RESERVE BANK
OF NEW ZEALAND

THE RESERVE BANK OF NEW ZEALAND ACT 1989: OUR ACCOUNTABILITY TO NEW ZEALANDERS

March 1998

The Reserve Bank of New Zealand Act 1989

Our accountability to New Zealanders

New Zealand's central banking legislation, the Reserve Bank of New Zealand Act 1989, has attracted world-wide interest. What's been special in New Zealand is that, by statute, the nation's elected representatives are responsible for setting the goals of monetary policy, while the Reserve Bank of New Zealand has full operational independence as to how it achieves those goals. Also, most critically, the goals of monetary policy must be made public.

Recently the essential features of this framework have been adopted by a number of other countries as well. This booklet explains how the Reserve Bank of New Zealand Act 1989 works.

How the Reserve Bank Act sets price stability as the Reserve Bank's top priority

The Reserve Bank of New Zealand Act 1989 is in six main parts, which lay out the Reserve Bank's responsibilities. The main sections relate to:

- the Reserve Bank's constitution (part 1);
- the Reserve Bank's functions and powers regarding monetary policy and foreign exchange (part 2);
- the issuing of currency (part 2);
- the internal management of the Reserve Bank (part 3);
- the registration and supervision of banks (parts 4 and 5); and
- the Reserve Bank's funding (part 6).

The Reserve Bank's main function, as set out in section 8 of the Act, is "to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices."

Having a single focus on price stability is markedly different from earlier Reserve Bank of New Zealand legislation. Before 1989 the Reserve Bank had a number of objectives, such as full employment and high levels of production and trade, as well as price stability.

Experience showed that having multiple objectives for monetary policy reduced the likelihood of any of them being achieved. Moreover, the best way monetary policy can assist long-term economic and social well-being is by delivering price stability, and the 1989 Act reflects this.

This is because price stability protects the value of people's incomes and savings, and encourages investment in the nation's productive capacity, thereby contributing to employment, growth, export competitiveness and a more just society.

In particular, monetary policy aimed at price stability promotes secure employment by smoothing out boom-bust business cycles. This means that when the economy falters, inflationary pressures fall and monetary conditions can be eased, which encourages the economy and employment to grow again.

How the Reserve Bank Act separates the Reserve Bank's and the Government's responsibilities

Prior to the 1989 Act, monetary policy was under the operational control of the Minister of Finance. The Minister directed the Reserve Bank as to what monetary policy should aim at, and how it should be achieved. These directions were not made public, and priorities shifted frequently. In that environment there was always a risk that a Government would direct a loosening of monetary policy to ensure that the economy was buoyant at the time of a general election, even at the risk of triggering higher inflation shortly afterwards. The result was high and variable inflation and general economic uncertainty, which was damaging to confidence, long-term investment and growth.

The Reserve Bank of New Zealand Act 1989 changed that. Under the current legislation, the Government sets the inflation target, but the Reserve Bank has operational independence in deciding how that inflation target will be achieved.

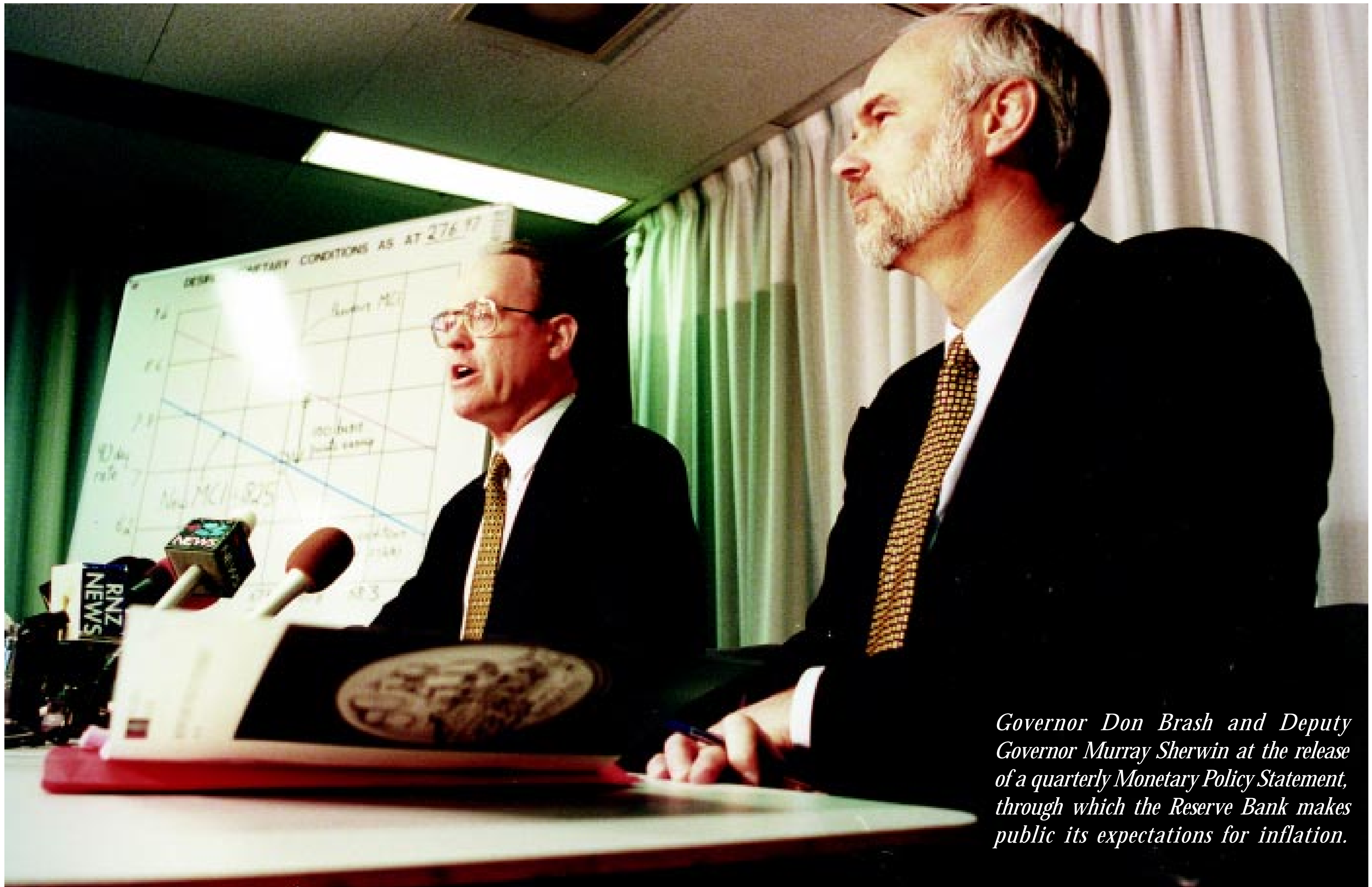
Transparency is the key

The inflation target must be made public, in writing. It is this requirement – that all the Government's instructions to the Reserve Bank be in the public arena – that is the most crucial feature of the New Zealand framework.

Inflation only works as a device for generating a short-term lift in economic activity if it comes as a surprise – to employers, employees, investors, savers and consumers. A surprise easing of monetary policy increases employers' profits, because prices go up while firms' labour costs remain unchanged. This gives the economy a brief lift, until employees gain compensatory pay increases. In effect, the surprise takes the form of an unexpected cut in real (or inflation-adjusted) pay.

If the Government had to make public that it intended to increase inflation, then a fake boost in economic activity would not happen, even if desired. That's because, if employees know from the start that prices are about to climb, they seek compensatory pay increases immediately, cutting off any politically-induced boom-bust before it happens. Likewise, lenders and bank depositors would instantly expect higher interest rates as compensation for inflation reducing the value of their money, further choking off any manipulated temporary lift in economic activity.

Because it is transparent, the monetary policy regime that now applies in New Zealand does not allow for sneak inflation by political directive.



Governor Don Brash and Deputy Governor Murray Sherwin at the release of a quarterly Monetary Policy Statement, through which the Reserve Bank makes public its expectations for inflation.

How a public agreement ensures that everyone knows the inflation target

In New Zealand the key to the transparency of the inflation target is a public agreement between the Treasurer and the Reserve Bank Governor (the Bank's chief executive). Called the Policy Targets Agreement (PTA), it states, in detail and numerically, what "stability in the general level of prices" shall be taken to mean, i.e. what the Reserve Bank must deliver.

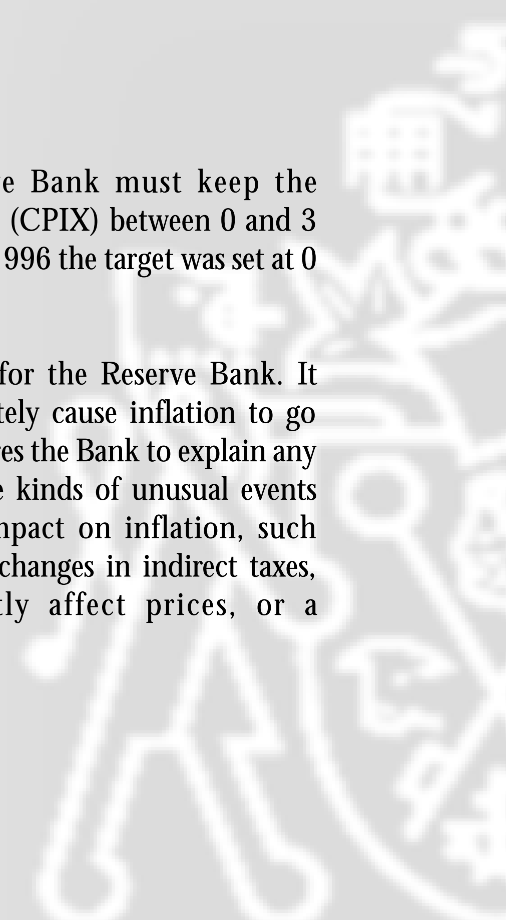
The PTA includes:

1. a statement as to the goal of monetary policy;
2. a description of how price stability should be measured numerically;
3. special factors which may justify inflation going outside the target range; and
4. principles for implementing monetary policy.

Under the current PTA, signed in December 1997, the price stability target is described as: "…maintaining a stable general level of prices, so that monetary policy can make its maximum contribution to sustainable economic growth, employment and development opportunities within the New Zealand economy."

The December 1997 PTA says the Reserve Bank must keep the Consumers Price Index excluding credit services (CPIX) between 0 and 3 percent, on an annual basis. Prior to December 1996 the target was set at 0 to 2 percent inflation.

The PTA sets out accountability obligations for the Reserve Bank. It acknowledges that certain events may legitimately cause inflation to go outside the 0 to 3 percent target range, and requires the Bank to explain any such breaches. The PTA gives examples of the kinds of unusual events which might have a significant temporary impact on inflation, such as sudden changes in import or export prices, changes in indirect taxes, government policy changes which directly affect prices, or a natural disaster.



This contract also instructs the Reserve Bank to:

- constantly and diligently strive to meet the policy target;
- implement monetary policy in a sustainable, consistent and transparent manner; and
- be fully accountable for its judgements and actions in implementing monetary policy.

Note also that section 12 of the Act permits the Government to over-ride the PTA's inflation target for a limited period, but this must be done in public and in writing.

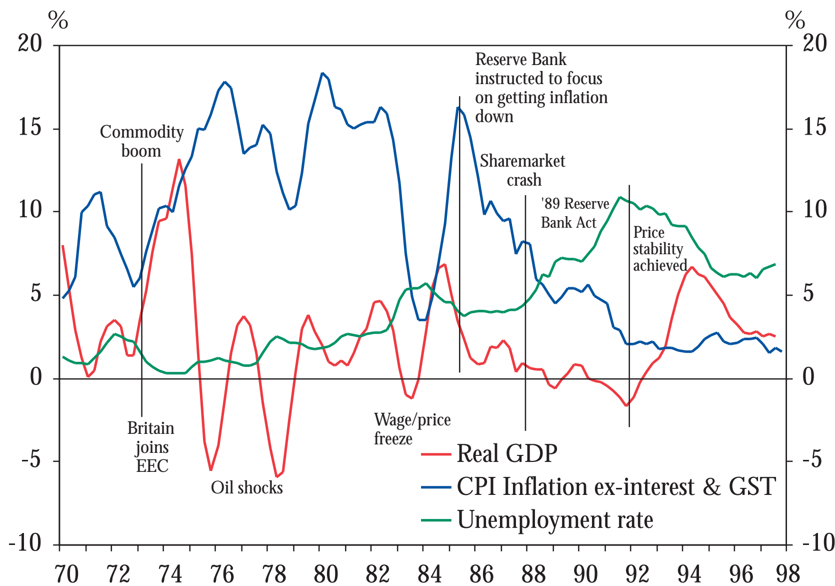
Governor Don Brash and Treasurer Winston Peters sign the December 1997 Policy Targets Agreement.

How the system has worked in practice

Has the New Zealand approach to monetary policy worked? The evidence says yes. Inflation has fallen dramatically since the mid-1980s. Once price stability was achieved in 1991, unemployment fell markedly, while gross domestic product (GDP) growth was the best in years, as Graph 1 shows. As of late 1997, New Zealand was at the bottom of the business cycle, with growth rates much better than at the same point in previous cycles. Since the passing of the 1989 Act, there has been a substantial reduction in inflationary expectations. This is important, because if people expect higher inflation they tend to put up the price of the labour, or the goods and services, which they sell. This then forces the Reserve Bank to restrict economic activity more to contain inflation, to everyone's cost. One measure of inflationary expectations is the yield on 10 year government bonds. If investors expect inflation to increase, they demand a higher yield on their bonds to compensate for the erosion of their bonds' value caused by inflation. Since 1985, 10 year bond yields have fallen substantially, as Graph 2 shows.

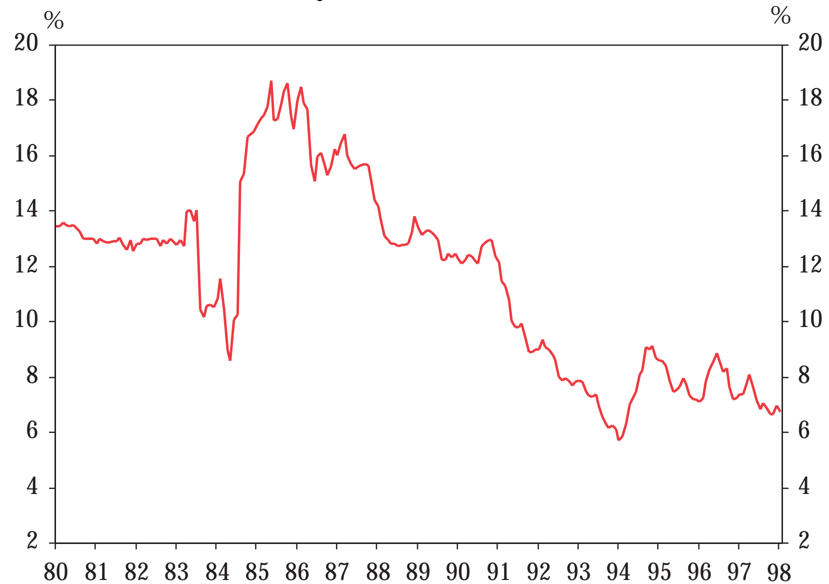
Graph 1

Real GDP growth, CPI inflation and unemployment



Graph 2

10 year bond rates



The political record

The separation of the Reserve Bank's and the Government's responsibilities has worked well in practice. The Reserve Bank has successfully demonstrated its willingness to take politically unpopular decisions necessary to deliver price stability. The Reserve Bank has stuck to its task without being deflected. Conversely, in 1996, when a Government was elected that wanted to widen the inflation target, this was able to happen smoothly, without a crisis, which is appropriate in a democracy, and is as the Act intended.

The current monetary policy framework also encourages closer scrutiny of fiscal policy decisions and discourages pump-priming. This is because any substantial fiscal loosening tends to be inflationary, which the Reserve Bank is obliged to resist, reducing any temporary flow-on increases in economic activity. This encourages governments and the public to assess spending and taxation decisions on their merits, case by case, which is as it should be.

As this cartoon shows, in 1988 price stability seemed impossible. Yet by March 1989 inflation was below 4%. Price stability (then defined as 0 to 2 percent inflation) was achieved in 1991.

Malcolm Walker/Sunday News

How the Reserve Bank is accountable

The Reserve Bank is held accountable in the following ways.

The Governor's personal accountability
Under the Act, the Governor is held personally accountable for achieving the inflation target set in the PTA. If the Treasurer or the Reserve Bank's Board of Directors believe that the Governor's performance in meeting this target has been inadequate, then the Governor can be dismissed. The concentration of authority in one person makes for clearer accountability. This gives the framework added credibility, as people know the Governor will be well motivated to deliver price stability.

Regular reporting to the Government and to the people of New Zealand
At least every six months, the Reserve Bank must publish a *Monetary Policy Statement*. Each *Statement* reviews monetary policy over the previous six months and describes how price stability will be delivered in the months ahead. The Governor and other Reserve Bank officials regularly appear before Parliament's Finance and Expenditure Select Committee to answer questions about these *Statements*, as they do for the *Annual Report*.

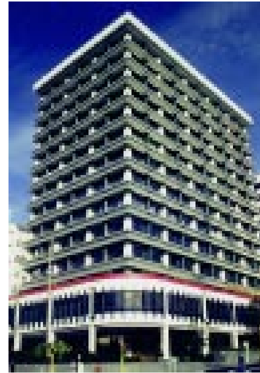
Board of Directors
On the Treasurer's behalf, the Reserve Bank's Board of Directors is required to keep the Reserve Bank's and the Governor's performance under constant review. The Board determines whether the Reserve Bank's *Monetary Policy Statements* and actions are consistent with achieving and maintaining price stability, and with the Policy Targets Agreement. However, the Board does not participate in the monetary policy decision-making process and does not receive market-sensitive information prior to the markets.

Funding agreement
The 1989 Act makes the Reserve Bank more accountable for its use of public money. Every five years a funding agreement is drawn up between the Government and the Reserve Bank, which specifies a level of expenditure for the Bank over the upcoming period. So far the Reserve Bank has been able to keep well within agreed limits, year by year. In fact, operating expenses in 1997/98 are budgeted to be 40 percent lower than expenses in 1989/90. Earlier legislation did not restrict the Reserve Bank's expenditure at all.

What they do elsewhere

Internationally, there are three well-known models for setting and implementing monetary policy. One is the New Zealand model, detailed earlier. Another option is the central bank deciding the inflation target and then implementing it. The third is a framework in which a government sets the inflation target and then implements monetary policy, as applied in New Zealand prior to 1989. The New Zealand statutory format was unique when implemented, but now it is perceived as increasingly orthodox, as the table indicates.

	Government sets target, central bank implements	**Central bank sets target and implements policy**	**Government sets target and implements policy**
Banca d'Italia (Italy)		✔	
Bank of Canada	✔		
Bank of England	✔		
Bank of Zambia			✔
Banque de France		✔	
De Nederlandsche Bank (The Netherlands)		✔	
Deutsche Bundesbank (Germany)		✔	
Federal Reserve System (US)		✔	
Reserve Bank of Australia	✔		
Reserve Bank of New Zealand	✔		
Swiss National Bank		✔	



For further information please contact:

Lisa Weekes
Communications Officer
Reserve Bank of New Zealand
PO Box 2498, Wellington, New Zealand

Telephone 04 471 3767
Fax 04 471 2270
E mail: weekesl@rbnz.govt.nz

Visit the Reserve Bank on the Internet at: http://www.rbnz.govt.nz