Financial reforms in New Zealand and their relevance to the central bank

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Introduction

Good evening. Thank you for again giving me the opportunity to address a meeting organised by the European Policy Forum.

Last year, when I spoke at a similar meeting, my topic concerned the issue of accountability for independent central banks and the way we had tackled that supposed dilemma in New Zealand.

This evening's address takes a broader view. I would like to discuss some of the principles which underpin recent reforms in New Zealand's public sector and show how those same principles were relevant to reforms in the Reserve Bank of New Zealand. With Europe in the process of increasing the independence of central banks and moving ultimately towards a new European central bank, insights from our experience of institutional reform may be of interest to you.

Setting the scene

In the 1970s and early 1980s, New Zealand's economic performance was poor compared to that of other OECD nations. Despite, and eventually because of, fiscal and monetary stimulation of the New Zealand economy, unemployment rose steadily and our growth rate fell well below that of the OECD average. We suffered from persistent balance of payments and fiscal deficits, with associated increases in external debt. Our net external debt increased as a percentage of GDP from around zero in 1974 to almost 50 percent in March 1984.

Moreover, inflation was difficult to control given the expansionary macroeconomic policies. Between 1970 and 1984 prices in New Zealand increased fivefold. Over the same period, prices increased only threefold in the OECD as a whole.

To a large extent, these problems stemmed from our lack of adjustment to changes in the global economy. Our economy had been geared to providing pastoral commodity exports to a few large markets - indeed mainly to this market (in 1966, almost half of our total exports were bound for the United Kingdom).

Over time, we were less able to find ready markets for all we could produce. The entry of the United Kingdom into the European Community significantly affected our access to this market (in 1993, around 6 percent of our total exports were to the United Kingdom).

Our responses to changing circumstances can now be seen as inadequate. In part, we tried to insulate ourselves and postpone adjustment. Agricultural production was heavily subsidised, while import quotas, tariffs and subsidies were used to encourage the development of a domestic manufacturing sector.

Extensive government intervention in the economy slowed the process of change. By altering the price signals faced by investors and producers, investment was frequently directed away from the areas of New Zealand's long-term comparative advantage.

Radical changes in economic policy were called for. The new Labour Government elected in 1984 set out both to address macroeconomic imbalances and to make the economy more market-oriented. The new policies were motivated by a desire to arrest the relative decline in our economic performance and to provide a framework for sustainable growth. The reforms were broad, as many of you will be aware.

At the macroeconomic level, the Government made a determined attempt to reduce the fiscal deficit and aimed monetary policy squarely at controlling inflation. But more was needed. Traditional macroeconomic policies to reduce inflation and the fiscal deficit could not deal with many of the distortions and inefficiencies in the economy.

Microeconomic reforms were also required. Here the focus was on allowing the price mechanism to function more effectively. The aim was to harness, rather than distort, the incentives which guide economic behaviour.

Deregulation occurred in a number of industries and border protection was reduced significantly. Tax changes in 1986 resulted in the consolidation of sales taxes into one broad-based, value-added tax, set at a single rate with virtually no exemptions. At the same time, marginal rates of income tax were rapidly reduced from relatively high levels. More recently, under the National Government elected in late 1990, significant labour market reform has occurred

It was against this background that public sector reform occurred. In many government departments, the distinction between commercial and non-commercial products was blurred. Social objectives were not clearly specified. Nor were they distinguished from other activities.

Furthermore, government agencies sometimes had conflicting objectives. The Reserve Bank of New Zealand was a case in point. We were to target low inflation, high growth and employment, and external balance - simultaneously!

Typically, public sector resource management was centralised. Managers generally did not have control over resources - and often had little freedom to hire or fire staff. The lack of responsibility also inhibited accountability.

Prior to the mid-1980s, the Reserve Bank's problems were similar to those of other public sector organisations. The legislation governing us contained multiple and inconsistent objectives, with no framework for prioritising them.

Finance Ministers took most monetary policy decisions and, as the theory of political economy would suggest, they did not always focus on inflation. Nor were they always open about what monetary policy was actually aimed at. The Minister of Finance could tell the public that monetary policy was directed at one objective, but instruct the Bank to pursue another goal.

With very little transparency about the Bank's goals and operations, monitoring was difficult. And of course, as the Opposition Finance Spokesman has recently observed, multiple objectives provided multiple excuses for failure.

Financial accountability was also limited. Unlike most other public sector organisations, the Bank was able to set its own budget. We spent what we considered necessary and passed what was left over from our seigniorage revenue to the Government. On the surface, that seems an attractive position to be in. But such an arrangement seldom encourages the most efficient use of resources. Nor does it force an organisation to review its purpose and activities in the way a tight budget does.

The reforms

The framework for improving public sector management was rooted in microeconomics and management theory. The changes revolved around altering the incentives faced by public sector managers and the constraints under which they worked.

Broadly, the reforms allowed the government to specify its objectives and structure the incentives of public sector managers so as to encourage the achievement of those objectives.

There are four features consistent with this which have been incorporated into public sector management in New Zealand. The features are first, specifying objectives; second, ensuring those who are responsible have the necessary control to meet those objectives; third, providing mechanisms to allow accountability; and fourth, providing assessment against objectives.

The objectives which are set should be clear and also achievable. In New Zealand, most of the objectives have been set in terms of outputs. The focus of monitoring is no longer on the inputs used by organisations.

To a much greater extent than previously, managers in the public sector have been given the means to enable them to achieve the objectives which they have been set. There is a higher degree of operating autonomy, and ministerial involvement in day-to-day management is reduced. In turn, this allows ministers to focus on broader policy issues.

The countervailing force to greater decision-making power and control over resources is increased accountability. Managers now have to answer for their performance, which is judged against the clear objectives set out in advance.

Making managers accountable requires setting up systems which allow performance to be measured against objectives. Assessment is easier when the objectives are clearly spelt out in advance.

The results of those reforms

(a) Objectives

The process of specifying the objectives of government bodies has facilitated a rethink of the role of government and the purpose of particular policies. One common question raised is the efficiency of public versus private provision of particular services, and I know there has also been debate on this issue in the United Kingdom.

As I noted earlier, there had been a very blurred distinction between the government's commercial and non-commercial activities. One of the earliest changes was to begin the process of separating the two.

Services which are completely commercial in nature are now operated on a 'user-pays' basis. Where there is some social aspect to the provision of those services, this can be explicitly funded by the government. As in the United Kingdom, many government businesses involved in commercial activities have been sold, while others have been set up as Crown-owned companies. Businesses such as Telecom, the national airline, state-owned banks and the rail network have all been sold.

The role of the Reserve Bank has also been carefully considered. Our objective is now specified in Section 8 of the Reserve Bank of New Zealand Act 1989. "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".

This clear and single goal is a direct result of thinking carefully about what monetary policy can and cannot do. The other objectives which were set out in the earlier legislation - growth, full employment, balance of payments equilibrium - are ones that monetary policy cannot sustainably achieve. The best contribution monetary policy can make to employment or growth is to maintain price stability.

We reached that conclusion on the basis of both our own experience in previous years and also that of other countries. Economic theory strongly supports our single focus on price stability.

In fact, the government directed the Bank to focus monetary policy solely on reducing inflation from late in 1984. Legislation formalising that single objective and giving the Bank operational autonomy was passed in 1989 and became effective early in 1990.

For reasons of accountability, we need a more precise objective than 'price stability'. That is why the Act requires the Minister of Finance and me to negotiate a Policy Targets Agreement, or PTA. This is negotiated whenever a Governor is appointed or reappointed, or by mutual agreement. The PTA specifies a target against which the Governor can be held accountable. The current target is to maintain twelve-monthly consumer price inflation between zero and two percent.

However, the PTA acknowledges that it will not always be sensible to keep inflation within this range. For a small economy which is very open to international markets, this is an important point.

Sometimes, a large shock, such as a dramatic increase in oil prices, may lift some prices markedly. If that happens, it would not be desirable to force other prices down so as to keep average price increases within our target. Instead, we would focus on ensuring that there was no wage and price spiral in response to the shock. We are required to ensure that the shock has only a 'one-off' impact on inflation.

Nevertheless, the presumption is that inflation should normally be kept within the target band, as has been the case since 1991.

(b) Authority or control

Changing the framework for public sector organisations has important implications for the way in which they operate and are managed. Managers now have greater control over resources, giving them the flexibility to achieve their objectives in the most efficient way. For example, employment conditions in the public sector have become more closely analogous to those in the private sector.

The Reserve Bank has a greater degree of autonomy than most government agencies. Our mandate is to operate monetary policy to meet the targets set out in the PTA. Ministerial involvement is limited to negotiating the targets with the Governor. Any attempt to redirect monetary policy to an objective other than price stability has to be done in public - by means of an Order in Council - which greatly reduces the chances of a change based simply on political expediency.

Our power to operate monetary policy is not limitless. For example, the legislation does not allow the Bank to control inflation by placing limits on bank lending. We did not seek those powers, as we do not think that an effective monetary policy can be operated via credit growth controls or reserve requirements. Again, our experience in earlier years provided plenty of evidence on the difficulties of a direct-control approach to monetary policy.

One further point on this. Our legislation explicitly recognises the link between monetary policy and the exchange rate. It would be very difficult to maintain price stability in New Zealand if the exchange rate was controlled by the government and used to pursue other objectives. So if the government wants to follow an exchange rate policy which is not consistent with price stability, the legislation requires that either new policy targets are negotiated or that monetary policy is formally and publicly directed to another objective. Exchange rate policy may be another issue to be dealt with in the move toward a European central bank.

Financial reform has also occurred in the Bank. The new framework requires the Governor and the Minister of Finance to negotiate a five-year funding agreement to limit the Bank's operational expenditure. The rest of our seigniorage revenue is passed to the government.

The arrangement seeks to balance two potentially conflicting objectives. First, the Bank should not continue to have unfettered power in setting the level of its expenditure. Second, the government should not be able to cut the Bank's budget in the face of a monetary policy tightening.

(c) Accountability and assessment

Accountability is now visibly in place for senior public servants. Previously, departmental heads were appointed on a permanent basis. But it is difficult to be fully accountable when ones job is not on the line. Consequently, senior staff, and some junior staff, are now on fixed term contracts. Contracts are only renewed if that is justified by performance.

The same applies in the Reserve Bank. As Governor, my job is on the line if the Bank does not deliver inflation within the target set out in the PTA. Indeed the legislation explicitly notes that inadequate performance in meeting the target established by the PTA is grounds for dismissal. The Bank's Board of Directors can recommend my dismissal to the Minister of Finance if they judge that I am following policies which are inconsistent with the PTA target.

Another way in which our framework encourages openness is the publication of a six-monthly Monetary Policy Statement. This document is similar to the Inflation Report published by the Bank of England. The Reserve Bank Of New Zealand Act requires that the statement reviews monetary policy implementation in the preceding period and explains the policy outlook.

How have reforms worked at the Bank?

I am very pleased to say that the reforms in the Reserve Bank have been extremely successful - both in my judgement and in that of most informed observers. That is not to say that implementing the reforms has always been easy. Any large change in an organisation tends to be painful for some, particularly during the transition stages. This was as true for the Reserve Bank as it was for other public sector bodies. However, now that the reforms are in place, we are able to see significant benefits.

First, we are more effective. We have met our primary objective, with both headline and underlying inflation remaining within the target range since 1991. In the year to June 1994, both underlying and headline inflation were 1.1 percent. Further, underlying inflation is forecast to remain within the target - both by our own forecasters, and by most other commentators. This reflects a high degree of credibility in the framework.

Other statistics confirm this. Interest rates on 10-year government stock fell from around 18 percent in early 1986, to just over 12 percent in early 1990, and are now around 8 percent.

Interest rates have also fallen relative to those in other countries. In March 1986, the yield on 10-year bonds in New Zealand was almost 10 percentage points above that in the United States. The differential had fallen to around 3.5 percentage points in March 1990, and in March this year long-term bond yields in New Zealand were around 0.5 percentage points below those in the United States. Such a dramatic fall in interest rates is telling evidence of our increased credibility.

Lower interest rates reflect lower inflation expectations, as well as a fall in New Zealand's country risk premium. Year-ahead inflation expectations in the Reserve Bank's survey of business respondents have fallen from almost 8 percent in 1988 to 1.8 percent in the latest survey. Household inflation expectations have fallen too, although not so dramatically.

Lower expectations of inflation have also been reflected in recent wage settlements. Average wages increased by only 1 percent in the year to June 1994. Over the same period, employment grew by 4 percent. The outcome suggests that New Zealanders are no longer setting wages based on expectations of rising inflation.

Perhaps more interestingly, many contracts recently settled provide for no increase in basic wages. In addition, a greater number of contracts are now for terms of over one year. The Reserve Bank itself has recently negotiated a new two year employment contract with those staff not on individual contracts. The settlement provides for basic wage increases of 1 percent in each of the two years, and replaces an agreement negotiated in 1992 which had similar terms. The Reserve Bank is confident that these wage increases are consistent with maintaining long-term price stability.

Second, financial savings have also been made. The Minister of Finance and I signed the current funding agreement in April 1991. Our operating expenditure was capped at 1990/91 levels, in nominal terms, for five years until June 1995, when the agreement will be renegotiated. When the budget was set, inflation in the previous year was over 5 percent and we were forecasting inflation to remain above 2 percent until late 1993. A fixed nominal budget was expected to be very tough in those circumstances.

In fact, we have made very significant productivity gains. Our operating expenditure is currently some 40 percent below that set in the funding agreement. In dollar terms, operating expenditure has fallen from $61 million in 1988 to an estimated $38 million in the current financial year. Staff numbers have fallen from around 570 in 1988 to just over 300 currently.

The efficiencies have been reflected in the Bank's structure. In 1990 the number of departments was cut from 11 to 7. Alongside this, the number of line managers has been reduced. In 1988 there were over 50. Now there are only around 30.

These savings have been made without a significant change in the functions for which the Bank is responsible. For example, around one half of the savings made have come from a simple decision to tender out the production of bank notes.

Third, we have comprehensively reviewed our functions and role. A prime example of this is in the banking supervision area. Here we are moving from a system of direct and intensive supervision toward a system which ensures banks provide substantially greater financial information to the public. The aim is to encourage prudent banking via market discipline, rather than control. However, institutions will still be required to meet a small number of prudential conditions to be registered as banks.

Like many central banks, the Reserve Bank tended to do what had always been done previously. There was resistance to doing things differently. However, the widespread changes in other parts of the economy provided an impetus for reform. Traditional ways of approaching issues were challenged, and often altered. We have found that to be a very positive experience.

Fourth, there has been a significant change in the way we approach questions within the Bank. A clear focus on objectives provides a very structured framework for internal debate on the stance of monetary policy. Also, the targets provide a structure for external debate on our actions.

Our relationship with the Treasury

Interestingly, the New Zealand Treasury was very supportive of the proposal to make the Reserve Bank operationally independent. They saw clear merit in targeting monetary policy at inflation, and in allowing us to get on with that job. After all, they are as interested as we are in promoting stable and sustainable economic policies. Our framework certainly encourages that.

The Treasury recognised that our independence would have consequences for other government policies. Running an expansionary fiscal policy puts upward pressure on real interest rates if the central bank does not accommodate the extra inflationary pressure.

Certainly, fiscal restraint makes our job as inflation-fighters easier. But, given we will fight inflation anyway, it also heightens the costs and lowers the benefits of running a lax fiscal policy. The two complement each other well. And, after more than fifteen years of fiscal deficits, New Zealand is on track to achieve a small surplus in the current fiscal year.

Summary

In Europe you have the exciting prospect of combining different methods of dealing with issues, and different ways of organising institutions. In some instances, your objectives are slightly different. Perhaps you will find, as New Zealand has, that a clear focus on realistic objectives is a useful first step. In any event, a discussion of objectives, and of incentives for achieving them, can be revealing.

You may even find some parts of our model useful when thinking about central bank organisation. I believe that the framework we operate under has much to commend it. The rights of the legislature are preserved in setting the objectives of monetary policy and that is clearly appropriate in a democracy. But the Act also gives the Reserve Bank both the autonomy and the incentive to get on with the job. This is a sensible way for a government which is committed to low inflation to achieve that goal.

Public sector reforms in New Zealand have been very comprehensive. They covered financial and managerial aspects and have boosted both efficiency and effectiveness.

There have been transitional costs. Considerable redundancies occurred as a result of public sector restructuring. Generally these represented productivity gains, rather than losses in service. Jobs now being created in the economy are more likely to be sustainable than was the case previously, when government regulation distorted many price signals.

Reforms at the Reserve Bank mirrored those in other organisations. We have become a leaner and sharper team. With a clear objective, we can focus on achieving it without distractions.

Was the temporary pain worth it? I believe so. We use our resources much more efficiently and there is a much greater sense of achievement for staff in being part of an organisation which is focused on goals, and meeting them.

And, finally, but by no means least, we have made a major contribution to the foundation of a sustainable economic recovery in New Zealand. Price stability is an essential element in providing greater economic stability and certainty. That, in turn, allows businesses and the community to prosper. I am confident that these are worthwhile achievements. ■