

Independent Review of the Operation of Monetary Policy in New Zealand

In May 2000, the Government announced that the New Zealand monetary policy framework would be reviewed. Professor Lars Svensson of Stockholm University was appointed to undertake the review and to report by the end of February 2001. Professor Svensson's report was released by the Treasurer/Minister of Finance on 28 February.

In this issue of the Bulletin, we have published the Executive Summary and recommendations of the Svensson Report, together with the terms of reference of the review. The complete report by Professor Svensson can be obtained from the New Zealand Treasury and can be accessed on www.monpolreview.govt.nz - the monetary policy review website, and on www.rbnz.govt.nz - the Reserve Bank of New Zealand's website.

As can be seen from the press statements issued by the Treasurer/Minister of Finance (reprinted in this Bulletin), the Government will be giving consideration to the recommendations made by Professor Svensson, with a view to announcing decisions before the end of May.

Executive Summary of the Report to the Minister of Finance, by Professor Lars E. O. Svensson

The following is a copy of the Executive Summary of Professor Svensson's report. Words in italics are italicised in Professor Svensson's report.

In May 2000, the Treasurer/Minister of Finance invited me to review the operation of monetary policy in New Zealand and provided me with the Terms of Reference. In undertaking the review, I have read the wide range of submissions provided to me and have met with a number of submitters and other interested parties. I visited New Zealand for two weeks in November 2000 in order to observe the operations of the Reserve Bank first hand and collect material for the review. I have also had discussions with a number of key people in the area of monetary policy from other countries.

In order to judge whether the operation of monetary policy has been effective, it is important to understand what monetary policy can and cannot do. People typically ask too much of monetary policy - no less in New Zealand than elsewhere. In the long term, monetary policy can only control nominal variables such as inflation and the nominal exchange rate. It is beyond the capacity of any central bank to increase the average level or the growth rate of real variables such as

GDP and employment, or to affect the average level of the real exchange rate. At best monetary policy can reduce the variability of these real variables somewhat. An attempt to increase the average level or growth rate of GDP or employment would trigger ever-rising inflation, at increasing cost to the economy in terms of less efficient resource allocation and arbitrary and inequitable redistributions of incomes and assets. For these reasons, an increasing number of countries have specified price stability as the primary goal for monetary policy.

In the short and medium term, monetary policy has effects on both nominal and real variables. However, the complex transmission mechanism of monetary policy, the varying lags and strength of the effects through different channels, unpredictable shocks and inherent uncertainty combine to prevent the use of monetary policy for any fine-tuning. There is considerable agreement among policymakers, academics and researchers in the monetary policy area that so-called flexible inflation targeting is the best monetary policy setup. Then inflation is stabilised around a low inflation target in the medium term rather than at the shortest possible horizon, and a gradual and measured policy response avoids creating unnecessary variability in the real economy. Because of shocks, uncertainty and imperfect control, considerable variability may remain in the real economy, especially for a small, open and less diversified economy like New Zealand.

Best-practice central banks which have adopted flexible inflation targeting include the Bank of England and Sveriges Riksbank (the central bank of Sweden). I believe these banks provide a relevant standard of comparison for the operation of monetary policy in New Zealand.

Overall, with regard to the operational framework and how monetary policy is managed in pursuit of the inflation target, I have found that *the period (mid 1997 to March 1999) when the Reserve Bank used a Monetary Conditions Index (MCI) to implement monetary policy represents a significant deviation from best international practice*. This has now been remedied, and *monetary policy in New Zealand is currently entirely consistent with the best international practice of flexible inflation targeting, with a medium-term inflation target that avoids unnecessary variability in output, interest rates and the exchange rate*. Only some marginal improvements, mostly of a technical nature, are recommended.

With regard to the governance and accountability structures, I have found some weaknesses. These have not yet caused any problems because of the qualities of the current Governor, but they could in different circumstances. Therefore, some substantial improvements are recommended.

The summary of the review and the recommendations below is organised according to the terms of reference.

Term of Reference 1: The way in which monetary policy is managed in pursuit of the inflation target

The Reserve Bank made some policy mistakes during the 1990s. It tightened policy too late in 1992/93 and eased policy too late in 1997/98. However, the Reserve Bank has been a pioneer in inflation targeting, without the possibility of learning from previous experience of other central banks. The economy has regularly been subject to new kinds of shocks. Mistakes in retrospect are unavoidable, and they need to be seen in a broader perspective.

The inflation history of New Zealand before the 1990s is dismal. During the 1990s *the Reserve Bank has achieved a remarkable stabilisation of inflation at a low level and*

successfully anchored inflation expectations on the inflation target. With hindsight, the timing of policy could have been somewhat better. However, *given the circumstances at the time of decisions, aside from the period when the Reserve Bank used the MCI to implement policy, there is no evidence that policy has systematically resulted in unnecessary variability in output, interest rates and the exchange rate*.

During the MCI period, the Bank let exchange rate depreciation result in automatic interest rate increases with little burden of proof that those interest rate increases were warranted and in spite of the MCI being an unreliable indicator of the monetary policy stance. This allowed interest rate increases at the onset of the first drought and the Asian crisis in 1997/98, when a more thorough analysis of the situation may have suggested differently. This certainly contributed to unnecessary interest rate variability and may have caused some unnecessary output variability. *The MCI period represents a substantial deviation from best-practice inflation targeting*.

During the 1990s, the Bank has lengthened its policy horizon and improved its understanding of the transmission mechanism of monetary policy. The Bank has developed an extremely well-designed decision-making process. Since March 1999, the Bank has abandoned the MCI as an instrument in favour of the Official Cash Rate (OCR). The December 2000 *Monetary Policy Statement* (MPS) is a prime example of flexible inflation targeting. I conclude that *the Reserve Bank's current conduct of monetary policy is entirely consistent with the best international practice of flexible inflation targeting, with a medium-term inflation target that avoids unnecessary variability in output, interest rates and the exchange rate*.

In line with current best practice, the Reserve Bank interprets the PTA as a medium-term point target of 1.5 percent. *I recommend that the current policy target in the PTA should continue to be interpreted as a medium-term point target for 12-monthly increases in the Consumer Price Index (CPI) of 1.5 percent*. At the beginning of the next term of the Governor, the PTA should be marginally modified to include the medium-term point target directly. There is no reason to make other changes in the PTA.

Frequent changes to the PTA can be disruptive to the economy. For this reason, it is desirable that each PTA is maintained for the full five-year duration of the Governor's term and *I recommend that any change to the PTA should be done at the beginning of the new term of the Governor.*

I also recommend some further technical improvements to the Reserve Bank's Forecasting and Policy System (FPS). These are detailed in my report. Although these are not likely to materially affect policy choices, they represent developments that will improve the internal consistency of the FPS and push the frontier of best international practice in inflation targeting further out.

Term of Reference 2: The instruments of monetary policy

There is considerable support for the OCR system in New Zealand and the consensus is that it has worked well. Additional instruments would either be without essential effect (reserve ratios and foreign-exchange interventions) or would be very difficult to implement in practice, create inefficiencies in financial markets, have high supervisory and compliance costs and probably result in a loss of confidence of international investors and corporations (capital controls and other tax or regulatory interventions). My conclusion is that *the Reserve Bank is currently using the appropriate instrument for the operation of monetary policy.*

Term of Reference 3: The information used by the Reserve Bank in its decision-making

I have had the opportunity to observe directly the information used by the Bank in its decision-making in terms of assessing the current state of the economy, in making forecasts of macroeconomic variables and in general economic analysis. I am convinced that the Bank uses available data in the same way and to the same extent as other best practice central banks. In addition to using available data, the Bank makes a considerable effort in collecting information directly from a large number of businesses and organisations all over New Zealand.

The availability and quality of data relevant for monetary policy are largely in place. However, some improvements are

required to bring data quality up to international standards. *I recommend that Statistics New Zealand collect monthly data on the CPI and industrial production.*

I also recommend that the Reserve Bank consider reporting and discussing alternative measures of inflation expectations for the medium and long term more extensively than is currently the case, as part of assessing the long-term credibility of the monetary policy regime. Some of the data, for instance, extensive surveys of inflation expectations of different categories of firms, organisations and households, should be commissioned at arm's-length from the Bank, perhaps from Statistics New Zealand.

Term of Reference 4: The monetary policy decision-making process and accountability structures

This term of reference concerns governance and accountability issues. In New Zealand, responsibility for monetary policy decisions rests with the Governor of the Reserve Bank alone. This is an unusual arrangement internationally; in most countries monetary policy decisions are the responsibility of a committee.

The current arrangement with a single decision-maker works very well. This is to a large extent because of the exceptional qualities of the current Governor, Dr Brash. In spite of the rigorous procedure for appointing the Governor, future Governors may not be of the same standing. Another Governor may not, to the same extent, encourage open and comprehensive discussion and advice within the Bank and support the Board in its monitoring of the Bank. Another Governor may not cope as well with the pressure, criticism and even abuse that seem to go with the territory, and may, in difficult times and under high pressure, lose confidence and let policy go awry in a number of different ways. The current system relies on the ability to quickly dismiss the Governor on such occasions. However, the lags in the effects of monetary policy, the difficulties in objectively identifying whether outcomes are the result of policy or luck, and the actual mechanics of removing a Governor together imply that removal of a Governor will never be easy and never be quick.

Consequently, I find the current arrangement's dependence on a single person's qualities too risky. For this reason, *I recommend that a formal Monetary Policy Committee (MPC) of the Reserve Bank, responsible for decisions related to monetary policy, be formed. A suitable time for this would be at the beginning of the next term of the Governor.*

The sound design of a committee is essential to overcome the existing risks without creating others. As in the committees of the Bank of England and Sveriges Riksbank, the members of the committee should be experts in monetary policy, macroeconomics or financial markets. Nonexperts would inevitably have reduced ability for independent assessment and less capacity to participate in monetary policy discussions, and effectively become hostage to the experts. Given the careful wording of the objectives set out in the PTA, meeting the PTA is largely a technical activity that requires technical expertise.

In a small country such as New Zealand, there is inevitably a limited supply of highly competent experts without serious conflicts of interest. While a sufficient pool of experts outside the bank may be available for initial appointments, with some turnover in the committee a drop in quality over time is unavoidable. There are also other problems with external experts discussed in my report. Therefore, I propose an internal MPC comprised of the Governor and Reserve Bank staff.

The MPC should have five members, each with one vote: the Governor as chair, the two Deputy Governors and two other senior Bank staff. The Governor and Deputy Governors should be appointed in the same way as now. The two senior staff should be appointed in the same way as the Deputy Governors, by the Board of Directors on the recommendation of the Governor. The terms should be five years and overlapping, so only one member is appointed or reappointed each year. Named votes and non-attributed minutes of the MPC should be published with a short lag. The MPC should only be responsible for decisions related to monetary policy. In all other respects, the Governor should continue to be the single decision-maker of the Bank.

The proposed MPC essentially institutionalises a well-tested internal decision-making structure worked out by the Bank. It represents the minimum change and provides the minimum

disruption necessary in moving to a formal committee structure. It retains the current coherent decision-making and communication processes better than alternative committee arrangements, especially those with external members. It retains the current accountability to the largest extent possible. Published minutes further improve accountability.

The accountability structure should be further strengthened. The current arrangement whereby the Governor and the two Deputy Governors sit on the Bank's Board is unsatisfactory and provides the potential for a conflict of interest. *I recommend that the Board of Directors only consist of non-executive directors. The chair should be selected by the non-executive directors themselves and not by the Treasurer, to ensure sufficient independence of the Board. The Board of Directors should publish an annual report with an evaluation of the Bank's monetary policy.*

The Bank itself can contribute to the accountability process by raising the profile of monetary policy discussion. *I recommend that the Reserve Bank fund an annual conference on the evaluation of monetary policy in New Zealand.*

The Parliament's Finance and Expenditure Select Committee also has an important role in the accountability structure. However, the Select Committee is typically pushed for time and lacks some of the technical expertise necessary to effectively question the Bank on policy matters. For these reasons, *I recommend that Parliament's Finance and Expenditure Select Committee conduct thorough and detailed hearings of the Governor and other Reserve Bank officials with the help of appointed experts and other assistance.*

Term of Reference 5: The coordination of monetary policy with other elements of the economic policy framework, including prudential policy

New Zealand is a leader in the transparency not only of its monetary policy, but also of its fiscal policy. Monetary policy and fiscal policy are coordinated by each focusing on medium-term objectives and making policy actions transparent. In this way fiscal actions can take full account of the likely monetary response and vice-versa. Given the

transparency and the medium-term orientation of both fiscal and monetary policy and the regular exchange of information that takes place between the Bank and the Treasury, any gains from more explicit coordination between fiscal and monetary policy are likely to be minor. In particular, they would be overwhelmed by the negative consequences of any reduction in the operational independence of monetary policy. Therefore, *no changes are required in the current coordination of monetary and fiscal policy.*

It is highly desirable that government policies in general are consistent with the price stability goal and that the Government informs the Bank well in advance of policy plans that may have consequences for inflation.

The current prudential-supervision arrangements are fully consistent with the price stability objective, but the profile of prudential policy could be raised. *I recommend that the Reserve Bank summarise its information about the financial system, including a number of macro-prudential indicators of financial stability, in a regular report, modelled on those published by the Bank of England and Sveriges Riksbank.*

Term of Reference 6: The communication of monetary policy

Effective communication is vital to the efficient operation of monetary policy. A high level of transparency is also an important part of the accountability structure of monetary policy. *The Bank's communication of monetary policy decisions to the public and the financial markets is generally exemplary.* This is a conclusion that is widely held and evident in many of the submissions to the review.

The Bank has recently reduced the level of detail reported in its MPS, in order not to give the impression of unrealistic precision. I believe there are far better means of illustrating the uncertainties inevitable in economic projections than in the rounding procedure introduced. *I recommend that the Reserve Bank consider alternative ways of conveying the inherent uncertainty in projections while maintaining transparency.* These can be modelled on those used by the Bank of England and Sveriges Riksbank.

Recommendations of Professor Svensson's Report

This section summarises the recommendations related to the operation of monetary policy and legislation that I find appropriate within the context of the Terms of Reference for the review. With regard to the operational framework, I have found that monetary policy in New Zealand is currently consistent with the best international practice of inflation targeting: flexible inflation targeting with a medium-term inflation target, which is consistent with avoiding unnecessary variability in output, interest rates and the exchange rate. Only some marginal improvements are suggested, mostly of a technical nature. With regard to the governance and accountability structures, I have found some weaknesses. These have not yet caused any problems because of the qualities of the current Governor, but they could in different circumstances and therefore should be addressed. The recommendations for improvements fall out of the discussion in sections 1–6 above. They have been ordered in four groups, concerning (1) the Policy Targets Agreement (PTA), (2) governance and accountability issues, (3) data issues, and (4) some issues for the Reserve Bank, most of which are technical.

The Policy Targets Agreement

1 The current formulation of the policy target in the PTA, including the clause “to avoid unnecessary instability in output, interest rates and the exchange rate”, should continue to be interpreted as a medium-term point target for 12-monthly increases in the Consumer Price Index (CPI) of 1.5 percent, the midpoint of the target range of 0 to 3 percent. The target should also continue to be interpreted as “soft-edged”, in the sense that the edges 0 and 3 percent do not indicate any hard and precise thresholds for policy responses. This is consistent with the best international practice of flexible inflation targeting and with avoiding unnecessary instability in output, interest rates and the exchange rate. It is also entirely consistent with the Reserve Bank's current interpretation of the PTA.

At the beginning of the next term of the Governor, section 2b should be modified to read "...the policy target shall be 12-monthly increases in the CPI of 1.5 percent over the medium term". There is no reason to make any other changes to the PTA.¹

- 2 To maintain stability and credibility of the monetary policy regime, it is desirable that each PTA is maintained for the full five-year duration of the Governor's term. At the formation of a new government, the existing PTA should normally be left in place. Any change to the PTA should be done at the beginning of a new term for the Governor.

Governance and accountability issues

- 1 A formal Monetary Policy Committee of the Reserve Bank, responsible for monetary policy decisions, should be formed. A suitable time for this is at the beginning of the next term of the Governor. The committee should have five members, each with one vote: the Governor as chair (with the casting vote), the two Deputy Governors, and two other senior Bank staff. The Governor and the Deputy Governors should be appointed in the same way as now. The two senior staff should be appointed in the same way as the Deputy Governors, that is, by the Board of Directors on the Governor's recommendation. The members of the committee should have overlapping five-year terms, so only one member is appointed or reappointed each year. Named votes and non-attributed minutes of the MPC should be published with a lag of about two weeks. The MPC should only be responsible for decisions related to monetary policy. In all other respects, the Governor should continue to be the single decision-maker of the Bank.

- 2 The Board of Directors should only consist of non-executive directors. To ensure sufficient independence

¹ Some technical changes where there are references to the target range are required, though. For instance, section 4b could be reformulated as: "It is acknowledged that inflation outcomes may deviate from the target. If inflation outcomes would deviate more than 1.5 percent from the target, or if such occasions are projected, the Bank shall explain in Policy Statements made under section 15 of the Act why such outcomes have occurred, or are projected to occur, and what measures it has taken, or proposes to take, to ensure that inflation comes back within that range."

of the Board, the chair of the Board should be selected by the non-executive directors among themselves and not by the Treasurer.

- 3 The accountability structure should be strengthened in several ways. The Board of Directors should publish an annual report with an evaluation of the Bank's monetary policy. This report could be separate or part of the Bank's Annual Report. The Board may appoint a panel of experts for its assistance.
- 4 The Reserve Bank should fund an annual conference for the evaluation of monetary policy in New Zealand. The conference should be organised by an independent committee. At the conference, the Board's and the Bank's annual reports, as well as reports by invited experts from within and outside New Zealand, should be presented and discussed by experts, Reserve Bank officials, interested parties and journalists.
- 5 Parliament's Finance and Expenditure Select Committee should, with the help of appointed experts and other assistance, conduct thorough and detailed hearings of the Governor and other Reserve Bank officials. This may require additional resources for the Committee. These arrangements could be modelled on those undertaken by the UK Parliament and the European Parliament.

Data issues

- 1 The availability and quality of data relevant for monetary policy are largely in place. However, some improvements are required to bring data quality up to international standards. In particular, Statistics New Zealand should collect monthly data on the Consumer Price Index and industrial production.

Issues for the Reserve Bank

- 1 The Reserve Bank may want to consider some further developments of its Forecasting and Policy System (FPS). Alternative interest rate reaction functions and alternative interest rate paths could be used and presented systematically to the MPC to provide a larger menu of policy choices for discussion and consideration. Although these are not likely to materially affect policy choices,

they represent developments that will improve the internal consistency of the FPS.

- 2 The Reserve Bank should consider reporting and discussing alternative measures of inflation expectations for the medium and long term more extensively than is currently the case, as part of assessing long-term credibility of the monetary policy regime. Some of the data, for instance, extensive surveys of inflation expectations of different categories of firms, organisations and households, may be commissioned at arm's-length from the Bank, perhaps from Statistics New Zealand.
- 3 The Reserve Bank should summarise its information about the financial system, including a number of macro-prudential indicators of financial stability, in a regular report, modelled on those published by the Bank of England and Sveriges Riksbank (the central bank of Sweden).
- 4 The Reserve Bank should consider alternative ways of conveying the inherent uncertainty in projections while maintaining transparency, for instance, modelled on those used by the Bank of England and Sveriges Riksbank.

Terms of Reference for the Review of the Operation of Monetary Policy issued by the Treasurer/ Minister of Finance on 28 February 2001

Background

Ten years have passed since the Reserve Bank of New Zealand Act 1989 ("the Act") came into force on 1 February 1990. Having come through a period of transition to sustained price stability, it is now appropriate to review the way in which New Zealand's monetary policy is conducted and its effectiveness in contributing to broader social and economic objectives.

Goal

The goal of the review is to ensure that the monetary policy framework and the Reserve Bank's operations within that framework are appropriate to the characteristics of the New Zealand economy and best international practice.

Context

The goal for monetary policy is set out in Section 8 of the Reserve Bank Act:

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.

Through the maintenance of medium-term price stability, monetary policy contributes to the Government's broader economic objectives. Accordingly, this section of the Act will not be reviewed, nor is the Government willing to lessen the accountability of the Reserve Bank for inflation outcomes or alter the operational autonomy of the Bank.

Terms of Reference

The review will consider:

- 1 The way in which monetary policy is managed in pursuit of the inflation target. The review will examine the way the Reserve Bank interprets and applies the inflation target set out in the Policy Targets Agreement, with a view to ensuring that this approach to achieving medium-term price stability is consistent with avoiding undesirable instability in output, interest rates and the exchange rate.
- 2 The instruments of monetary policy. The review will assess whether the Reserve Bank has an adequate range of instruments and is using its current instruments effectively in altering monetary conditions in the desired direction.
- 3 The information used by the Reserve Bank in its decision-making. The review will consider the range of sources, availability, type and timeliness of data, and the impact of these variables on forecasting and decision-making.
- 4 The monetary policy decision-making process. The review will consider whether the decision-making process and

accountability structures promote the best outcomes possible.

- 5 The coordination of monetary policy with other elements of the economic policy framework, including an evaluation of the relationship between monetary policy operations and other Reserve Bank functions such as prudential oversight of financial institutions.
- 6 The communication of monetary policy. The Reserve Bank's communication of monetary policy decisions will be reviewed to ensure that these decisions are explained to the public and financial markets in the simplest, clearest and most effective way possible.

The reviewer may, where appropriate, seek to identify lessons for the future from the last decade's experience with the framework and the Reserve Bank's conduct of monetary policy over that period.

Process

The reviewer will:

- 1 Invite interested parties to submit their views on the operation of monetary policy in the areas detailed in these terms of reference. The reviewer is not required to consult further with parties making submissions or other parties but will consult where it is useful to the review.
- 2 Obtain such other relevant expertise, including external research services, as is desirable to assist in the examination of issues covered in the report.
- 3 Report to the Minister of Finance and make such recommendations pertaining to the operation of monetary policy and legislation as is appropriate within the context specified above.

Reporting Date

The review report shall be with the Minister by 28 February 2001.