RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

In service to society

New Zealand's revised monetary policy framework and the imperative for institutional change

A speech delivered at Wharewaka Function Centre, Wellington, New Zealand

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By Adrian Orr, Governor

Written with Omar Aziz, Economic Advisor

2 The Terrace, PO Box 2498, Wellington 6140, New Zealand
Telephone 64 4 472 2029 Online at www.rbnz.govt.nz

Introduction

Tēna koutou katoa.

Thank you for joining us today to discuss New Zealand's new monetary policy framework.

The recent amendment to the Reserve Bank's legislation sets up a Monetary Policy Committee that is responsible for a new dual mandate of keeping consumer price inflation low and stable, and supporting maximum sustainable employment.

The Committee's deliberation process will ensure that all decisions benefit from a diverse range of views, and offer greater transparency and accountability to monetary policy decision-making.

Before I outline the features of the new framework and its underlying principles, I would like to paint the backdrop to this institutional change.

The business of central banking is evolving as circumstances change. Some of the change is favourable, some is confronting.

On the favourable side, we have low and stable inflation, low unemployment, and broad financial stability. This advantageous position must never be taken for granted. I thank all of the wise people – past and present – who have worked hard on creating the current environment.

On the challenging side, in addition to maintaining the status quo, we have new and significant long-term economic challenges among which central banks operate. For example, in the financial system alone, we must deal with global economic inter-dependence, dominant financial institutions, significant debt burdens, technological change that challenges employment and financial inclusion norms, climate change, and much more. The list is long and the challenges have intergenerational implications. I spoke about many of these issues in a recent speech about the dangers of short-term thinking.[1]

The refreshed Reserve Bank Act and monetary policy practices, and the ongoing reviews of our legislation, position us to adapt to these changes. The aim is to ensure that the Reserve Bank can continue to achieve its fundamental purpose, which is "to promote the prosperity and well-being of New Zealanders, and contribute to a sustainable and productive economy".[2]

Institutions, Legitimacy & Identity

Let's take a step back and talk about the backdrop to recent and pending changes to the Reserve Bank's frameworks.

The key role of a public institution is to bring to life the terms of a contract that arises between society and its representative government. This 'social contract' will always evolve, with its terms negotiated via the democratic process.

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[1] Orr, A., (2018), *Geopolitics, New Zealand and the Winds of Change*, Reserve Bank of New Zealand speech delivered to the "Shaping Futures National Conference" Financial Services Council in Auckland, 7 September 2018

[2] Reserve Bank of New Zealand Act (1989).

Institutions must therefore adapt in keeping with shifting political, economic, environmental, and social realities, so as to serve the well–being of the people. After all, it is from people that institutions derive their 'social license' to operate - their legitimacy.

Earning and retaining institutional legitimacy is an evolving challenge. Similar institutions may serve similar functions across countries, but they operate in a unique national and cultural context. Hence, they best earn local legitimacy when they appeal to a collective national identity.

It is therefore important to reflect on the national and cultural context in which the Reserve Bank of New Zealand exists.[3]

This is why we have chosen the significant Māori legend of Tāne Mahuta to tell our story during these times of change.

Central to the Māori belief system is the narrative of the earth mother / Papatūānuku and the sky father / Ranginui who needed to be separated to allow the sun to shine in so that life could flourish.

Tāne Mahuta – the god of the forest and birds – stepped up to the task and, after some false starts, achieved this with help from his wider whānau (family).[4] A life of economic, social, cultural and environmental sustainability took hold. Knowledge, trade and exchange flourished, and Māori found affinity with the land, the sea, and the native flora and fauna around them.[5]

Thereafter, Tāne Mahuta served as the kaitiaki (guardian) of this ecosystem – protecting it against threats to its existence, and enhancing the well-being of all within it.

What does this story say about the role of the Reserve Bank and the journey of change it has embarked on?

No, we are not anointing ourselves a god. Instead we are using the legend of Tāne Mahuta to tell a story.

The establishment of the Reserve Bank of New Zealand in 1934 gave our country the flexibility and benefits of its own currency, monetary policy and financial system. Sunshine was allowed into New Zealand's own monetary and financial system, and the Bank was given the responsibility to act as a guardian of this system.[6]

I draw two significant lessons from the legend of Tāne Mahuta.

First, while we all love progress, we resist change. Just as Tāne Mahuta struggled to create change, we recognise there are many hurdles to overcome, many interests to balance, and many compromises needed to reach a collective greater good. Sometimes change means letting go of, or carefully scrutinising, that which has worked in the past - so that we are more resilient for the future.

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[3] *The Journey of Te Pūtea Matua: Our Tāne Mahuta*, Reserve Bank of New Zealand, September 2018, https://www.rbnz.govt.nz/news/2018/09/the-journey-of-te-putea-matua-our-tane-mahuta
[4] Ibid.
[5] Ibid.
[6] For further historical background, see Wright (2006), *The Policy Origins of the Reserve Bank of New Zealand*, RBNZ Bulletin, Vol. 69. No. 3. Sep 2006 https://www.rbnz.govt.nz/research-and-publications/reserve-bank-bulletin/2006/rbb2006-69-03-01

Second, just like Tāne Mahuta, change cannot happen in isolation. The role of a kaitiaki is to protect. However, the fulfilment of that role depends on the approval and help of others.

The Reserve Bank has a social license to serve as a guardian of our monetary and financial system because it is unique to the identity and heritage of New Zealand.

Te Pūtea Matua. It is **New Zealand's** central bank.

The Changing Landscape of Central Banking

Let's tie this discussion about legitimacy and institutional change to the current landscape of central banking.

Over the past decade, countries have looked to central banks to mitigate the dire consequences of the global financial crisis (GFC). During, and after, the GFC, central banks around the world rallied to stabilise financial systems and provide renewed vigour to damaged economies. This challenge remains, and securing sustainable prosperity for all requires our continued attention.

In the world today, the dynamics of global and national economies are interacting to a greater extent and, at times, working at cross-purposes. Underlying these interactions are social and political movements driven by a desire for greater well-being, both for current and future generations.

More recently we have been confronted with the issue of climate change, and its complex and powerful economic and financial impact.

We have barely scratched the surface in understanding the intergenerational impacts of these developments.

This desire for well-being is regularly reflected in discontent along the lines of economic, gender, racial, and intergenerational inequities - to name just a few. Therefore, ensuring social inclusion as a way forward in capitalist societies is necessary.

As such, these developments continuously alter the landscape in which central banks conduct their business.

This is why we have been led to ponder the impact the Reserve Bank can have in securing the well-being of New Zealand's current and future generations. It is also useful to do so while the pervasive ill-effects of the GFC remain in our memories and continue to shape the policy landscape.

The success that central banks had in addressing the early impacts of the GFC, and their effectiveness during earlier decades in transitioning economies from high- to stable-inflation regimes, is due in large part to their ability to act decisively, within a clearly defined remit.

They must continue to be empowered to do so.

The challenge for us now is a more nuanced one:[7]

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[7] In New Zealand, the scope of this debate, is informed by the Bank's remit and the letter of expectations (LoE) from the Minister of Finance to the Governor of the Reserve Bank outlining broad expectations of the Bank's relationship with the Minister and areas of particular interest. LoE 2018/19: https://www.rbnz.govt.nz/about-us/letters-of-expectations/letter-of-expectations-2018

- Do the remits of central banks reflect the objectives most important to the welfare of their societies in the post-GFC world? And do they have the requisite policy instruments to address these objectives? [8]

- Are central banks using their influence in an inclusive and transparent manner befitting of the trust societies have invested in them?

- Are central banks fulfilling their role as stewards of sound and efficient financial systems by creating effective regulatory regimes?

- And is there alignment across a country's economic policy establishment to offer a coherent and unified response to future crises? [9]

These are hard questions that we continue to confront.

At the Reserve Bank we believe that it is timely to review our policy frameworks and the role we play in wider society to ensure we remain fit for purpose.

Over the past year, we have embarked on several review and public consultation processes. These processes – some of which are still underway – have spanned our monetary and financial policy frameworks, as well as the role of physical currency.

We are not alone in conducting such reviews. Our counterparts in Sweden (Riksbank) and Norway (Norges Bank) recently have, or currently are, undertaking reviews of their monetary policy frameworks and legislation.[10] [11] The US Federal Reserve has initiated a review of

[8] Historically, central banking objectives have evolved with the wider political economy concerns faced by countries. See Smith, C, O. Aziz (2019), *Monetary Policy Objectives*, Reserve Bank of New Zealand *Bulletin*, Vol. 82, No. 2 (forthcoming).

[9] Paul Tucker argues that "[a] central bank regime for all seasons cannot be designed without a good fiscal constitution existing too. Setting boundaries to the authority of central banking needs to factor in what is on the other side of the border", *The Governance of Monetary & Financial Stability Policy*, Banking Perspective, Quarter 2 2018 (http://paultucker.me/the-governance-of-monetary-and-financial-stability-policy/)

[10] The Riksbank's monetary policy was reviewed by Marvin Goodfriend and Martin King over 2010 – 2015 and a report published in 2016. The review was commissioned by the Committee on Finance of the Riksdag and made several recommendations. Following this review the Riksbank Executive Board has made several changes to its framework in May 2017, the rationale for these changes are further explained in a memorandum produced by the executive Board, and in the Riksbank Economic review. In addition, a parliamentary review of the Riksbank Act has been initiated. The recommendations from the Riksbank Act review are due no later than 31 May 2019.

[11] The Norges Bank has had two reviews which have translated into changes in the Norges Bank Act, and the Regulation on Monetary Policy. The Gjedrem review was an external review conducted by the Norwegian Law Commission and chaired by a previous Governor Sevin Gjedrem. ReFIT (Review of Flexible Inflation Targeting) was an internal review over 2013 to 2017 and explored possible improvements to the monetary policy framework in Norway. See: https://www.norges-bank.no/en/about/Research/ReFIT--Review-of-Flexible-Inflation-Targeting/
And https://www.regjeringen.no/en/aktuelt/report-of-the-law-commission-on-the-act-relating-to-norges-bank-and-the-monetary-system/id2558679/

"strategies, tools and communication practices" that service its dual mandate.[12] And, the Bank of Canada is well into a regular five-yearly review of its "inflation control agreement". [13] [14]

Beyond this, calls to build further resilience in the financial system – especially in its interface with the wider economy – is an emerging theme on the international agenda.[15]

The first review of the Reserve Bank of New Zealand Act 1989 to be completed was that of monetary policy. Now enacted in law, New Zealand's new monetary policy framework is being formally introduced on 1 April 2019.

I will now elaborate on the specifics of the revised monetary policy framework with reference to its history, locating it in the wider context of other external policy reviews and consultation processes that the Bank is involved in.

Reserve Bank Act 1989: Objectives & Accountability

The Reserve Bank Act of 1989 was introduced at a time when there was great uncertainty about economic conditions in New Zealand.

In the 1970s and 80s, our country, like many others, had adopted a variety of strategies to deal with high and volatile inflation; none were successful.

The 1989 Act gave the Reserve Bank operational independence to achieve the objective of price stability.

A single decision maker model was introduced making the Governor responsible and singularly accountable for the substance of monetary policy.

The Policy Targets Agreement (PTA) between the Minister of Finance and the Governor set explicit goals for monetary policy to pursue.[16]

An agreement between a single decision maker and the government provided sufficient flexibility to make the appropriate revisions to the inflation target as we adjusted from high to low inflation.

Over time, there have been several revisions to the inflation target, settling in recent times on a band of 1 – 3 percent with a focus on the 2 percent midpoint.[17]

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[12] *Federal Reserve to review strategies, tools, and communication practices it uses to pursue its mandate of maximum employment and price stability,* Press Release, 15 November 2018, (https://www.federalreserve.gov/newsevents/pressreleases/monetary20181115a.htm)

[13] Wilkins, C., A., *Choosing the Best Monetary Policy Framework for Canada*, Speech, 20 November 2018 https://www.bankofcanada.ca/2018/11/choosing-best-monetary-policy-framework-canada/

[14] https://www.bankofcanada.ca/toward-2021-reviewing-the-monetary-policy-framework/

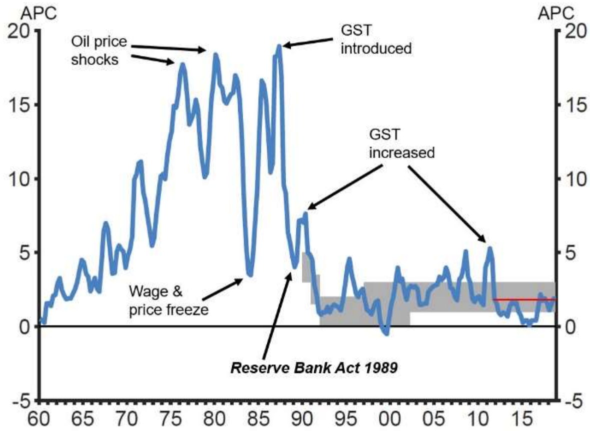
[15] Lagarde, C., *The Financial Sector: Redefining a Broader Sense of Purpose*, 32nd World Traders' Tacitus Lecture, London, United Kingdom, February 28, 2019

[16] PTA's were renegotiated between the Minister and Governor each time the latter was appointed or reappointed, although there is precedence to revisit the terms of the agreement during a change of government as well. 13 PTA's were signed from 1990 onwards, each ratification reflecting incremental adjustments to inflation targets. See Wadsworth (2017), "An international comparison of inflation targeting frameworks", RBNZ Bulletin 80(8) for more information.

[17] In the versions of the PTA from 1990 to 1992, annual inflation was to be kept within a target band, initially 3 - 5 percent, then 1.5 – 3.5 percent before settling on 0 – 2 percent as inflation was initially

When you look at the contrast between inflation in the years before and after 1989 (figure 1), the Reserve Bank's record of servicing its price stability objectives over the last 30 years stands on its own merit.

Figure 1: Annual CPI Inflation (target range shaded)



Source: Statistics New Zealand

Such has been the success and influence of New Zealand's inflation targeting regime, that in 2014 – on the eve of the 25th anniversary of the Reserve Bank Act – the New York Times declared it to be "virtually an economic religion" and "global economic gospel" among the international central banking community.[18]

Amendment to the Reserve Bank Act

We have prospered in the certainty and security of a low and stable inflation regime for the past 30 years. What then is the imperative for any change to the way monetary policy is conducted in New Zealand?

Simply put: our Act has been amended to address emerging policy challenges, and to operate with greater transparency and accountability.

To reinforce our societal legitimacy.

The Reserve Bank Act now sets monetary policy with a dual mandate: to maintain price stability and support maximum sustainable employment.

The remit – which replaces the earlier PTA – provides the Bank with its specific inflation target and direction on how to consider its contribution to maximum sustainable employment.[19]

While unemployment is currently low in New Zealand, it is, and will continue to be, one of the defining issues of any society.

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brought under control. Through the mid-90's onwards, 0 – 3 percent, then up to 1 – 3 percent (our current target) in 2002. The focus on the 2 percent midpoint was added in 2012.

[18] Irwin, N., *Of Kiwis and Currencies: How a 2% Inflation Target Became Global Economic Gospel*, New York Times, Dec. 19, 2014.

[19] The remit and charter can be accessed at: https://www.rbnz.govt.nz/monetary-policy/about-monetary-policy/monetary-policy-framework.

Labour market dynamics both within and across countries have changed significantly as a consequence of recent rapid globalisation, the impact of the GFC, and as ongoing technological developments have reshaped the needs of the workforce.

Likewise, concerns about income and wealth inequities, low productivity growth, and the impact of population ageing, all intersect at some level with the functioning of the labour market.

Historically, the Bank has always taken labour market developments into account while formulating monetary policy.

Over time, "this has been encouraged by our increasingly flexible approach" to inflation targeting.[20]

The shift to a dual mandate is to acknowledge the impact monetary policy has on employment and economic activity, and also the prominence given to labour market outcomes when the Bank is formulating monetary policy.[21]

Our new mandate means the Bank is legally obliged to provide a more detailed assessment of, and outlook for, the labour market.[22] This obligation recognises that 'maximum sustainable employment' cannot be measured using a single metric, and that there are limits to the degree to which monetary policy can affect employment outcomes.

Let's now talk process.

The changes enacted as part of the phase 1 review of the Reserve Bank Act made the processes and principles underlying the Bank's earlier monetary policy decisions explicit.

I mentioned that up until now the Bank had operated with a single decision maker model for monetary policy. In reality however, successive Governors relied on internal advisory committees consisting of senior members within the ranks to discuss ideas, build consensus and guide decisions on monetary policy.[23]

The amendment to the Act formalises a Monetary Policy Committee (MPC) consisting of members internal and external to the Bank.[24]

A committee structure will add further rigour to monetary policy decisions, drawing on the diverse views and perspectives of its members.

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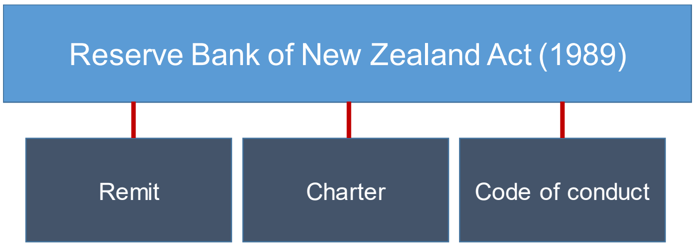
[20] McDermott & Williams (2018), "*Inflation targeting in New Zealand: An experience in evolution*", speech delivered to the Reserve Bank of Australia conference on central bank frameworks, in Sydney 12 April 2018.
[21] The former being the stabilisation role of monetary policy.
[22] Ibid. For example, the Bank has dedicated a chapter to output and employment in each *Monetary Policy Statement* since May 2018, and has also included tables and discussion of indicators of maximum sustainable employment.
[23] This was formalised in practice, if not it law, by the creation of a Governing Committee in 2013. See Wheeler (2013) "*Decision making in the Reserve Bank of New Zealand*", speech delivered to the University of Auckland Business School on 7 March 2013, and Richardson (2016) "Behind the scenes of an OCR decision in New Zealand", RBNZ *Bulletin* 79(11).
[24] With the majority internal (and including the Governor and Deputy Governor *ex officio*).

Figure 2: Secondary Instruments to Direct the MPC



The Act and remit set out the economic and operational objectives for the MPC respectively.

The charter governs the committee's decision-making and ensures accountability.

The charter emphasises that the MPC should aim to reach decisions by consensus, informed by rigorous discussion taking into account a diverse range of views and perspectives on emerging issues. In the event consensus cannot be reached, each member has an equal vote to determine a decision.[25]

Furthermore, accompanying the remit and charter, is a code of conduct that sets the standards of ethical and professional conduct that must be adhered to by the Committee.[26]

All this sounds very technical, but these instruments bring to life the principles that underpin the Bank's major monetary policy decisions.

An MPC with a diverse set of opinions that is committed to inclusive and constructive debate about important policy issues, will ultimately be of great service to New Zealand society.[27]

Interconnectedness of Institutions & Policy Regimes

The story of Tāne Mahuta is a metaphor for change, but also one for interconnectedness. This is a theme I would like to end with.

Each year, the Minister of Finance issues a Letter of Expectations that sets out the strategic priorities for the Reserve Bank. [28] In 2018, the Bank was given a renewed strategic direction underscoring the imperative for institutional change.

As the letter states, in fulfilling its monetary policy mandate, the Bank is expected to "support sustainable and inclusive growth". And in promoting a sound and efficient financial system, the Bank is expected to contribute "to the living standards of New Zealanders by being a conscientious, high performing regulator".[29]

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[25] The charter refers to the provision in the Act for each member to have an equal vote to determine a decision.
[26] Monetary Policy Framework, https://www.rbnz.govt.nz/monetary-policy/about-monetary-policy/monetary-policy-framework
[27] *Principles and processes behind monetary policy committee deliberation at the RBNZ*, Forthcoming RBNZ Bulletin, Price, G., & Wadsworth, A., 2019
[28] Letter of Expectations 2018/19: https://www.rbnz.govt.nz/about-us/letters-of-expectations/letter-of-expectations-2018
[29] Ibid.

The flagship strategic projects on the Bank's current work agenda all align with the "Government's broader economic objectives while maintaining the Bank's operational independence". [30]

These ongoing projects at the Bank include:

- the implementation of our new monetary policy framework
- the review of the Bank's prudential and regulatory functions
- the bank capital adequacy consultation that is currently underway, and
- exploratory work on the emerging impact of technology on the Bank's currency functions and research on digital currencies

The imperative for this work program also arises from the global policy environment that central banks are presented with: that is, balancing uncertain growth and continued low nominal interest rates - against inflated central bank balance sheets, and the ever-present threat of asset price bubbles.

More specifically, as a small, open economy New Zealand is especially vulnerable to downturns in its trading partner economies. And with a high reliance on banks for overseas borrowing, we are vulnerable to the transmission of financial instability through the banking system.

This is why we are thinking holistically at the Reserve Bank about the collective impact of our various monetary, financial, and currency policy initiatives. For example,

- What effect do low nominal interest rates have on wider financial stability?

- How can monetary-fiscal coordination be better managed, and in a low interest rate environment, what role will fiscal policy play in the event of a downturn? And,

- Recognising that the "impact of bank failures would be broader and harsher the larger and more intertwined the failed banks are with New Zealand's economy" what regulatory and prudential settings would mitigate the risk of failure?[31]

These are all immediate challenges being confronted by your team working at Te Pūtea Matua.

Furthermore, our mandate, to support sustainable and inclusive growth, and higher living standards, necessitates the Bank to work more interactively with wider society and public institutions. We will do so without loss of focus on our core activities.

Our Te Ao Māori strategy includes engagement with the 'Māori economy', which has undergone a rapid renaissance.[32] This work is necessary and a gateway into assisting wider financial inclusion in New Zealand and the region.

We remain focused on our role in our region and the wider international economy. The Bank is currently refreshing its international engagement strategy to give greater focus to New Zealand's bilateral and multilateral engagements.[33] We are working on our contribution to

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[30] Ibid.

[31] Bascand (2019), "*Safer Banks for Greater Wellbeing*", speech delivered to the Institute for Governance and Policy Studies, Victoria University in Wellington, 26 February 2019

[32] *RBNZ's Strategic Approach to Te Ao Māori*, Forthcoming RBNZ Bulletin, 2019

[33] One example being contributing to New Zealand's progress towards the UN Sustainable Development Goals (SDGs). In 2019, New Zealand is presenting its first progress report (Voluntary

building capacity and capability in central banks through our region – including the central banks of the South Pacific and East Asia.

Finally, underscoring our need to be a good global citizen, we have embarked on our climate change strategy, playing our part in the link between necessary global climate action and the role of the financial system.[34]

I want to assure you all that the Reserve Bank – Te Pūtea Matua – remains grounded and has not lost focus on its core business.

We are committed to meeting the currency needs of the people, ensuring low and stable inflation, maximising sustainable employment, and promoting a sound and efficient financial system. These activities are necessary for economic well-being.

But, I also want to assure you we will work beyond just the 'necessary'.

We will ensure that both 'necessary' and 'sufficient' work is done so that the Bank is best able "to promote the prosperity and well-being of New Zealanders, and contribute to a sustainable and productive economy".[35]

I am told that the first step to running a marathon is to tell everyone of your intentions. Commit.

You have just been told of our intentions to work collectively – locally, regionally, and globally – in pursuit of maximising our mandate.

We desire to be a great team and the world's best central bank. The resounding results that past and present people at the Reserve Bank have achieved provides a fantastic platform to progress this work.

Me mahi tahi tātou mo te oranga o te katoa.

Work together for the wellbeing of everyone

Meitaki

Thank you

National Review) on the national implementation of the SDGs. Several SDG targets can be mapped to the core functions of central banks, for instance: inclusive access to banking, insurance and financial services (target 8.10), regulation and monitoring of global financial markets (10.5), reducing transaction costs of migrant remittances (target 10.c), reducing illicit financial flows (16.4), enhancing macroeconomic stability (17.13) and providing data capacity-building support to developing countries (17.18) (https://unstats.un.org/sdgs/indicators/indicators-list/)

[34] *Reserve Bank Climate Change Strategy*, https://www.rbnz.govt.nz/financial-stability/climate-change/strategy

[35] Reserve Bank of New Zealand Act (1989).