MPC should seek to avoid *unnecessary* instability, which does not limit the MPC's ability to respond in a way that causes volatility when necessary.

A few consultation submissions argued against the ongoing inclusion of this requirement. They noted that the flexible inflation targeting framework and the MSE objective already implicitly require the MPC to avoid causing unnecessary volatility in the real economy. There were also some concerns that the policy implications from this clause could be unclear.

However, most public submissions on this matter supported the Reserve Bank's position of retaining this requirement in the *Remit*. Several noted that it was an important aspect of the flexible inflation targeting regime and supported monetary policy's role in macroeconomic stabilisation.

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<sup>115</sup> This language of the requirement under [Section 119](#) aligns with the Reserve Bank's broader responsibilities when setting financial policies under [Section 9\(1\)\(b\)](#).

<sup>116</sup> See [Woodford \(2003\)](#) and [Rotemberg and Woodford \(1999\)](#) as examples in literature showing that reducing interest and output volatility, at the expense of higher inflation volatility, can improve welfare outcomes. Also see [Bernanke \(2004\)](#) for a discussion on how gradual policy rate changes may assist financial stability by allowing businesses and households to adapt, as well as reducing the risk of shocking the bond market.

### 3.3 Governance of additional monetary policy tools

The Reserve Bank implemented AMP tools for the first time in 2020. In the face of the significant uncertainty, and in anticipation of a significant economic downturn, the MPC saw these tools as necessary to achieve its objectives in the *Remit*. The second public consultation discussed the existing arrangements for the use of AMP tools, and asked whether any requirements that related to the use of those tools should be incorporated into the *Remit*. Such a clause could specify that the MPC should have regard to the implications for financial risks or risks to the public balance sheet from their decisions, possibly in relation to specific tools.

The Reserve Bank does not recommend introducing an additional requirement of this nature to the *Remit*. The existing arrangements already see Reserve Bank staff, working under the Reserve Bank Board, consider important matters such as financial risks when advising the MPC on the design and use of AMP tools. Furthermore, such a requirement would carry risks to the perception of the Reserve Bank's operational independence and could have unintended consequences. It could also reduce public clarity on the MPC's commitment to achieving its operational objectives.

#### Existing arrangements

AMP tools are not perfect substitutes for the OCR; they act to influence interest rates and the economy through different channels and may have implications that conventional monetary policy does not. In light of this, the Reserve Bank used a set of principles to guide the design of AMP tools over 2020 and 2021. These principles ensured that Reserve Bank staff took into account a range of important considerations when developing the tools, such as the efficiency of a tool's use and the effects it may have on the stability of the financial system.

As part of the framework for AMP tools in 2020, the Minister of Finance and the Reserve Bank also agreed to a *Memorandum of Understanding*. It noted the potential need for AMP tools, the Reserve Bank's operational independence and that the use of some AMP tools could result in a significant increase in financial exposure for the Crown. These considerations were also reflected in the AMP principles under 'public balance sheet risk'.

**Table 5: Principles governing our monetary policy tools**

|                                   |                                                                                                                                                                                                                                                                                                  |
|-----------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Effectiveness</b>              | Tools are designed to provide a strong influence over inflation and employment, to ensure the monetary policy objectives are achieved.                                                                                                                                                           |
| <b>Efficiency</b>                 | We take into account the distortionary impact of the tools on the efficient allocation of resources within the economy, including between various groups and sectors of the economy.                                                                                                             |
| <b>Financial system soundness</b> | We take into account the impact of the tools on financial system risks, to avoid the costs of financial crises.                                                                                                                                                                                  |
| <b>Public balance sheet risk</b>  | We take into account the financial risks that the tools create for the Crown's and our balance sheets, to protect public funds and central bank independence.                                                                                                                                    |
| <b>Operational readiness</b>      | Use of the tools take into account the operational readiness of each tool, to ensure the transmission channels function as expected. This includes our readiness to implement each tool and the readiness of financial markets and the New Zealand public to respond appropriately to the tools. |

Since AMP tools were first used in New Zealand in 2020, the broader governance framework of the Reserve Bank has changed following the implementation of the Reserve Bank of New Zealand Act (2021). The Act places responsibility for the management of the Reserve Bank's financial resources on the Reserve Bank Board, with the Board needing to ensure that the Reserve Bank operates in a financially responsible manner. Reserve Bank staff who develop advice to the MPC also work under internal frameworks approved by the Board.

The Reserve Bank Board is accountable to the Minister of Finance. The current framework provides a number of avenues for the Minister to influence how the Reserve Bank takes on financial risk, including the provision of capital and indemnities and directions on financial risk management. In addition, the *Memorandum of Understanding* on the use of AMP tools sets expectations on the process for requesting indemnities from the Government and reporting requirements for the use of AMP tools. As the Minister represents the elected government, these arrangements support the legitimacy of AMP tool use by the Reserve Bank.

Under [Section 121](#) of the Act, the Reserve Bank is not required to implement monetary policy formulated by the MPC if the Board considers that it would be inconsistent with its financial responsibilities. This provides a further incentive for the MPC to consider the financial consequences of its decisions around AMP tools and for Reserve Bank staff to ensure that their advice adequately addresses any concerns that the Board may have.

#### **Excerpts from the *Reserve Bank of New Zealand Act (2021)***

##### **47 Bank must operate in financially responsible manner**

- (1) The board must ensure that the Bank operates in a financially responsible manner and, for this purpose, that it prudently manages its assets and liabilities.
- (2) In particular, the board must take all reasonable steps to ensure that—
  - (a) the Bank's expenditure complies with the requirements imposed under section 210(1)(c); and
  - (b) the Bank complies with a direction given under section 208.

...

##### **121 Bank not required to implement monetary policy that is inconsistent with financial responsibility duties**

Despite [section 120](#), the Bank is not required to implement a monetary policy formulated by the MPC to the extent that the board considers that implementing the policy would be inconsistent with either or both of the following:

- (a) the board's duty under [section 47](#);
- (b) the Bank's duty to comply with a direction given under [section 208](#).

## Considerations

A general concern about the use of AMP tools by central banks is whether monetary policy decisions appropriately account for important matters other than outcomes for monetary policy objectives. A particular focus has been on the role of financial risk, for example, whether the MPC should seek to adopt an alternative policy that would achieve much the same outcome with less financial risk. Introducing a requirement for the MPC to have regard to financial risks – directly to the Reserve Bank or the Government – would reinforce the consideration of financial risks in monetary policy decision-making. This could support the legitimacy of the *Remit* by aligning the MPC decision-making process with concerns around financial risk for the public balance sheet.

However, the existing arrangements already consider a wide range of relevant matters, including financial risks. The MPC is incentivised to ensure that decisions comply with the financial responsibility duties of the Reserve Bank Board. Furthermore, Reserve Bank staff will consider the key trade-offs when developing advice on the design and use of AMP tools. These include the financial responsibilities of the Board, the public balance sheet risks and broader considerations such as tool effectiveness and implications for efficiency. The Reserve Bank's principles governing AMP tools in Table 5 are an example of how the current framework considers these matters.

The Reserve Bank considers that there are a number of risks involved in incorporating a requirement relating to financial risks or AMP tools more broadly into the *Remit*.

A clause that is broad and general could unintentionally capture a wider range of decisions or considerations for the MPC. For example, it may unintentionally capture conventional monetary policy tools, such as the effect of the OCR on government finances. This could undermine the credibility of the MPC's commitment to price stability. The existing framework allows for Reserve Bank staff and the MPC to take into account the trade-offs between different tools in a more practical way.

Conversely, a clause that specifies the AMP tools to which it applies could limit the Reserve Bank's ability to adapt monetary policy implementation alongside changes in the market and could restrict its operational independence. It would also require a high degree of foresight in relation to possible future policy instruments. Similarly, a clause that is specified in terms of 'fiscal' or 'Crown' risk would be difficult to monitor as it would require an understanding of the complex interactions between monetary policy actions and financial risks on the Crown balance sheet.

The addition of such a clause could also be perceived as an erosion of the operational independence of the Reserve Bank. This risk is accentuated by the potential for such a clause to be misinterpreted – as has been the case for the *Remit* requirements related to house price sustainability – and perceived as more onerous than intended.

Finally, focusing additional attention on one particular aspect of AMP tool use and design – financial risk or public balance sheet risk – could result in relatively less emphasis on other legitimate considerations. These include, for example, the trade-offs around the efficiency and effectiveness of monetary policy tools.



## Stakeholder views

There was not significant public engagement on this issue. A few submissions supported the incorporation of some clauses in the *Remit* that would govern the design and use of AMP tools, although the options and concerns discussed varied across submitters. One focused on the financial cost to taxpayers of AMP tools, and another argued for a more comprehensive range of considerations around AMP tools to be incorporated into the *Remit*.

Several submissions supported the recommendation to not incorporate in the *Remit* any requirement related to the governance of AMP tools. These submissions pointed to managing governance arrangements through other channels and also to the downsides of such a clause, including the risks to central bank operational independence.

MPC members also opposed such a requirement being incorporated into the *Remit*.

### 3.4 House price sustainability

Clauses 2(d) and 3 of the 2021 *Remit* require the MPC to assess the effect of monetary policy on the Government's policy to support more sustainable house prices. These clauses were introduced on 1 March 2021 and are unique to New Zealand, with no other comparable central bank having such an explicit focus on house prices in their monetary policy frameworks.

The Reserve Bank considers that there are risks to such clauses, including precedents for more frequent changes to the *Remit*. These clauses also contribute to a more complex document that undermines clarity for the public. Alternative avenues – such as the *Letter of Expectations* – can serve to create the same expectations on the Reserve Bank's research outcomes.<sup>117</sup> The Reserve Bank therefore recommends that these clauses be removed from the *Remit*.

Given the importance of the housing market to the New Zealand economy, the Reserve Bank and the MPC already internalise many of the effects of house prices on the economy. Additionally, under clause 2(a) of the 2021 *Remit*, the MPC considers risks associated with house prices to the extent that they affect the soundness and efficiency of the financial system.

Retaining the clauses related to house prices may hinder the clarity of the *Remit*, as they contribute to a more comprehensive list of additional considerations that clouds what the MPC should be considering in the pursuit of the inflation and MSE objectives. Additionally, these clauses reduce overall clarity for the public on the MPC's operational objectives. As discussed in Section 1.3, having clear objectives is an important aspect of the Reserve Bank's operational independence.

Although the 2021 *Remit* requires the MPC to assess the effect of its decisions on the Government's policy to support more sustainable house prices, some observers have misinterpreted these clauses as requiring the MPC to *have regard to*, or *consider* house prices in their decision-making.<sup>118</sup> This could hinder credibility if the public perceive the MPC as more responsible for house prices than is accurate. While the wording in the 2021 *Remit* does not directly influence monetary policy decision-making, removing the clauses would alleviate these concerns.

<sup>117</sup> The 2022 *Letter of Expectations*, which is addressed to the Reserve Bank Board Chair, sets out expectations regarding the coordination of monetary, financial, and fiscal policy. As an example, this has included an encouragement to share insights from Reserve Bank analysis of the monetary policy interactions with distributional outcomes.

<sup>118</sup> See [The Economist \(2022\)](#), and [Ferryhough \(2022\)](#).

The inclusion of the house price sustainability clauses in the 2021 *Remit* also introduced a Government priority directly into the operational objectives. This increases the risk that Government priorities, which may be time and context specific, could be introduced to and amended in the *Remit* more frequently. This contrasts with the enduring nature of the *Remit* intended under the Act, with reviews conducted every five years. While the *Remit* may be amended by the Minister of Finance at any point, a stable *Remit* helps ensure clarity and central bank credibility in communicating an enduring commitment to setting operational objectives.

In response to the addition of house price sustainability to the *Remit* in 2021, the Reserve Bank has undertaken further research to understand the New Zealand housing market. Over 2021 and 2022, the Reserve Bank produced a series of research pieces relating to house price sustainability and the housing market.<sup>119</sup> However, while the *Remit* is the only place where the Government can set objectives for monetary policy, there are other mechanisms that could be used to influence the Reserve Bank's research programme and communications.

These concerns were echoed in the public consultations response, and there was more support for removing the clauses than there was for their retention. Of the submitters who supported the removal of the clauses, some expressed concern that mentions of house prices in the *Remit* detracted from the price stability objective, and some noted that the Reserve Bank would still consider the relationship between central bank policy and house prices, whether or not it was explicitly in the *Remit*. Conversely, those who supported the retention of the clauses stressed the importance of the housing market to wellbeing and the economy.

### 3.5 Monetary and fiscal policy coordination

Some public submitters to the consultations discussed the importance of monetary policy and fiscal policy coordination, with some suggesting that the *Remit* could formalise such an arrangement.<sup>120</sup>

While the importance of coordination was highlighted during the COVID-19 pandemic, the main consideration in the Remit Review has been whether the *Remit* or the *Charter* are appropriate avenues for these matters. The Reserve Bank considers that adding a requirement for coordination between agencies to either the *Remit* or the *Charter* would not be appropriate.

The *Remit* is about setting the operational objectives of the MPC, while the purpose of the *Charter* is to promote transparency and accountability in connection with the performance of the MPC's functions and decision-making procedures. Discussing fiscal policy and monetary policy coordination in these documents may contribute to a more comprehensive list of additional considerations that clouds the guidance provided to the MPC around how it should incorporate or trade-off these requirements when pursuing the primary objectives. A large number of considerations could also reduce the overall clarity of the *Remit* and the *Charter* for the public.

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<sup>119</sup> See [Fitchett and Jacob \(2022\)](#), [Chadwick, Dasgupta, and Jacob \(2022\)](#), [Chadwick and Nahavandi \(2022\)](#), [Carvalho, Baker, and Farquharson \(2022\)](#), and [Brunton and Jacob \(2022\)](#).

<sup>120</sup> For research considering the coordination benefits of monetary policy and fiscal policy, see [Woodford and Xie \(2022\)](#), [Bianchi and Melosi \(2019\)](#), and [Schmitt-Grohé and Uribe \(2004\)](#).

Additionally, the coordination of fiscal policy and monetary policy already occurs through a range of channels. These include working-level meetings of the Reserve Bank and The Treasury, regular meetings of the Reserve Bank Governor and the Secretary to The Treasury, briefings on the economic outlook to the Prime Minister and Minister of Finance, and pre-Budget briefings to the Reserve Bank. In addition, a Treasury observer participates in MPC deliberations on forecasts and risks in the economy. The Reserve Bank and The Treasury also have a Memorandum of Understanding that formalises much of this working relationship.

Submitters on the second public consultation expressed mixed views on this issue. The arguments against including references to monetary and fiscal coordination in the *Remit* or the *Charter* were generally based on the risk that it would undermine public confidence in the Reserve Bank's independence. One respondent also noted that information-sharing by policymakers was already taking place and did not require the *Remit* or *Charter* to enable it.

In contrast, some submitters argued that the *Remit* should have a role in supporting monetary and fiscal coordination, noting that the challenges facing the economy require monetary, fiscal and regulatory actions to work together, particularly in the context of "overburdened" central banks. Additionally, a few respondents commented on the importance of monetary-fiscal policy coordination, but did not argue for putting the issue in the *Remit* or the *Charter*.

Ultimately, fiscal and monetary policy coordination happens in the context of the Reserve Bank being operationally independent of the Government in setting monetary policy. The Reserve Bank views that adding a requirement for fiscal and monetary policy coordination into the *Remit* or the *Charter* would reduce the clarity of these documents and potentially reduce the public perception of the Reserve Bank's operational independence.

### 3.6 Accompanying text to the operational objectives

The operational objectives in the 2021 *Remit* are accompanied by preceding text that outlines the Government's economic objective and the context for the *Remit*. While the text does not set formal objectives for monetary policy, it does provide the broad context within which monetary policy operates and can convey broad expectations from the Government. This contrasts with the operational objectives in the *Remit* which define formal requirements on the MPC.

The text can play an important role in supporting the legitimacy of the overall monetary policy framework. It draws a connection between monetary policy objectives and the overarching purpose of monetary policy to support the wellbeing and prosperity of New Zealanders. It can clarify to the public that the operational objectives – decided by the Minister of Finance – are designed to achieve this overarching purpose.

However, such text can also create perception risks around the Reserve Bank's operational independence. In particular, the language on broad Government objectives that are not directly related to monetary policy may be viewed as an erosion of Reserve Bank operational independence. It could also contribute to a longer and more complex document, potentially undermining the clarity to the public of the focus of the MPC.

The text accompanying the operational objectives in the 2021 *Remit* is made up of three paragraphs:

- A paragraph outlining the Government's economic objective.
- A context paragraph that describes the interaction of the role of monetary policy under the Act and, by extension, the Government's economic objective.
- A third paragraph reiterating the objectives of monetary policy set out in the Act.

These paragraphs are not technically part of the 2021 *Remit*.<sup>121</sup> However, the issue of the text was raised by some submitters in response to the first *Remit* review consultation paper. Following this feedback, the second consultation paper specifically asked for comments on the non-*Remit* text.

The Reserve Bank recommends the removal of text that is related to the Government's economic objective. This includes the removal of the first paragraph and the first sentence of the second paragraph in the 2021 *Remit* document. The removal of this text could increase the *Remit*'s clarity and enhance the perception of central bank independence. Furthermore, the text poses a practical issue: if the Government's objective were to change, the *Remit* document may need to be updated. This would create unnecessary processes and potentially open the *Remit* to more frequent changes. This could undermine the general purpose of having five-yearly reviews with substantial public engagement: to support a more enduring *Remit* document based on a thorough review process. The Reserve Bank considers that the text relating to the Government's objective would be more appropriate in a supporting document that could be published alongside the *Remit*.

However, the Reserve Bank considers that some text preceding the operational objectives could provide useful context on the legislative background for monetary policy and support the legitimacy of the *Remit*. The Reserve Bank recommends that these aspects of the 2021 *Remit* document be redrafted, in the spirit of improving the clarity of the document, to remove unnecessary text and to update references to the Act.

Four of the six respondents who answered this question favoured removing this text. Generally, these submitters noted that removing it could improve the clarity of the *Remit* and enhance the perception of central bank independence. This generally aligned with the comments raised in submissions in the first consultation. Additionally, one respondent noted that the wording of paragraph two could imply that employment was considered over price stability. However, another submitter argued that this text supported the democratic legitimacy of monetary policy.

While the Reserve Bank's recommendation is to remove and redraft this text in the *Remit* document, an alternative option is to retain a preamble to the operational objectives that outlines the broader context within which monetary policy operates. This could also incorporate expectations relating to house price sustainability, the Reserve Bank's financial risks from monetary policy, and fiscal policy and monetary policy coordination. This would set broad expectations on the MPC that are not as strict as those in the operational objectives.

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<sup>121</sup> See [Section 4\(3\)](#) of the Reserve Bank of New Zealand (Replacement of Remit for Monetary Policy Committee) Order 2021.

There would still be risks associated with such a preamble, and such an alternative should still consider the principles for designing the *Remit* in Section 1.3 and the potential risks to the Reserve Bank's operational independence. This would include ensuring that the objectives are clear and that such text is relevant to monetary policy, so that the MPC can reasonably meet these expectations. Goals or expectations that are too vague or not achievable could undermine the legitimacy of the *Remit* over time as the MPC would not be able to meet the public's expectations.

***Excerpt from the Reserve Bank of New Zealand (Replacement of Remit for Monetary Policy Committee) Order 20***

**The Government's economic objective**

The Government's economic objective is to improve the well-being and living standards of New Zealanders through a sustainable, productive, and inclusive economy. The Government's priority is to move towards a low carbon economy, with a strong diversified export base, that delivers decent jobs with higher wages and reduces inequality and poverty. An effective functioning housing market is a critical component of a sustainable and inclusive economy and promotes the maintenance of a sound and efficient financial system.

**Context**

Monetary policy plays an important role in supporting the Government's economic objective. The Reserve Bank of New Zealand Act 1989 (the Act) requires that monetary policy promote the prosperity and well-being of New Zealanders, and contribute to a sustainable and productive economy. Monetary policy contributes to public welfare by reducing cyclical variations in employment and economic activity whilst maintaining price stability over the medium term.

**1 Monetary policy objectives**

Under section 8 of the Act the Reserve Bank, acting through the MPC, is required to formulate monetary policy with the goals of maintaining a stable general level of prices over the medium term and supporting maximum sustainable employment.



# 4

## The MPC *Charter*



## 4 The MPC Charter

When deciding whether to revise the *Remit* following the Review, the Minister of Finance and the Monetary Policy Committee (MPC) are required by the Act to consider whether the *Charter* should be amended. Unlike the *Remit* – which is set by the Minister of Finance following advice from the Reserve Bank – the *Charter* is agreed between the MPC and the Minister.

Following the formal introduction of an MPC and the addition of external members in 2019 – from a single decision-maker model – the MPC and the Minister of Finance agreed on a *Charter* to govern the decision-making processes and transparency of the MPC.<sup>122</sup>

The *Charter* is required by the Act to include:

- Requirements to promote transparency and accountability.
- Requirements for summary records of the MPC's meetings and other information to be published by the MPC.
- Decision-making procedures.

The Act intentionally leaves the details of MPC decision-making and communication to be determined in the *Charter*. It was expected that these would evolve over time as experience with the committee model for monetary policy decisions grew.

The Act requires the Reserve Bank Board to review the performance of the MPC and its members regularly and state its opinion on whether the MPC has adequately discharged its duties in the *Annual Report*. The Board must advise the Minister of Finance if there are grounds for the removal of an MPC member. The *Charter* can support the Board in these duties through its requirements for transparency and accountability, as well as the information the MPC must publish. Individual MPC members can also raise any concerns with the Chair of the MPC or the Board.

### 4.1 Decision-making procedures in the *Charter*

#### How the MPC makes decisions under the 2021 *Charter*

Decisions on monetary policy are made with a high degree of uncertainty.<sup>123</sup> The MPC does not have perfect knowledge of the current state of the New Zealand economy due to release lags and revisions to data and the challenges of unobservable variables like the output gap. Further, the structure of the economy and the transmission of economic events are difficult to know for certain and can change over time. Monetary policy decisions must consider the likely future path of the economy, but unforeseen events are always pushing New Zealand's economy in new – and unforeseeable – directions. It is important that the decision-making process supports a culture that enables robust discussions on these matters and the wider economy.

The 2021 *Charter* requires the MPC to seek consensus when making monetary policy decisions, with the option of undertaking an unattributed vote if necessary. It directs MPC members to engage constructively and embrace diverse opinions. Box F describes the decision-making process for the MPC in practice.

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<sup>122</sup> The *Charter* was amended slightly in early 2021 to account for the replacement *Remit*, and came into force on 2 March 2021.

<sup>123</sup> See [Richardson \(2016\)](#) for a more detailed discussion on the main sources of uncertainty.



## Box F: How the MPC makes decisions under the 2021 *Charter*

The *Monetary Policy Handbook* sets out the process for making monetary policy decisions. This process is a continuous cycle of analysis, policy advice, and decision-making. Within this broad cycle, details such as the timing, length, and purpose of meetings have been designed to uphold the principles of 'clear objectives', 'diversity', and 'inclusion of both information and people'.

### Stage 1: Information-pooling

To start the process, Reserve Bank staff present relevant information to the MPC regarding recent developments, issues and risks, as well as the future outlook and strategy. A senior policy expert leads the meetings to signal that the focus is on facts and understanding, while staff present their own work so that the MPC members have direct access to experts when forming their views. This ensures decision-making is evidence-based, upholding the principle of 'inclusion of information'.

Information-pooling meetings are spread over two working days. This gives members time to absorb information and raise queries in ways that suit them. It also allows for reflections between meetings and provides time for MPC members to engage informally with analytical staff if needed, so that all MPC members have a good opportunity to contribute, upholding the principle of 'diversity'.

### Stage 2: Deliberation meetings

Following information-pooling, the next stage focuses on the MPC considering what that information means for monetary policy. The MPC discusses risks, strategy, external messaging and tactics.

Deliberation meetings are spread over two days, allowing time for open discussion and constructive dissent. Senior Reserve Bank staff are also present at some of these meetings, this time as advisors rather than presenters.

### Stage 3: Preliminary opinion formation

Following the information-pooling meetings, the preliminary opinions of individual MPC members are independently recorded. These opinions include their view on the balance of risks for the primary inflation and MSE objectives, the likely impacts of monetary policy on the secondary considerations in the *Remit*, and their recommendations for the level and direction of the monetary policy instrument (or instruments). This process can include members expressing their views in terms of a distribution of different policy outcomes.

### Stage 4: Decision meetings

The decision-making process begins with a discussion on the preliminary opinions recorded by the MPC members and the reasoning behind them. This provides an opportunity for different views to be aired, discussed and challenged, building on the benefits of having a diverse committee with different perspectives. The Reserve Bank Governor chairs this meeting in accordance with the Act – in a way that ensures collegial discussion and the airing of diverse views – and MPC members aim to reach a consensus view. If MPC members cannot reach a consensus, they can then undertake a vote on the policy decision.

During the decision meetings, the MPC also reviews written advice from key Reserve Bank staff and decides on its wider strategy and key messages.

## Stage 5: Final decision and publication

The final decision meeting is on the morning of the *Monetary Policy Statement (MPS)* release day, reducing the risk of sensitive information being inadvertently released. This is where the MPC decides on the level and direction of the policy instrument(s) and agrees on the content of two key outputs.

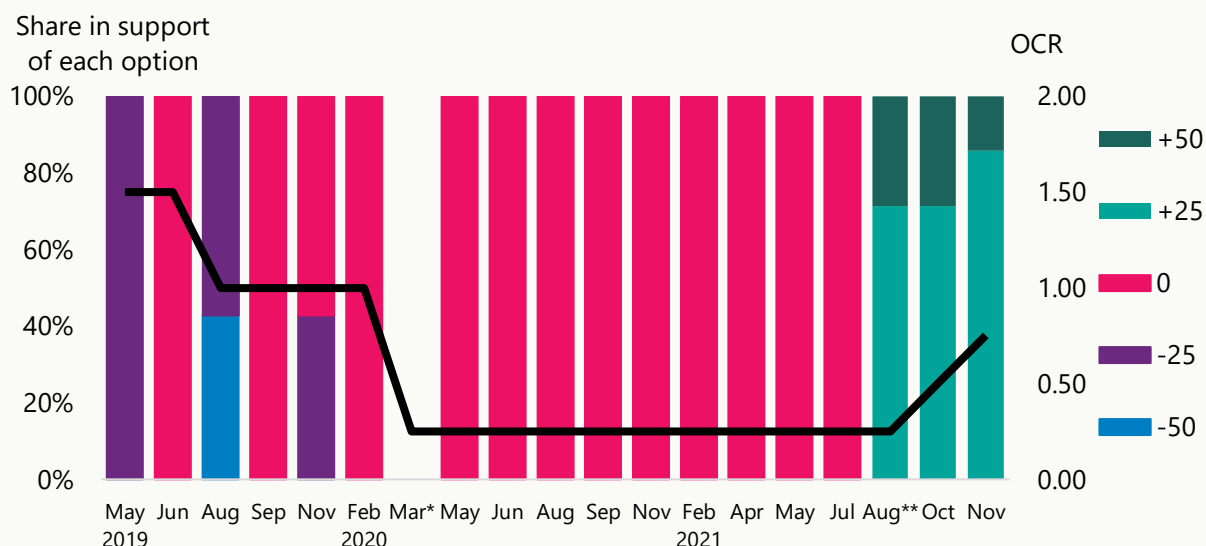
The first is the MPC's decision on and view of the key risks that need to be emphasised. This is included in the *MPS* as its first chapter and is also released as a media statement. The second is the *Record of Meeting* that is also included in the *MPS*. It describes the discussions during the decision meetings and provides an avenue for differing views to be expressed publicly.

## Reaching consensus under uncertainty

Since the MPC was established it has been able to reach consensus on each monetary policy decision without needing to use the option to vote, even though there have been periods of considerable economic uncertainty.<sup>124</sup> However, MPC members have not always been unanimous in their recommendations at the preliminary opinion stage. Instead, consensus has been attained through discussion and debate during the decision-meeting stage, despite differing initial opinions among individual members. Reaching consensus does not imply all members' views were perfectly aligned, instead it reflects the fact that a decision could be reached that all members can support.<sup>125</sup>

There has been diversity in views during this preliminary opinion stage. Weighted averages of their recommendations from 2019 to 2021 are shown in Figure 6. Notably, in the August 2019 decision, a 25 basis point cut in the OCR was more supported in the preliminary opinions. However, the MPC chose to reduce the OCR by 50 basis points. Discussions during the deliberation and decision-making stages led to a consensus in favour of what was originally the minority view.

**Figure 6: Preliminary opinions of MPC members May 2019- November 2021**



Source: Reserve Bank of New Zealand.

Note: See footnote 126.

<sup>124</sup> As at the time of writing this advice, April 2023.

<sup>125</sup> Previous European Central Bank presidents have defined consensus as when conclusions "are supported by the entire Governing Council, by some more enthusiastically than others, but this does not require a vote" (Duisenberg, 2002); or when "everybody could either agree or not object" (Draghi, 2015). See also Claeys and Linta (2019).

<sup>126</sup> Figure 6 shows the proportion of MPC members that recommended each possible OCR change at the 'preliminary opinion' stage, since the MPC was established in April 2019. From May 2019 to February 2020, MPC members provided views in the form of a distribution over OCR values. After this point a range of methods was used to obtain a specific policy recommendation from members. \* There was an out-of-cycle OCR review on 15 March 2020, hence there is no data on the preliminary opinions of MPC members. \*\* The night before the August 2021 decision Auckland was put into lockdown and the MPC decided to delay the start of the tightening cycle.

## Options for decision-making in the *Charter*

There are two main approaches that the *Charter* could prescribe for MPC decision-making. These are:

- Decisions made by consensus, with votes only when no consensus is reached.<sup>127</sup>
- Decisions made by voting, with the Governor having the casting vote.

It is not clear which of these models would lead to the most robust decision-making.<sup>128</sup> In a consensus-based model members need to engage constructively when different views arise to reach a decision they all agree on. This may support the exchange of perspectives and lead to more in-depth discussions than voting, where the minority view could be marginalised. Given the levels of complexity and uncertainty involved in making a decision on monetary policy, this rigorous discussion could support better decision-making, building on the benefits of the diversity of MPC members' views.

There are some risks with a consensus-based model. It may encourage views of MPC members to converge over time, reducing the benefits associated with having a diverse committee. However, including a stage in the decision-making process when members independently develop views and then discuss them – as the MPC does in New Zealand – can help to reduce the risk of 'groupthink' developing.

There is a further risk of the chair or other MPC members being overly dominant when using a consensus-based model, and this could limit the benefits associated with inclusion.<sup>129</sup> However, it is unlikely that moving to a voting-based model would remove this risk entirely.

A voting-based model could improve accountability and reduce the risk of individual MPC members 'free-riding'. This would support the ability of the Reserve Bank Board and the public to monitor the performance of individual MPC members. However, there is no guarantee that MPC members would reveal their underlying views during a vote, as they could be incentivised to vote so as not to be in a minority. Further, a vote can actually reduce debate if members do not feel compelled to explain or defend their positions.

Overall, it is likely that neither model would consistently deliver better decisions than the other.<sup>130</sup> It may also be that other factors – such as meeting processes and a culture that promotes debate and challenge – are just as important.<sup>131</sup> Regardless of the model, it is important that the *Charter* is clear and understandable.

The majority of submitters did not comment on the decision-making model in the *Charter*, or note that they did not have strong views or feel qualified to comment. Two members of the public explicitly said they were happy with the current decision-making arrangements, while eight respondents stated that they would favour compulsory voting.<sup>132</sup>

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<sup>127</sup> Some literature, such as [Demertzis et al. \(2022\)](#), refer to 'collegial' and 'individualistic' models, rather than consensus and voting.

<sup>128</sup> See [Blinder \(2007\)](#) for a consideration of the advantages and disadvantages of individualistic and collegial models. [Farvaque, Matsueda, and Méon \(2009\)](#) also discuss the implications of monetary policy decision-making on interest-rate volatility.

<sup>129</sup> [Blinder \(2007\)](#) compares the period when Alan Greenspan was the Federal Reserve Chair – when decisions were made in an "autocratically collegial" manner with the chair dictating the group consensus decision – with the period when Ben Bernanke was Chair and the Committee arrived at decisions in a "genuinely-collegial" manner, based on debate and decisions reflecting the majority view.

<sup>130</sup> [Ehrmann and Fratzscher \(2005\)](#) assess the strategies of the European Central Bank, the Federal Reserve and the Bank of England and find that there is not a single best approach for central banks to adopt.

<sup>131</sup> For example, group decision-making conventions can also help discourage or reduce the influence of dominant personalities on an MPC. [Maier \(2010\)](#) argues that MPC members should take turns in putting forward initial policy proposals for decisions to prevent a dominant chairperson, decision-making patterns or groupthink.

<sup>132</sup> Other issues related to decision-making that were raised in the consultation include: moving to a scenario-based risk management approach for decision-making; how Māori and Māori values could be involved in decision-making; and governance of AMP tools.



Broadly, proponents of a voting model argued that it would increase the accountability and transparency of individual MPC member's contributions, noting this would improve the ability of the public and the Reserve Bank's Board to monitor the effectiveness of MPC members. Some respondents also emphasised the benefit that voting – and the increased transparency of individual member's views – would bring in terms of communicating the degree of complexity and nuances in monetary policy decisions, and that it could reduce the risk of groupthink. Some respondents focused on the importance of ensuring that the MPC is not overly influenced by the Governor, with some suggesting voting could support this outcome.

The MPC supports retaining the consensus-based model for decision-making. This is because of the crucial role that reaching consensus plays in encouraging rigorous debate on members' diverse viewpoints. The MPC acknowledges that 'consensus' can be interpreted in different ways, and that providing a definition of consensus would avoid confusion about its meaning. To aid transparency and improve clarity, a definition of consensus could be added to the *Charter* to explain that a consensus decision is one that all members can support. The MPC also sees benefits in making sure the *Record of meeting* provides a rich sense of the views expressed in reaching a decision.

## 4.2 Communications requirements in the *Charter*

This section sets out the main approaches the *Charter* could prescribe for MPC communication, and what they mean for accountability and transparency.

The effective communication of monetary policy decisions helps financial market participants, economic analysts, the government and the public to understand how the MPC will respond to different forces that affect the economy. This helps to improve policy outcomes by keeping inflation expectations anchored and maintaining credibility in the MPC's ability to meet its *Remit*. Monetary policy communication should convey targeted information and limit confusion.<sup>133</sup>

Monetary policy communication should also enable public accountability.<sup>134</sup> Open and transparent communication is crucial for the public legitimacy of monetary policy. Communicating which data was used to inform policy, what perspectives were shared in the deliberations and how decisions were made enables the public and financial markets to assess the credibility of policy decisions and processes.

### How the MPC communicates under the 2021 *Charter*

The 2021 *Charter* sets out a requirement for the MPC's communications to "contribute to the overall effectiveness of monetary policy decisions... and the accountability of the MPC".

In relation to transparency and accountability, it sets out a requirement to produce a *Record of meeting* after each monetary policy review, including a record of any material differences of views and an unattributed record of any vote taken. It also sets out requirements related to the Reserve Bank's quarterly *MPS*.

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<sup>133</sup> See [Price and Wadsworth \(2019\)](#).

<sup>134</sup> See [Bascand \(2013\)](#).

The *Charter* allows for individual MPC members to communicate publicly and provides a set of rules for members when doing so. For example, it requires an MPC member to consult other members before giving speeches and to not characterise other members' views. The Governor is the sole spokesperson for the official announcement of monetary policy decisions, and there are restrictions on external communications during the period following the receipt of MPC briefing papers and before decisions are announced.

### Options for external communication in the *Charter*

The *Charter* can prescribe a wide range of possible approaches for the MPC to take in relation to external communications, which all have implications for accountability and transparency. The three main options are set out below in Table 6. Similar to the decision-making model, there is no one approach that is clearly better than the others.<sup>135</sup>

**Table 6: Communication models**

|                              | Coordinated                                                             | Balanced                                                        | Individualistic                         |
|------------------------------|-------------------------------------------------------------------------|-----------------------------------------------------------------|-----------------------------------------|
| Minutes or record of meeting | Consensus view only                                                     | Range of views set out, but not attributed                      | Views attributed to individuals         |
| Votes (if used)              | No vote published                                                       | Vote result published without attribution to individual members | Individual MPC members' votes published |
| Speeches                     | Speeches in line with consensus view or limited number of speeches made | Individual speeches, but approved by MPC                        | No constraints on speeches              |

The 2021 *Charter* was drafted in a way that could support a balanced or coordinated approach to communication. For example, there is nothing in the 2021 *Charter* that prevents MPC members giving speeches that represent their views, as long as they consult other members first. The *Charter* also requires any material differences in judgements to be expressed in the *Record of meeting*. If a vote is taken, the result is unattributed.

In practice, the MPC has operated closer to the coordinated approach. In part, this may reflect the fact that external members have only been part of the MPC since 2018. The MPC *Records of meeting* have mostly presented consensus views on monetary policy decisions.<sup>136</sup> However, the *Records of meeting* do often report a range of views on specific issues, and notes when some members see the balance of risks differently from others.

Coordinated communication has the benefit of providing clarity to financial markets. This is particularly important as the Reserve Bank influences interest rates across the economy through the signals it sends about the outlook for monetary policy.

<sup>135</sup> Ehrmann and Fratzscher (2005) find that different communication and decision-making approaches deliver similar outcomes in terms of predictability of decisions for financial markets.

<sup>136</sup> There have been times when a *Record of meeting* has included a discussion of different views on the appropriate monetary policy decision – such as in [October 2022](#).

There could be benefits in moving towards a more balanced approach. Allowing individual MPC members to share their views more could increase the public's understanding of MPC decisions, increase the public legitimacy of policy and provide more information to financial markets on how the balance of views within the MPC is developing. It may also increase trust and credibility over time by demonstrating the uncertainty inherent in monetary policy decisions. Having monetary policy messages being delivered by a broader range of members could also support reaching a broader spectrum of the public.<sup>137</sup>

However, there is a risk that publicly expressing diverse views would conflict with the goal of supporting clear and effective policy signals. It could reduce the clarity of policy signal to the market and expressing dissenting views could reduce the credibility of decisions. Further, it could create incentives for individuals to retain previously published positions – even as new information emerges – for fear of being seen as conceding their positions.<sup>138</sup>

At the time of formally introducing the MPC and adding external members, another risk highlighted around more individualistic communication was the high transition costs. Now that the MPC with external members is well established, this risk has likely diminished.

In response to the consultation, the majority of respondents did not comment on this matter. Three submitters supported the current approach to communication from the MPC. Seven respondents supported more communication from individual MPC members setting out their viewpoints.

The arguments for more individualistic communication were mostly based on the importance of demonstrating to the public that the MPC engages in robust debate when reaching monetary policy decisions. Others mentioned the role that more individualistic communication could play in balancing the influence of the Reserve Bank Governor and other MPC members. Some also discussed the potential improvement to public discourse around monetary policy, and improving decision-making through increasing scrutiny. Two submitters stressed the importance of ensuring external MPC members have the support and resources they need to engage in speeches and statements.

The responses to the consultation also illustrated that the *Charter* can be interpreted in different ways: one respondent interpreted the *Charter* as preventing MPC members contributing to public discourse without the Governor's agreement, whereas another noted that more individualistic communications could be achieved within the current (2021) *Charter*.

The MPC supports all members being able to communicate externally on topics related to monetary policy and the MPC's collective views and decisions, including discussing which factors were important to them individually when reaching those collective views. It remains important to retain an avenue for MPC members to express their individual views. For example, when a vote has been triggered and a member wants to explain their viewpoint in more detail than they would in the *Record of meeting*. The MPC sees benefits in making changes to the Charter to make it clearer that MPC members are able to do this if they wish. Other changes could be introduced to clarify requirements for notifying and publishing speeches and other remarks from MPC members.

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<sup>137</sup> D'Acunto, Fuster and Weber (2021) conducted a randomised control trial of how trust and attention paid to messages change when the salience of female and minority representation on the Federal Reserve's Monetary Policy Committee was varied. They found that more diverse policy committees were better able to reach underrepresented groups.

<sup>138</sup> As set out in Hawkesby (2019).

## Glossary

|        |                                                                                |
|--------|--------------------------------------------------------------------------------|
| CPI    | All Groups Consumers Price Index                                               |
| AMP    | Additional monetary policy                                                     |
| ECB    | European Central Bank                                                          |
| ELB    | Effective lower bound                                                          |
| MPC    | Monetary Policy Committee                                                      |
| MPS    | Monetary Policy Statement                                                      |
| MSE    | Maximum Sustainable Employment                                                 |
| PTA    | Policy Target Agreement                                                        |
| OCR    | Official Cash Rate                                                             |
| RAFIMP | Review and Assessment of the Formulation and Implementation of Monetary Policy |

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2021/29



### **Reserve Bank of New Zealand (Replacement of Remit for Monetary Policy Committee) Order 2021**

Patsy Reddy, Governor-General

#### **Order in Council**

At Wellington this 22nd day of February 2021

Present:

The Right Hon Jacinda Ardern presiding in Council

This order is made under clause 6 of Schedule 2 of the Reserve Bank of New Zealand Act 1989—

- (a) on the advice and with the consent of the Executive Council; and
- (b) on the recommendation of the Minister of Finance made in accordance with clause 6(2) of Schedule 2 of that Act.

#### **Contents**

|                                            | Page     |
|--------------------------------------------|----------|
| 1 Title                                    | 2        |
| 2 Commencement                             | 2        |
| 3 Revocation                               | 2        |
| 4 Remit for monetary policy committee      | 2        |
| <b>Schedule</b>                            | <b>2</b> |
| <b>Remit for monetary policy committee</b> |          |

## Order

### 1 Title

This order is the Reserve Bank of New Zealand (Replacement of Remit for Monetary Policy Committee) Order 2021.

### 2 Commencement

This order comes into force on 1 March 2021.

### 3 Revocation

This order is revoked on the close of 13 February 2024.

### 4 Remit for monetary policy committee

- (1) The remit is as set out in the Schedule.
- (2) The remit replaces the remit issued under Schedule 1 of the Reserve Bank of New Zealand Act 1989.
- (3) The following are not part of the remit, but are intended to provide further information and context in connection with the remit:
  - (a) the information under the heading “The Government’s economic objective”;
  - (b) the information under the heading “Context”;
  - (c) the information under the heading “Monetary policy objectives”.

## Schedule

### Remit for monetary policy committee

cl 4

#### The Government’s economic objective

The Government’s economic objective is to improve the well-being and living standards of New Zealanders through a sustainable, productive, and inclusive economy. The Government’s priority is to move towards a low carbon economy, with a strong diversified export base, that delivers decent jobs with higher wages and reduces inequality and poverty. An effective functioning housing market is a critical component of a sustainable and inclusive economy and promotes the maintenance of a sound and efficient financial system.

#### Context

Monetary policy plays an important role in supporting the Government’s economic objective. The Reserve Bank of New Zealand Act 1989 (the **Act**) requires that monetary policy promote the prosperity and well-being of New Zealanders, and contribute to a sustainable and productive economy. Monetary policy contributes to public wel-

fare by reducing cyclical variations in employment and economic activity whilst maintaining price stability over the medium term.

## **1 Monetary policy objectives**

Under section 8 of the Act the Reserve Bank, acting through the MPC, is required to formulate monetary policy with the goals of maintaining a stable general level of prices over the medium term and supporting maximum sustainable employment.

## **2 Operational objectives**

- (1) For the purpose of this remit, the MPC's operational objectives shall be to:
  - (a) keep future annual inflation between 1 and 3 percent over the medium term, with a focus on keeping future inflation near the 2 percent mid-point. This target will be defined in terms of the All Groups Consumers Price Index, as published by Statistics New Zealand; and
  - (b) support maximum sustainable employment. The MPC should consider a broad range of labour market indicators to form a view of where employment is relative to its maximum sustainable level, taking into account that the level of maximum sustainable employment is largely determined by non-monetary factors that affect the structure and dynamics of the labour market and is not directly measurable.
- (2) In pursuing the operational objectives, the MPC shall:
  - (a) have regard to the efficiency and soundness of the financial system; and
  - (b) seek to avoid unnecessary instability in output, interest rates, and the exchange rate; and
  - (c) discount events that have only transitory effects on inflation, setting policy with a medium-term orientation; and
  - (d) assess the effect of its monetary policy decisions on the Government's policy set out in subclause (3).
- (3) The Government's policy is to support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers.

Michael Webster,  
Clerk of the Executive Council.



## Explanatory note

*This note is not part of the order, but is intended to indicate its general effect.*

This order, which comes into force on 1 March 2021, replaces the remit for the monetary policy committee (the **MPC**). The existing remit was issued by the Minister of Finance under Schedule 1 of the Reserve Bank of New Zealand Act 1989 (the **Act**).

The MPC has the function of formulating monetary policy in accordance with the Act. The MPC must formulate monetary policy in a manner consistent with—

- the economic objectives of achieving and maintaining stability in the general level of prices over the medium term and supporting maximum sustainable employment; and
- the remit.

The remit in this order carries over the wording of the existing remit, including the operational objectives for carrying out the function of formulating monetary policy. However, the new remit now requires the MPC to assess the effect of its monetary policy decisions on the Government's policy to support more sustainable house prices.

This order is revoked on the close of 13 February 2024.

Issued under the authority of the Legislation Act 2012.

Date of notification in *Gazette*: 25 February 2021.

This order is administered by the Treasury.

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Wellington, New Zealand:

Published under the authority of the New Zealand Government—2021

## Annex 2: 2021 MPC Charter

### Monetary Policy Committee Charter

Reserve Bank of New Zealand

This charter is issued and comes into effect on the day it is signed by both the Minister of Finance and an authorised representative of the Monetary Policy Committee.

The Monetary Policy Committee (MPC) is responsible for formulating monetary policy directed at achieving the economic objectives of price stability and support of maximum sustainable employment, as set out in section 8 of the Reserve Bank of New Zealand Act (1989) ("the Act") and in accordance with the remit. This charter aims to facilitate effective decision making by the MPC and ensure transparency of these decisions and the decision-making process, in order to aid the effectiveness of monetary policy and hold the MPC accountable.

#### 1) *Decision making*

- a) MPC members are tasked to abide by the code of conduct, and engage constructively with each other to achieve informed and timely monetary policy decisions. The MPC's decision making is enhanced by embracing diverse opinions that reflect, for example, members' unique personal and professional experiences and educational backgrounds. Members will respect each other's contributions and embrace any difference in view as a benefit of a diverse committee.
- b) The MPC will seek consensus in decision making. This is to ensure that the MPC engages in in-depth discussions and a true exchange of perspectives regarding monetary policy strategy – including consideration of the expected time taken to achieve operational objectives, any trade-offs that arise, and communication of this strategy – before specific decisions are taken.
- c) When consensus cannot be reached, specific policy decisions will be determined by a simple majority vote as per clause 44 of schedule 2 of the Act (which includes that the Governor, as chairperson, has a casting vote if required).

#### 2) *Transparency and accountability*

- a) The MPC will publish each monetary policy decision promptly on the Bank's website. The announced decision of the MPC will include a summary record of the MPC meeting that includes an overview of the economic outlook, the risks and policy options discussed, any material differences of view or judgement, and an unattributed record of any vote taken.
- b) On a quarterly basis, the announced decision will also be accompanied by a *Monetary Policy Statement* that will, in addition to the requirements set out in section 15C of the Act:
  - (i) Explain how the MPC has sought to meet the requirements of clause 2(2) in the remit; and
  - (ii) When inflation outcomes, and/or expected inflation outcomes, are outside of the target range explain the reasons for this; and
  - (iii) Explain how the current monetary policy decisions contribute to supporting maximum sustainable employment within the economy.
- c) If the MPC decides that the Bank should intervene in financial markets, it shall also consider whether prompt publication of details of the decision would impede the

achievement of the intervention's purpose. If so, the MPC may withhold such details until it deems that publishing them is no longer likely to create such impediment.

3) *External communication*

- a) The MPC's communications – both collective and individual – should contribute to the overall effectiveness of the monetary policy decision, the public's understanding of monetary policy, and the accountability of the MPC.
- b) The Governor (or another member of the MPC with the Governor's permission) will be the sole spokesperson for the official announcement of the decision.
- c) In any public remarks regarding the MPC's policy strategy and decision, members are to draw on the MPC's official communications and on the Governor's media conference remarks where appropriate. Any non-public remarks on monetary policy or the economic outlook must be consistent with the MPC's official communications, to avoid providing, or appear to be providing, new information to a subset of individuals. A MPC member who wishes to publicly express his or her view around the balance of risks and/or economic outlook may, but should do so with respect for other members and the MPC as a whole. Members are to consult with the MPC within a reasonable timeframe in advance of any public communication, refrain from characterising the individual views of other MPC members, and ensure such communication is publicly advised in advance and on the record (on the Bank's website) in real-time.
- d) Given financial market sensitivities, MPC members must refrain from any public communications relevant to monetary policy following receipt of MPC briefing papers and prior to the decision being announced.