Executive Summary

New Zealand’s monetary policy arrangements were fundamentally changed by the Reserve Bank of New Zealand Act of 1989. The changes brought about by the Act were part of the new approach to economic management initiated in reaction to the poor economic performance of earlier decades. Many features of the 1989 Reserve Bank Act were analogous to the broad thrust of public sector reform occurring over the same period.

Perhaps the single most important feature of the new framework is the single, clear objective of achieving and maintaining price stability. Multiple macro-economic objectives had, in the past, led to stop-go monetary policy which was, on average, accommodating and which had allowed high inflation to become entrenched. Moreover, it was recognised that easier monetary policy could have no lasting benefit for employment and growth.

Under the Act, the Bank is to both “formulate and implement monetary policy,” reflecting the Government’s desire to facilitate monetary policy being directed towards low inflation over the medium to long run. However, the Bank’s discretion to formulate policy is limited by the requirement to set and publish targets for monetary policy, under a Policy Targets Agreement negotiated between the Minister of Finance and the Governor of the Reserve Bank. Also, the Act allows the Government to temporarily change the objective for monetary policy by use of a formal and public override provision. Responsibility for exchange rate policy determination was not changed substantively by the 1989 Act, but the procedures for resolving any conflict between monetary and exchange rate policy are specified.

The 1989 Act also put in place strong and transparent accountability mechanisms, including the Policy Targets Agreement and formal six monthly Monetary Policy Statements. Furthermore, the new Act made the Governor of the Reserve Bank personally accountable for the outcome of monetary policy, and gave the Bank’s Board of Directors an explicit

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monitoring role. Appointment and dismissal procedures for the Governors and Directors are specified in the Act. The dismissal procedures relate directly to the Governor’s and Directors’ performance in terms of achieving monetary policy targets and objectives, and in terms of effective monitoring, respectively.

The article concludes with a discussion of the extent to which the Act appears to have contributed to improving monetary policy credibility, lowering inflation expectations and facilitating price stability since its introduction. New Zealand does now have very low inflation consistent with price stability, and there is some partial evidence and anecdotal support for the view that the Act has contributed to this outcome. However, as the evidence is at best only broadly suggestive, conclusions can only be tentative at this stage.

Introduction

The Reserve Bank of New Zealand Act 1989 changed fundamentally the nature of the monetary policy arrangements in this country. The new Act gives the Reserve Bank considerable autonomy to “formulate and implement monetary policy” in pursuit of a statutory objective of achieving and maintaining price stability, subject to a requirement to negotiate and publish targets intended to facilitate monitoring of policy performance. There are some notable differences between the new Reserve Bank arrangements and the arrangements under which other independent central banks operate.

Previous Reserve Bank publications have explained the nature of the changes brought about by the 1989 Reserve Bank Act and the reasons for these changes in broad terms.1 However, to date, there has been no detailed published explanation of why these particular monetary policy arrangements were chosen, as opposed to arrangements like those of other central banks such as the Bundesbank of Germany, the Swiss National Bank, or the Federal Reserve System of the United States. Explaining the rationale behind the particular features of the New Zealand policy regime is the objective of this article.

There has been considerable overseas interest in our legislative arrangements, not least perhaps because New Zealand now has one of the lowest inflation rates within the OECD. More generally, central bank independence has become increasingly topical internationally, both in the professional economics literature and in the context of specific policy proposals in a number of countries. Proponents of central bank independence see important advantages in terms of achieving very low inflation rates on a continuing basis, and in terms of reducing the costs of doing so.

1 The Bank has published a pamphlet “Explaining the Act”, and a Bulletin article “Reserve Bank of New Zealand Act 1989” by S Dawe, which relatively briefly describes the new Act and its benefits compared to the previous legislation.
Why Central Bank Autonomy?

The genesis of the changes to the legislative framework for monetary policy in this country lies mainly in our economic history in the decade or two up to the mid 1980s. Over this period, and especially in the decade immediately prior to the mid 1980s, New Zealand had one of the slowest growth rates in the OECD, persistent balance of payments and fiscal deficits, rapidly rising external and internal public debt, unemployment beginning to rise rapidly from traditionally very low levels, and a seemingly entrenched tendency towards high and increasing inflation (see Table 1 and Figure 1). Indeed, as Figure 2 illustrates, beginning in at least the early 1960s, there was a clear tendency for inflation to be ratcheted up over successive economic cycles. Amongst other undesirable effects, inflation was encouraging inefficient resource allocation and thereby contributing to the poor growth performance.

### TABLE 1

GDP per Head¹

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<th>Year</th>
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<th>Germany</th>
<th>Japan</th>
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Unemployment Rate²
(per cent)

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Inflation³

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<td>6.7</td>
<td>2.1</td>
<td>2.0</td>
<td>15.5</td>
</tr>
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</table>

¹ Expressed in current purchasing power parity equivalents, with the average of OECD Countries = 100. Source: OECD Economic Surveys, New Zealand, 1990/91.

² Source: OECD main economic indicators.

³ Annual percentage change. Source: OECD Main Economic Indicators.
Figure 1
Public Debt as per cent of GDP, fiscal years. *

* Fiscal years end in March up to and including 1988/89. Beginning in 1989/90, the fiscal years end in June.

Figure 2
Year on Year CPI Inflation
Monetary policy throughout this period was largely accommodating and, in general, tended to switch between competing objectives (reducing inflation versus lowering interest rates in pursuit of increased growth/employment). Thus it took on a stop-go nature; the monetary brakes were never applied long enough and hard enough to have more than a temporary effect on inflation. In addition, as policy was based mainly on the use of regulatory controls (particularly intensively from the early 1980s), its inherent effectiveness was also becoming increasingly doubtful.  

By mid-1984, the poor economic performance had brought the country to what was widely seen as a crisis point. Whether or not this was fully accurate, there was a broad consensus following the election of a new Government at that time, that the direction and style of economic policy needed to change fundamentally and quickly. The new approach to economic management reflected a shift from short to longer-term objectives, and from a concentration on one economic problem at a time to an acceptance of the need to tackle a range of economic problems comprehensively and consistently.

In 1984-85, in line with this new approach, monetary policy was changed in two important respects. Firstly, the stance of policy was directed deliberately and explicitly at reducing inflation over the medium term. This reflected a recognition that firm monetary policy was fundamental to controlling inflation, that monetary policy is effective only after a lag, and that a consistent approach had to be maintained over time.

Secondly, monetary policy moved from operating through direct controls to operating through market based instruments and procedures. In the space of nine months, interest rate controls, credit ceilings, exchange controls, reserve requirements and other balance sheet controls were all removed, and the exchange rate was floated. More use was also made of open market operations to control the reserves base of the financial system. As part of this change, the Government adopted a policy of "fully funding" its budget deficit, meaning that over the course of a year, the deficit would be financed by sales of illiquid debt to the market, at market rates (determined by tenders).

These monetary policy reforms encouraged further development and deepening of the main financial markets in New Zealand. This deepening, and specifically the new flexibility in interest rates and especially the exchange rate, helped impose a form of discipline on monetary policy, in that any future shifts in policy away from an anti-inflationary stance would tend to be reflected fairly quickly in the exchange rate and, to some extent at least, longer bond rates. At the same time, however, the existing level of rates would also reflect any doubts about the ability of monetary policy to remain on an anti-inflation path beyond the shorter term. Especially given the history of monetary policy in this country, it was always likely that such doubts would be one

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2 Interest rate and exchange rate controls meant that two major monetary policy transmission mechanisms were largely unavailable in key periods. The main financial institutions were constrained by reserve asset ratio requirements, public sector security requirements and lending ceilings which, in combination with interest rate controls, made it difficult for them to compete. Financial flows therefore tended increasingly to escape the regulatory net on which monetary policy was based.

3 This is reflected, for example, in the conclusions of the Economic Summit of late 1984.

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reason for inflation expectations adjusting relatively slowly to the actual disinflation path toward which monetary policy was working.\footnote{This “credibility” problem for monetary policy has been formalised in the economic literature in terms of the concept of “time-inconsistent” monetary policy. A time-inconsistent policy is one which is optimal for the policy-maker when initially formulated and announced but which becomes suboptimal for the policy-maker to implement at some stage in the future, given the policy-maker's other objectives. For a detailed review, see Blackburn and Christensen (1989).} Therefore, to the extent that there remained uncertainty about the longer term commitment to low inflation, interest rates would be higher than necessary, and similarly, the cost of disinflation would be higher than necessary.

In order to improve the prospects for monetary policy to remain - and be seen to remain - on the track to low inflation, and thereby help reduce the costs of disinflation, attention turned to possible institutional arrangements which would improve monetary policy credibility. During 1986, the Government initiated consideration of ways of allowing the Reserve Bank to operate monetary policy more autonomously.

At the time, some theoretical literature was pointing to the desirability of distancing monetary policy somewhat from day-to-day political control (and a lot more literature in this vein has appeared since). The literature also provided some empirical support for the hypothesis that central bank independence was conducive to low inflation. It found that those central banks who were the most independent - for example Germany, Switzerland and the United States - were generally the most successful at attaining and maintaining low rates of inflation.\footnote{See, for example, Bade and Parkin (1987), Alesina (1989), Alesina and Summers (1991).} This empirical evidence was never taken to be fully conclusive, because it embodied a number of measurement and other technical weaknesses, and only demonstrated association, not causality. Nevertheless, it was at least suggestive that a more autonomous central bank would be helpful, even if neither necessary nor sufficient by itself for achieving and maintaining low inflation.

Apart from the monetary policy background itself, another important aspect of the environment at the time was the major reforms underway in the public sector more generally. These included, in particular, establishing clearer objectives for public sector organisations, clearer accountability for the attainment (or otherwise) of those objectives, individual performance-based contracts for chief executives, and more management and financial autonomy within agreed policies and budgets. The details of the Reserve Bank’s arrangements are analogous in many respects to these features of public sector reform. The analogies should be fairly clear from the discussion in the following sections of this article.

Statutory Objectives

“The primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices.” (Section 8, Reserve Bank Act 1989.) This statutory objective is probably the single most important feature of the new monetary policy framework.

Previously, the Reserve Bank Act stated that monetary policy “shall be directed
towards the maintenance and promotion of economic and social welfare, having regard to the desirability of promoting the highest level of production and trade, and full employment, and of maintaining a stable internal price level.” (Section 8 (2), Reserve Bank Act 1964.)

Why did the 1989 Act specify only one macro-economic objective for monetary policy? There are a number of reasons, partly reflecting the preceding history of monetary policy, noted earlier.

- Firstly, and fundamentally, the single objective chosen for monetary policy reflects a general acceptance that monetary policy is the fundamental determinant of inflation in the longer run, but that a monetary easing cannot beneficially affect output (employment and growth) in the long run.

- Secondly, monetary policy, as essentially a single instrument, cannot be directed simultaneously towards multiple objectives which are in conflict, at least in the short run.

- Thirdly, where multiple and at least partly conflicting objectives exist (as under the previous legislation), rational observers will take account of the possibility that the priority of the different objectives can change. This reduces the credibility of an anti-inflationary monetary policy, leads to higher rather than lower inflation expectations, and results in a built-in inflation bias.

- Fourthly, if the central bank were to pursue multiple macro-economic objectives, which in full or in part were also being pursued by other arms of Government, effective policy coordination would seem to require that the Government firmly control the Reserve Bank. This would not have been consistent with the intention of increasing the Bank’s autonomy.

- Fifthly, multiple objectives would tend to reduce the transparency of monetary policy, and also, therefore, weaken the accountability of both the central bank, and the Government. Given multiple objectives, failure to achieve one objective can too easily be explained by reference to another objective.

Some thought was also given to whether there could be some sort of subsidiary macro-economic objective for monetary policy rather than dual or multiple objectives as such. An example might be achieving price stability subject to avoiding a fall in growth below some level. This approach was rejected, however, because from an accountability perspective, a constraining objective is essentially no different to having dual objectives, and so all the arguments above still apply. (Both the primary and the subsidiary objective would have to be achieved for the Bank to be judged successful, and so the Bank would essentially be pursuing both objectives.)
It should be emphasised, however, that the single price stability objective embodied in the Act does not mean that monetary policy is divorced from consideration of the real economy. At the technical level, the state of the real economy is an important component of any assessment of the strength of inflationary pressures. More importantly, inflation/real economy trade-offs may need to be made on occasion, particularly in the context of a decision about the pace of disinflation. The real issue here, though, is not whether or not there are short-term trade-offs to be made, but rather, who makes those trade-offs. The main trade-offs are essentially political ones, and it is appropriate that they be made clearly at the political level. The framework allows trade-offs in areas such as the pace of disinflation, or the width of target inflation ranges, to be reflected in the PTA negotiated with the Governor. The override provision can also be used, if required, to reflect a policy trade-off.

Although there is only one macro-economic objective for monetary policy specified in the legislation, in operating policy in pursuit of price stability, the Bank must “Have regard to the efficiency and soundness of the financial system” and “Consult with, and give advice to, the Government and such persons or organisations as the Bank considers can assist it to achieve and maintain the economic objective of monetary policy.” (Section 10 (a) and (b), Reserve Bank Act 1989.)

The first consideration has two aspects. Firstly, it relates to the choice of policy instruments and procedures and in particular directs attention to those which are most efficient. Secondly, it reflects a recognition of the relationship between monetary stability and financial system stability, particularly in the sense that very sharp swings in monetary policy and monetary conditions could be detrimental to the soundness of the financial system.

The requirement to consult with other parties recognises that the Bank will and indeed ought to have contact with other organisations and the Government. Consistent with the policy autonomy given to the Bank by the Act, the Act indicates clearly that it is the Bank’s responsibility to initiate discussion with other groups.

**Formal Monetary Policy Responsibility**

Prior to the 1989 Act, the responsibility for formulating monetary policy formally lay solely with the Government. The Bank was to “advise the Government on matters relating to monetary policy...”, and “Within the limits of its powers, to give effect to the monetary policy of the Government as communicated in writing to the Bank, ...and to any resolution of Parliament in relation to that monetary policy.” (Sections 8 (c),(d). Reserve Bank Act 1964.)

In contrast, the 1989 Reserve Bank Act delegates to the Bank the authority to formulate (within limits) and implement monetary policy in pursuit of its statutory price stability objective. The limits to the Bank’s discretion in formulating policy derive both from the clear statutory objective and the fact that the Act requires the Minister
of Finance and the Governor of the Reserve Bank to negotiate and make public, a Policy Targets Agreement (PTA).\textsuperscript{6} The PTA sets out specific targets by which monetary policy performance, in relation to its statutory objective, can be assessed during the period of the Governor’s term. (The PTA is discussed further in a subsequent section.) The PTA can be renegotiated from time to time.\textsuperscript{7}

In addition, the Act gives the Government the right to temporarily change the objective of monetary policy by using the formal and public “override” provision. The override provision represented a balance between explicit recognition that monetary policy is ultimately a Government responsibility, (rather than a responsibility of unelected officials)\textsuperscript{8}, and the Government’s wish to constrain its own scope for monetary policy freedom in the future, and to thereby improve monetary policy credibility. The Act provides such constraints by requiring an Order in Council to depart from the statutory objective. Such Orders in Council are valid for one year only, and hence further Orders in Council must be promulgated to extend the departure from the objective. Furthermore, any use of the override provision which results in a conflict with the Policy Targets Agreement requires the Agreement to be publicly abandoned and a new one negotiated and tabled in Parliament. Thus, the Act ensures that changing the objective for monetary policy involves a major and very public endeavour.

Aside from reflecting this desired balance, the public override might also be seen as a mechanism that could make the framework more sustainable over the longer run. While an arrangement containing no such formal but public override power might appear, at first sight, to be superior from a monetary policy point of view, this may not actually be the case from a longer perspective. In the event of a major policy dispute between a Governor and a Government, the options for the Governor in this case might be only two - to give way, probably “behind the scenes”, to the pressure; or to force a confrontation leading perhaps to his or her resignation, and/or to the central bank’s legislation being changed.\textsuperscript{9}

A public override provision, on the other hand, provides a sort of safely valve for both the Governor and the Government. Arguably, this could be beneficial from a monetary policy perspective: forcing a major confrontation/resignation may not by itself be a very credible option in some circumstances, while “behind the scenes” resolution of conflicts may mean that policy outcomes would depend too much on the personalities involved at various times, and policy may be more likely to revert to a stop-go style.

\textsuperscript{6} The PTA is made public by the Minister publishing the PTA in “The New Zealand Gazette” and presenting it to the House of Representatives.

\textsuperscript{7} The first PTA was signed in March 1990 and was renegotiated with the new Minister of Finance in December 1990.

\textsuperscript{8} Even in countries traditionally seen as having the most independent central banks, monetary policy remains ultimately a Government responsibility (though not always very explicitly), if for no other reason than that a Government with sufficient political support can change the legislation granting independence. The fact that, universally, Governments have the major role in appointing central bank Governors and Board members is consistent with the ultimate policy responsibility of Governments.

\textsuperscript{9} Something very like this happened in Canada. In 1967, the Bank of Canada’s legislation was changed to give the Canadian Minister of Finance power to issue directives and therefore override the Governor’s policies. This followed a very public dispute several years earlier when the then Governor was forced to resign, having pursued a monetary policy contrary to the Government’s wishes.
Another point of note with respect to the allocation of monetary policy responsibility is that it is the Government (i.e., the executive arm) rather than Parliament (the legislature) which can use the formal override, which negotiates the PTA, and to which the Reserve Bank is most directly accountable. Some writers argue that monetary policy independence should be strengthened by having the legislature perform any such tasks, rather than the executive arm of Government. In the United States, for example, the Federal Reserve is directly accountable to Congress, rather than the President.

This sort of option was not chosen in New Zealand because it would have been inconsistent with the existing constitutional division of responsibilities. The arrangements in the 1989 Act thus ensure that the Government has the right to make any trade-offs in economic policy and that it remains clearly accountable politically for the objective of monetary policy. Furthermore, it should be noted that in New Zealand, the governing party by definition has the majority in Parliament, and party lines are usually adhered to fairly strictly - a situation very different from that in the United States, for example. All this is not to say that Parliament does not have an important role in monetary policy - for example the Bank’s performance is formally reviewed by Parliament’s Finance and Expenditure Committee - only that Parliament’s role is similar to that in other areas of policy.

Exchange Rate Policy Determination

Exchange rate policy and monetary policy are very closely related. For example, under a flexible exchange rate regime, the exchange rate is both a key indicator of domestic monetary conditions, and a major channel through which monetary policy has its effects. Nevertheless, in common with arrangements for other independent central banks, exchange rate policy remains the prerogative of the Government.

The new Act did not seek to change exchange rate policy determination to a great degree, but sought instead to set up the processes for resolving any conflict between the Government’s exchange rate policy and the Bank’s monetary policy. The 1989 Reserve Bank Act states that the Bank is to advise the Government on exchange rate policy, and specifies that the Government may give a written directive to the Bank to intervene in the foreign exchange market, or to set a particular exchange rate for the Bank’s foreign exchange dealings. Such directives (or at least their existence) must, however, be made public.

If the Governor considers any Government directive to be inconsistent either with the price stability objective and/or the PTA, the Governor has the right to so notify the Government. In the case of inconsistency with the statutory objective, the Bank is then not required to implement the directive until the objective of monetary policy is formally changed. In the case of inconsistency with the PTA (but not the statutory objective), the Bank is then not required to meet the PTA targets, and a new PTA has to be negotiated.
Monetary Policy Accountability and Monitoring

In keeping with the philosophy behind the broader public sector reform, delegated responsibility must be accompanied by clear accountability. Especially given the importance of monetary policy, it was thought essential that the Act also provide robust and transparent accountability mechanisms to enable monetary policy performance to be monitored by the Government and the public. These mechanisms include the Policy Targets Agreement (PTA); formal, six-monthly Monetary Policy Statements; the annual report; external performance audits which can be commissioned by the Minister of Finance at any time; and the Bank’s Board of Directors (discussed separately).

It is also important to note that the 1989 Act was designed to ensure that the Governor of the Reserve Bank is personally responsible for achieving monetary policy targets. Thus, there is no doubt as to who is formally accountable, should the targets be missed. Indeed, a Governor may be dismissed, or their contract not renewed, if the policy targets defined in the PTA are not attained. That the Governor was made personally accountable for the monetary policy objective was consistent with the broader public sector reforms discussed earlier.

The legislation requires that a PTA be negotiated between the Minister of Finance and the Governor, the PTA being essentially a performance contract for the Governor over his or her term of office. The Act requires explicit policy targets to be spelt out in the PTA, but does not specify the nature of the targets.

The current PTA sets an explicit inflation target, but the target could instead be in terms of some other relevant variable, such as a monetary aggregate, if it was agreed that this would be preferable. The choice of the particular type of target is therefore seen as an essentially technical matter, revolving around issues such as whether monetary policy can actually achieve a given inflation target; or whether a specific monetary aggregate target instead (such as a money base target, which the Bank could presumably achieve more directly) would actually deliver desired inflation outcomes. The judgement to date has been that a target specified in terms of the final inflation objective (suitably defined) is preferable to an intermediate monetary aggregate target, mainly because empirical work had not been able to identify any particular money aggregate which demonstrated a sufficiently close relationship with nominal income growth and inflation. As elsewhere, financial market deregulation and innovation appear to have been important factors in the breakdown of the relationships between these variables, and thus it was considered unlikely that an exploitable relationship would exist in New Zealand, for the time being at least.

The New Zealand definition of price stability in the current PTA (0-2 per cent annual increases in the CPI) is, by world standards, a strict and transparent definition, and this target greatly enhances accountability and monitoring of policy performance.10 In Germany, price stability is not defined as such, but the Bundesbank must direct

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10 In addition to the inflation target in the PTA, the Bank has published, in its Monetary Policy Statements, indicative inflation ranges for the years leading up to 1995, by which time the 0-2 per cent inflation target was to be achieved. These ranges provide another benchmark against which the Bank’s performance may be monitored.

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monetary policy towards “stabilising the value of the currency”. Similarly, the United States does not define price stability numerically: monetary policy aims to have inflation “at a level so low as to not systematically affect economic decisions”. Some other countries have now also announced specific inflation targets (Canada in 1991, and very recently Italy), but without the supporting legislative framework developed here.

The Monetary Policy Statements are the main formal channel through which the Bank accounts for its monetary policy performance. Statements must be produced at least every six months, and must be published and tabled in Parliament. They must review the implementation of monetary policy over the period since the last Statement, and detail the policies and means by which monetary policy will be directed towards price stability in the coming periods. The reasons for adopting the specified policies must also be given.

The annual report provides a vehicle for accountability and monitoring of the Bank as a whole (not just in terms of monetary policy). This is also tabled in Parliament. The Governor and/or Deputy Governors are questioned by the Parliamentary Select Committee for Finance and Expenditure on both the Monetary Policy Statements and the annual reports.

Role and Composition of the Board
The role of the Board is set out explicitly in the 1989 Act, and is to monitor the Bank and, in particular, the Governor, on behalf of the Minister. (The previous legislation did not clearly define the particular responsibilities of the Board.) Thus the Board acts as an agent of the Government. Monitoring involves assessing the performance of the Bank and the Governor in terms of meeting the policy targets and the Bank’s statutory objective, in terms of consistency between the policy targets and the Monetary Policy Statements, and in terms of efficient utilisation of the Bank’s resources. The Board may advise the Governor on any matter pertaining to the Bank’s functions.

Clearly establishing the Board as a monitoring board, rather than a policy-making board (as in some other central banks) reflected the Government’s desire to have only one person accountable for the outcome of monetary policy. Compared to a single decision-maker, it is sometimes argued that a policy-making board would tend to deliver policy outcomes which are less variable in the face of changing personalities, but would involve more diffuse accountability for policy. Given the other features of the new arrangements for the Reserve Bank of New Zealand, the arguments in favour of a policy-making board did not appear compelling.

The Board is comprised of between seven and ten Directors, including the Governor as chairman of the Board, and either one or two Deputy Governors. Between four and seven of the Directors are non-executive appointments, and non-executive Directors are required to always be in the majority at Board meetings. The Act specifies that decisions of the Board are to be made by a majority vote of the Directors present, and that the presiding Director (the Governor, or in his or her absence, the Deputy Governor) has a deliberative vote, and in the case of “tied” votes, has a casting vote.
There is no specific requirement to achieve a mix of sectional and regional interests amongst non-executive Directors (as is required in Switzerland, Germany, Japan and France for example), but in practice, some such mix is usually achieved. Instead, the Act requires the Minister to consider a person’s knowledge, skill and experience in the appointment of a Board member, as well as the potential for any conflict of interest.

Previously, the Reserve Bank Act specified that the Secretary of the Treasury was to be a Board member, ex-officio. This provision has been removed in the new Act, which also prevents parliamentarians from becoming Directors. This is consistent with the intention of delegating monetary policy autonomy to the Bank, and establishing a clear monitoring role for the Board. A direct government representative on the Board could dilute the Board’s role of monitoring the Bank’s performance independently, as an agent for the Minister of Finance.

Appointment and Dismissal of Governors and Directors

Board appointments, excluding that of the Deputy Governor(s), are formally made by the Governor General, but are effectively decided by the Minister of Finance. The Minister’s decision on the Governor’s appointment is made on the recommendation of the Board, and thus the successful candidate must satisfy both the Board and the Minister, which is a type of “double veto” arrangement. Deputy Governor’s appointments are made by the Board, on the recommendation of the Governor. Governors and Directors are appointed for initial five year terms, and can be reappointed. Non-executive Directors’ terms are staggered so that no more than two Directors’ positions come up for renewal in the same year.

Consistent with the wish to establish strong accountability and incentives for the achievement of specified objectives and targets, the new legislation contains explicit dismissal powers. The Board has the right to recommend to the Minister that the Governor be removed from office if the Board is satisfied that the Governor, or the Bank, is failing to meet its statutory objectives, or the PTA targets, or is failing to utilise its resources effectively. Whether or not the Board recommends it, the Government has the power to dismiss the Governor for unsatisfactory performance in relation to the same criteria. The Governor may also be removed if new Policy Targets Agreements are not signed within one month of the use of the formal override of the price stability objective.

The Deputy Governor may be removed for unsatisfactory performance or for hindering the Governor’s performance, either by the Board on the recommendation of the Governor, or by the Government. And finally, the non-executive Directors themselves can be removed by the Government for unsatisfactory performance in relation to the Board’s defined monitoring role.

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Limits on Financing Government
There are no specific legal limits on central bank financing of Government in New Zealand. In contrast, specific limits of various sorts do exist in countries such as Chile, Germany, Switzerland, and the Netherlands. Such limits are often seen to be helpful for monetary policy, to the extent that they prevent an expansion in the monetary base due to central bank lending to governments. However, there are usually loopholes in such arrangements and the limits are therefore seldom fully binding in restricting effective central bank credit to government. Their effect may therefore be more presentational. In any event, it may not be practical to totally exclude such credit because, for example, the central bank may, at times, wish to purchase government securities from the market for liquidity management purposes.

In the past, the Reserve Bank has effectively monetised government deficits either directly by purchasing additional government securities on its own books, or indirectly by allowing increased amounts of government securities to be discounted on demand. Such actions lead to higher inflation, of course, and if undertaken today, would be inconsistent with the anti-inflation stance required of the Bank by its legislation and the PTA. It would also be inconsistent with the Government’s “full funding” policy noted earlier. Thus, legislating against Reserve Bank funding of Government was unnecessary given the rest of the statutory framework for the Bank.

Central Bank Budgetary Independence
In New Zealand, the legislation provides that a 5-year funding agreement be made between the Governor and the Minister, and that this be ratified by Parliament. The five year period corresponds to the length of the Governor’s contract. Thus the Governor, in signing his or her contract, and negotiating a PTA, would wish to be satisfied that the resources agreed to are adequate for the Bank’s purposes. The Governor and the Minister may agree to renegotiate the agreement from time to time, but the new agreement must also be ratified by Parliament.

The Reserve Bank’s funding agreement, being of five years duration, does give the Bank more budgetary independence than most other Government funded institutions in this country. However, the Bank’s budgetary independence is considerably less than that enjoyed by central banks in most other countries, where there is usually rather more freedom for the central bank to set its own expenditure budget, typically funded from interest earned on assets backing the note and coin issue and banks’ reserve deposits.

Constraints on budgetary independence are sometimes seen as potentially limiting a central bank’s policy independence, but they also remove the possibility of a central bank benefitting from inflation. In general, it is good practice to ensure that financial incentives are at least not inconsistent with an organisation’s overall objectives. (The current funding agreement freezes the Bank’s expenditure budget in nominal terms, over the term of the agreement,11)

11 Before the framework was enacted, there had been some discussion of the possibility of linking the Governor’s personal remuneration directly to success in meeting inflation targets. This proposal was not implemented, however.

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Just as important in the New Zealand context, budgetary constraints are visible financial efficiency and accountability considerations for the Bank’s operation. As financial efficiency and accountability were fundamental aspects of broader public sector reform, it would have been inconsistent to leave the Reserve Bank to set its own budget, as it did prior to 1989. Thus, the 5-year funding agreement struck a balance between the desire for a degree of financial independence, and the desire for clear financial accountability.12

Conclusion - The Act, Three Years On

The 1989 Reserve Bank Act sought to put in place mechanisms that would improve the credibility of monetary policy, reduce inflation expectations, and facilitate the achievement of price stability. It set out to do this by (amongst other things) specifying one macro-economic objective for monetary policy; giving the Bank the monetary policy autonomy to achieve this objective (within the umbrella of the formal override provision and the Policy Targets Agreement); requiring transparency throughout, and particularly in respect of arrangements to resolve any policy conflict between a Government and a Governor; setting clear targets for the Bank in the PTA; assigning accountability for the achievement of the objective to one person, the Governor of the Reserve Bank; explicitly requiring the Bank’s Board to monitor the Bank’s performance, on behalf of the Minister of Finance; and allowing for the dismissal of the Governor or Directors for poor performance relative to their defined responsibilities.

The Act has been in place now for nearly three years. To what extent has the Act fulfilled its purpose over this period? Conclusions as to the success or otherwise of the Act can, of course, only be tentative, as we can never know what inflation would have been in 1992 had we carried on with the previous regime. We can certainly note that inflation has been significantly reduced over the last three years, and that price stability as defined in the PTA has now been achieved in New Zealand. That outcome, which not so very long ago seemed unthinkable to many people, certainly suggests the framework has been beneficial.

There is some partial evidence and anecdotal support for the view that the new Reserve Bank Act has improved monetary policy credibility. For example, inflation expectations have fallen steadily over the last two years and are now at record lows (see Figure 3). Unfortunately we cannot categorically assume that expectations are forward looking and thereby attribute low inflation expectations definitively to a more credible monetary policy. Surveyed inflation expectations have followed the actual inflation rate downwards, and this could be consistent with either predominantly backward looking expectations (in which case, the credibility of future policy is largely irrelevant), or with (at least partially) forward-looking expectations which are somewhat slow to adjust (in which case, the credibility of future policy is still very relevant).

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12 Over the last few years, the Bank has taken major steps to improve its internal financial efficiency, including reductions in staff numbers.

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We do have some other partial indicators of improved credibility, including declines in the level of long-term interest rates; reductions in the "risk premium" implicit in the relationship between real returns on longer bonds in this country and those overseas; and the increased speed of financial market reaction when monetary conditions appear out of line with the Bank's inflation targets. Table 2 shows a 5.2 percentage point decline in nominal 5-year bond rates since 1988, and a 1.9 percentage point fall in real rates over the same period. As can also be seen, the real return on domestic 5-year bonds has been falling quite significantly relative to real bond rates overseas, which may well imply a market perception of reduced risk of re-emerging inflation in the future.

On the last of the points mentioned above, in recent months, when the exchange rate has, for one reason or another, has moved to levels which markets perceive to be inconsistent with the inflation track desired by the Reserve Bank, interest rates have adjusted quickly to bring the exchange rate back to levels the markets perceived to be appropriate. The development of this automatic stabilising mechanism is again partial evidence of increased policy credibility.


**TABLE 2**

5-YEAR GOVERNMENT BOND RATES

<table>
<thead>
<tr>
<th>Year</th>
<th>Nominal(^1) (per cent)</th>
<th>Real(^2)</th>
<th>Margin over overseas real rates(^3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>13.4</td>
<td>8.1</td>
<td>3.3</td>
</tr>
<tr>
<td>1989</td>
<td>12.8</td>
<td>7.8</td>
<td>3.6</td>
</tr>
<tr>
<td>1990</td>
<td>12.5</td>
<td>8.0</td>
<td>3.3</td>
</tr>
<tr>
<td>1991</td>
<td>10.0</td>
<td>7.1</td>
<td>1.8</td>
</tr>
<tr>
<td>1992 (Jan-Aug)</td>
<td>8.2</td>
<td>6.2</td>
<td>1.4</td>
</tr>
</tbody>
</table>

1 Yearly averages.
2 Nominal rate less average of actual and forecast inflation, yearly average.
3 New Zealand's real long-term interest rates less TWI countries' real long-term interest rates, yearly averages.

Although indicators such as these are not conclusive, they are at least, taken together, suggestive of some beneficial effect from the new legislative framework for monetary policy. A more complete analysis will need to be based on a longer period of operation under the Act. In particular, the statutory objective of monetary policy is to achieve and maintain price stability. The contribution of the legislative framework to maintaining price stability is thus still quite some distance away from being assessable. But irrespective of the effect of the framework on public perceptions, within the Reserve Bank itself the framework has provided a clear objective and clear targets, and has therefore focused attention more closely than was the case in the not too distant past. By itself, this is likely to have helped in the achievement of price stability in New Zealand.
References


