
A brief history of monetary policy objectives and independence in New Zealand¹

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The legislative framework for monetary policy has been fairly settled for more than 20 years. This stability contrasts with the frequent revisions that occurred to statutory provisions dealing with monetary policy objectives and the relationship between the Reserve Bank and the government in the decades following the Bank's establishment in 1934. This article traces the changes in the legislation governing monetary policy and outlines some of the influences on the evolution of monetary policy objectives and the role of the Reserve Bank in conducting monetary policy.

1 Introduction

Views about the appropriate role for monetary policy, and the appropriate legal relationship between the government and the Reserve Bank, have evolved considerably since the Reserve Bank's inception in 1934. In this article we outline the evolution of the legislative objectives for monetary policy in New Zealand and the changing nature of the Reserve Bank's statutory responsibility for monetary policy.

The statutory objectives governing monetary policy and the Reserve Bank's independence have been repeatedly modified since the 1930s. These provisions have been influenced by differing domestic political emphases and by the evolution of economic thought about what monetary policy can usefully achieve. The current form of the legislative provisions governing monetary policy was also extensively influenced by the rethinking of wider public sector governance in New Zealand in the late 1980s. Although New Zealand's approach to monetary policy has evolved in much the same way as in other countries, many of the details of our framework have retained a distinctly New Zealand flavour.

At inception, the purpose of the Reserve Bank was to manage money and credit conditions to promote New Zealand's economic welfare. An integral part of this was the requirement that the Reserve Bank maintain the New Zealand pound's convertibility into the British pound. In subsequent amendments and acts between 1936 and

1964, the number and scope of monetary objectives expanded – variously encompassing economic and social welfare, production, trade, employment, and price stability, though not necessarily in that order. Eventually, with the floating of the New Zealand dollar in 1985 and the passage of the Reserve Bank Act 1989, the primary objective of monetary policy settled on domestic price stability,² under the implicit, oft-repeated, understanding that monetary policy pursuing price stability provided the best possible contribution to the economic welfare of New Zealand.

The legal independence of the Reserve Bank in respect of monetary policy has also been amended over its history. The Bank was granted a high degree of formal independence under the inaugural Reserve Bank Act of 1933, but this independence was substantially removed later in the 1930s and in other subsequent amendments to the Reserve Bank Act. The 1989 Act put in place a balanced arrangement in which the Reserve Bank has full operational autonomy in the conduct of monetary policy, while the Minister of Finance has considerable (transparent) involvement in agreeing how price stability should be pursued, and some reserve powers of intervention.

2 The responsibility of a new central bank

By the late 1920s, most countries were once again part of the Gold Standard, with national currencies being convertible into gold at a fixed price. For example, the UK, New Zealand's most important trading partner, returned

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² Previous Reserve Bank legislation, as enacted, can be downloaded from http://www.nzlii.org/nz/legis/hist_act

to the Gold Standard in 1925, following its temporary suspension during World War I. Convertibility of paper currency into gold was seen as a basic feature of sound money in this era, establishing confidence in the currency and promoting macroeconomic stability.

Until the late 1920s, New Zealand trading banks managed domestic credit conditions to maintain a *de facto* fixed exchange rate close to parity between the New Zealand pound and the British pound (Hawke, 1973, pp 17, 19). Prior to the establishment of the Reserve Bank in 1934, trading banks in New Zealand issued their own bank notes. Before World War I, these notes were convertible to gold upon request (Wright 2006, p 6).

Concerns about foreign reserves and domestic credit provided an impetus for the establishment of a central bank. In the late 1920s, four of New Zealand's six trading banks were Australian owned. These four banks held common pools of sterling reserves for the two countries, which led some to believe that adverse macroeconomic conditions in Australia were constraining credit conditions and the availability of foreign exchange for New Zealand (Ashwin, 1930). It was thought that a New Zealand central bank would provide greater differentiation between the two Australasian monetary systems, and would thus ensure that New Zealand credit conditions better reflected New Zealand's export earnings and borrowing capacity.

In July 1930 Sir Otto Niemeyer, a Bank of England official, was invited by the New Zealand government to give advice on banking and currency issues. His report to Parliament in February 1931 recommended the formation of an independent central bank. Niemeyer's report advised that the central bank should maintain a fixed exchange rate for the New Zealand pound, with the exchange rate to the British pound being at or near parity (Niemeyer, 1931).

In the period between Niemeyer's report and the passage of the inaugural Reserve Bank Act of 1933 the international environment changed substantially. In 1931 the UK (and various other countries) left the Gold Standard, and the US followed in 1933. In New Zealand, the devaluation of January 1933 was the first policy action to set an exchange rate against sterling at other than parity.

In the 1933 Act, the Bank's overall purpose was stated broadly:

It shall be the primary duty of the Reserve Bank to exercise control [...] over monetary circulation and credit in New Zealand, to the end that the economic welfare of the Dominion may be promoted and maintained (1933, s12).

Convertibility was an important feature of the Act and the Reserve Bank was required to convert New Zealand pounds into British pounds on demand (though only in wholesale amounts). The Act stated that "the rate at which the exchange is effected shall be fixed by the Bank" (1933, s16).

3 Early Reserve Bank independence

Niemeyer's report had argued that "the Bank must be entirely free from both the actual fact and the fear of political interference" (Niemeyer 1931, p 4), a view shaped no doubt by the Bank of England's independence (Wright 2006, p 11). Gordon Coates, the United-Reform coalition's Minister of Finance, qualified Niemeyer's view somewhat and suggested that while the government should have ultimate responsibility for monetary policy, the Reserve Bank's implementation of policy should be free from "the fact, as well as the suspicion, of being influenced by [anything] other than the economic welfare of the Dominion as a whole" (Coates, 1933, p 3).

The 1933 Act was designed to constrain the government's formal influence over the Reserve Bank. The Act established the Bank as a semi-private institution, entrusted with the management of the national currency but limited by Parliament's determination of its statutory objectives, duties, and powers. One-third of the Reserve Bank's paid up capital was issued to the public (Singleton *et al*, 2006) and while the Crown retained a majority shareholding of the Reserve Bank, the Minister of Finance was not entitled to vote at shareholder meetings (1933, s6). The Governor of the Bank was appointed by the Governor-General, but this appointment was to be made on the recommendation of the Board (1933, s24), and four of the seven board members were to be appointed by the

shareholders (1933, s29). The Board was, from inception, ultimately responsible for the affairs of the Reserve Bank (1933, s3).

The government had no formal powers to direct the Bank in any of the areas of its operations. The Reserve Bank took over the government's banking business but, importantly, the Reserve Bank's ability to lend to the government was limited by statute (1933, s14). In most other operational areas, the Bank had considerable formal autonomy but a rather limited range of instruments (1933, s13, s14, s45). Foreign exchange inflows and outflows would, in practice, be the biggest influence on domestic monetary conditions, as they had been prior to the Bank's establishment.

4 Monetary policy in the 1930s

Despite the formal statutory provisions, from the time of the Reserve Bank's inception it was generally agreed that its independence should be limited to the implementation, rather than the direction, of monetary policy. Following the 1933 Act, the Reserve Bank's Board formally resolved that the government should be responsible for setting the overall direction of monetary and exchange rate policy, while the Reserve Bank should carry it out. This stance was endorsed by the government (Hawke 1973, p 64).

The first Labour government, elected in 1935, had an extensive reform agenda. The newly elected government put the amendment of the Reserve Bank Act at the top of its legislative priorities (Hawke 1973, p 65), intending to have the Reserve Bank play a more active role in the government's overall economic programme. Elements of Labour Party thinking at the time were influenced by the Douglas Credit (ie, Social Credit) movement, which was highly suspicious of private banks' creation of credit and saw an important role for government credit creation in sustaining a fully-employed economy.

The 1936 amendment to the Act stated

It shall be the function of the Reserve Bank [...] to give effect as far as may be to the monetary policy of the Government [...] For this purpose, and to the end that

the economic and social welfare of New Zealand may be promoted and maintained, the Bank shall regulate and control credit and currency in New Zealand, the transfer of moneys to or from New Zealand, and the disposal of moneys that are derived from the sale of any New Zealand products and for the time being are held overseas (1936, s10). [Emphasis added.]

This amendment made explicit the government's responsibility for the direction of monetary policy. Furthermore, additional provisions introduced the power for the government to make regulations under the Act, putting greater power directly in the hands of the Minister of Finance.³ The Secretary to the Treasury also became a voting member of the Board. Such provisions constrained the Bank's ability to implement policy in an independent manner and provided scope for a correspondingly larger role for the government.

The 1936 amendment removed restrictions on the Reserve Bank lending to the government (1936, s12, s14, s15). These changes allowed the government to borrow from the Bank to finance government activities directly. For example, the Labour government set up an account at the Reserve Bank to fund a guaranteed price system for dairy farmers, and also borrowed from the Bank to finance state housing (Sutch, 1966, pp 185, 189).

The 1936 amendments gave the government explicit responsibility for policy, but the definition of "policy" and the practical distinction between it and "implementation" were not always clear. Following disagreements about the Reserve Bank's control over credit expansion, foreign exchange, and the maintenance of low interest rates, the government tightened its control over the Reserve Bank further (Hawke, 1973, pp 66-67). The 1939 amendment to the Act stated that

The Governor and the Board of Directors shall have regard to any representations that may be made by the Minister of Finance in respect of any functions or business of the Reserve Bank, and shall give effect to any decision of the Government in relation thereto conveyed to the Governor in writing by the Minister of Finance (1939, s2).

³ For example, the introduction of exchange controls following the foreign exchange crisis of late 1938.

This amendment made it clear that the Bank enjoyed only as much operational freedom as the government of the day chose to allow it. The directive powers were never formally invoked but the possibility of direction and the regulation-making powers were sufficient to maintain effective government control over monetary policy. While the Act was amended repeatedly over the next few decades, from 1940 until the mid 1980s there was little effective change in the relationship between the Reserve Bank and government.

5 Monetary policy in the post-war period

Monetary policy, in New Zealand and most similar countries, played very little active role during World War 2 and the years immediately afterwards. The focus of policy during the war had clearly been on mobilising resources through an extensive web of controls (including on prices, wages, and financial sector activity). The controls were only slowly unwound in the subsequent decades. Consistent with the practice in a variety of similar countries influenced by the experience of the Great Depression, post-war economic management placed a very high priority on full employment.

Unlike many countries, whose exchange rates had been floated in the 1930s, New Zealand's exchange rate had remained fixed. Following the war, most countries also returned to fixed exchange rates against the US dollar, while the dollar was convertible into gold. This "Bretton Woods system" continued until 1971. There were only two discretionary adjustments to New Zealand's exchange rate during those decades.

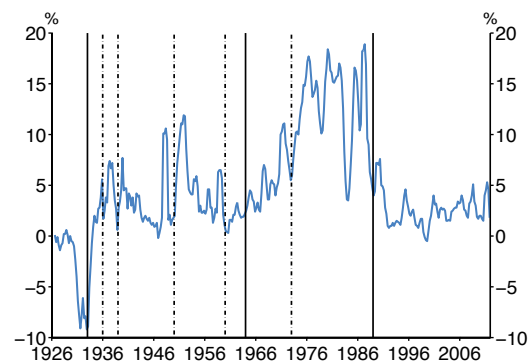
Inflation in the late 1940s was sometimes high and variable (see figure 1), and the National Party had campaigned vigorously in the 1949 election on getting the cost of living under control. Once elected, the new government amended the Act, keeping overall responsibility for monetary policy within the government's control but adding an additional requirement that

[The Bank] shall do all such things within the limits of its powers as it deems necessary or desirable to promote and safeguard a stable internal price level

and the highest degree of production, trade, and employment that can be achieved by monetary action (1950, s2).

Though domestic price stability had been discussed at the Reserve Bank's inception (Hawke, 1973), this was the first statutory reference to it. In 1950, the inclusion of price stability as an objective for the Bank preceded the single focus on price stability in the 1989 Act by some forty years.

Figure 1
CPI inflation in New Zealand and Reserve Bank legislation 1926-2011



Source: Statistics New Zealand
Note: The solid vertical lines indicate the passing of the 1933, 1950, and 1964 Reserve Bank Acts. The dashed vertical lines indicate the passing of the 1936, 1939, 1950, 1960, and 1973 Reserve Bank Act amendments.

It is also worth noting that the goals for real economic variables ("production, trade, and employment") were not absolute but were to be pursued only to "the highest degree...that can be achieved by monetary action".

The 1950 legislation also removed the power of the Minister to direct the Reserve Bank, shifting that power to Parliament:

In the exercise of their functions and powers under the principal Act the Governor and the Board of Directors shall give effect to any resolution of the House of Representatives in respect of any functions or business of the Reserve Bank (1950, s3).

This change made formal direction of the Reserve Bank more difficult (although all governments at the time had absolute majorities in Parliament), by making any such direction more transparent, and open to public scrutiny. In practice, given the nature of the instruments available to the Reserve Bank, which required ministerial approval to use or vary, the change had quite limited effect and is

probably best seen as a statement of principle (Hawke 1973, pp 76-77). Like the change to the Reserve Bank objective, it is probably more interesting for the thinking that prompted the form of the legislative change than for any concrete impact on the way in which monetary policy was subsequently conducted.

In the 1954 election, the new Social Credit Political League won a surprising 11 percent of the total vote. The Social Credit movement worried about the role of trading banks in the creation of credit and urged a greater role for interest-free central bank credit. In response, a Royal Commission on Monetary, Banking, and Credit Systems was established in 1955 (Hogan 1956, p 305). The Commission found little of substance in the Social Credit arguments.

The Commission did, however, make a number of important comments about monetary policy. It argued that following the Reserve Bank Act amendment of 1950, the government had failed to adopt clear goals for monetary policy and its overall economic programme (Hogan 1956, p 308). The Commission also argued that the relationship between the Reserve Bank and the government was still not sufficiently clear and that the government should have more explicit responsibility for monetary policy.

While the governing National Party was not receptive to the Royal Commission's recommendation, the Labour government elected in 1957 introduced the following amendment:

The Minister of Finance may from time to time communicate to the Reserve Bank the monetary policy of the Government, which shall be directed to the maintenance and promotion of economic and social welfare in New Zealand having regard to the desirability of promoting the highest degree of production, trade, and employment and of maintaining a stable internal price level (1960, s2).

The 1960 amendment also made some other shifts of emphasis. First, the amended clause made clear that the statutory objectives were for the government's monetary policy, rather than goals for the Reserve Bank itself. In a sense, this change brought the statement of objectives into line with the fact that all the effective instruments were already under the control of the Minister of Finance. In a

parallel change, the power to direct the Reserve Bank was shifted from Parliament back to the Minister of Finance.

Second, the amendment altered the emphasis of the statement of objectives. A new preamble to the objectives was introduced stating that "it is the sovereign right of the Crown to control currency and credit" (1960, s2). This change appears to have been largely symbolic in nature, aimed at those Labour supporters sympathetic to the Social Credit movement (eg see Hawke, 1973, p 74; Sinclair, 1976, p 347). In addition, internal price stability was relegated to the bottom of the list of the government's monetary policy objectives (1960, s2), and there was no longer any reference to the limits of what could be "achieved by monetary action".

In 1964, under a National government, a new consolidated Reserve Bank Act was passed, replacing the 1933 Act and its numerous amendments. Only two changes were directly relevant to the material covered in this article. The power to direct the Reserve Bank was once again shifted from the Minister to Parliament. However, and perhaps consistent with the very limited operational freedom the Reserve Bank had, an additional primary function was added, listed before responsibility for the conduct of monetary policy; "to advise the Government on matters relating to monetary policy, banking, and overseas exchange" (1964, s8).

The formal scope for the Minister of Finance to direct the Bank varied under successive amendments to the Act. However, the Minister's continuing control over specific instruments used to influence monetary and exchange conditions (e.g., required reserve ratios, exchange controls, interest rate restrictions, and restrictions on new corporate capital issues) meant that the Reserve Bank's effective independence changed very little. The Reserve Bank's impact on monetary policy was more likely to depend on its ability to influence thinking within official and government circles (and on the quality of its published analysis) than on any significant discretionary scope to operate on its own. In that respect, the Bank's position during these years was not so different from that of its counterparts in the United Kingdom and Australia.

The use of interest rates as a monetary management tool had long been contentious. Bank and Treasury

submissions to the 1955 Royal Commission were divided about whether more flexible interest rates were appropriate (RBNZ *et al*, 1955), but the Commission recommended that greater use be made of variations in overdraft rates to influence savings and investment behaviour. However, the Commission's recommendations were largely ignored as governments preferred to use tools that worked primarily by rationing credit, allowing only limited flexibility in interest rates (Hogan 1956, p 311; Quigley 1989, p 222; Singleton *et al* 2006). Scope for variation in interest rates increased only gradually over the following decades, with periodic reversals and fresh rounds of regulation.

By the late 1960s, inflation was becoming more persistent in New Zealand and various other advanced economies. In this period, Milton Friedman's research was challenging conventional views about what monetary policy could achieve. In his famous 1968 presidential address to the American Economic Association, Friedman argued that there was no long-run trade-off between inflation and variables such as real activity and unemployment, and long-lasting efforts to stimulate real activity by holding interest rates low would only result in higher inflation. Friedman and like-minded 'monetarists' argued that in a closed economy (such as the US) monetary policy should aim to maintain a modest growth rate in some definition of money to maintain inflation at low levels. Friedman's work became hugely influential as the US (and other countries) entered a period in which both inflation and unemployment were high simultaneously (so-called stagflation).

6 Monetary policy in the 1970s

The 1970s became a period of macroeconomic turbulence both in New Zealand and internationally. In 1971, the Bretton Woods system that had governed international exchange rates since 1945 broke down when the US ended the convertibility of its dollar to gold. Many larger countries let their exchange rates float. New Zealand broke its fixed exchange rate against the pound

sterling in October 1971 and instead fixed its exchange rate against the US dollar until July 1973. Thereafter, New Zealand maintained a fixed exchange rate relative to a basket of currencies, though with periodic adjustments, both up and down.⁴

In 1973, the newly-elected Labour government once again amended the Act. General powers of direction were left with Parliament but the new amendments specifically allowed the government to direct the Reserve Bank to lend to it: "the Bank shall make such loans to the Government and on such conditions as the Minister decides from time to time, in order to ensure the continuing full employment of labour and other resources of any kind" (1973, s2). It is not obvious that patterns of government borrowing from the Reserve Bank were any different after this amendment than they had been in the 1960s, however.

In a further nod in the direction of the Social Credit movement, the 1973 amendment included a requirement "to ensure that the availability and conditions of credit provided by financial institutions are not inconsistent with the sovereign right of the Crown to control money and credit in the public interest" (1973, s5). As the Reserve Bank had no independent regulatory or other policy powers, this addition can be seen as largely symbolic in nature.

New Zealand's terms of trade fell sharply after 1973, and macroeconomic policy faced major adjustment challenges through the following years. Large fiscal deficits, gradually rising unemployment, low productivity growth and the adjustment costs of various microeconomic reforms, all made it more difficult to secure support for the necessary measures to keep inflation low. Headline inflation would remain above 10 percent for most of 1974-87 (with a brief interruption associated with the wage and price freeze in 1982-84), and for much of the 1970s and early 1980s the policy emphasis on stemming the rise in unemployment limited the extent to which interest rates were allowed to rise. The government and much of the private sector borrowed at very low or negative real interest rates, complicating efforts to keep inflation in check.

Monetarist approaches of the type advocated by Friedman did not take hold strongly in New Zealand. The Reserve Bank noted its own reluctance to recommend

⁴ See the timeline in the 1973-98 historical exchange rate series at <http://www.rbnz.govt.nz/statistics/exandint/b1/>

simple monetary targets and that “governments in New Zealand have not been as inclined to strongly held monetarist type views as governments in some other countries” (Reserve Bank, 1983, p. 298).

7 Transforming the monetary policy regime

The election of the Labour government in 1984 heralded major changes in economic policy, including monetary policy. Financial markets were liberalised when interest rate and credit controls, and foreign exchange and borrowing restrictions, were removed, and the exchange rate was floated in 1985, just over a year after Australia floated its own currency.

Inflation had been high from the early 1970s (see figure 1), and additional inflationary pressure was expected as a result of a large exchange rate devaluation in 1984 and the final lifting of wage and price controls. As a result, reducing inflation became the central concern of monetary policy (Reddell 1999, p 64). This focus on inflation came a little late by international standards: the United States and the United Kingdom had successfully disinflated in the early 1980s, while countries such as Japan, Germany, and Switzerland had achieved low inflation even earlier.

By the mid-1980s the Reserve Bank and the Treasury agreed with the academic consensus that there was no long-run trade-off between inflation and real activity, a view also endorsed by the Minister of Finance. It was thus agreed that the Reserve Bank should concentrate on reducing inflation to lower, more acceptable, levels. From early 1985, only indirect instruments (affecting banking system liquidity) were used to influence interest rates, exchange rates, and financial system behaviour more generally. The reliance on indirect instruments, rather than on regulatory provisions requiring formal ministerial authorisation, assisted in the transition to operational independence.

8 Reserve Bank of New Zealand Act 1989

The 1989 Act, which continues to govern monetary policy today, markedly reshaped the nature of the Reserve Bank’s monetary policy powers and responsibilities, and the relationship between the Reserve Bank, the Minister of Finance, and Parliament. That legislation adopted insights from international experience suggesting that central banks with monetary policy independence had more success in sustaining low inflation. It also reflected the wide-ranging reform of public sector organisation and management taking place at the same time. Those reforms were designed to allow Ministers to specify objectives for public agencies, while holding the agencies themselves accountable for the achievement of those objectives (Reddell, 1999).

The preamble to the 1989 Act specifies that the purpose of the Act is “to provide, while continuing to recognize the Crown’s right to determine economic policy, for the Reserve Bank of New Zealand, as the central bank, to be responsible for formulating and implementing monetary policy designed to promote stability of the general level of prices” (1989, a). Thus, the government retains overall control of economic policy (in pursuit, no doubt, of a wider goal of improving economic well-being) while delegating operational responsibility for monetary policy to the Reserve Bank.

Although the Act explicitly grants the Reserve Bank independence to carry out monetary policy, the government retains an important influence over the overall direction of monetary policy by giving the Minister of Finance a central role in setting monetary policy objectives: “the Minister shall, before appointing, or reappointing, any person as Governor, fix, in agreement with that person, policy targets for the carrying out by the Bank of its primary function” (1989, s9). While the Minister formally appoints the Governor, such appointment is made on the recommendation of the Board of Directors of the Reserve Bank (1989, s40).

⁵ The Secretary to the Treasury is, however, no longer a member of the Board.

The Act places clear primacy on the price stability objective, stating that nothing in any other act of Parliament “limits or affects the obligation of the bank to carry out its primary functions” (1989, s13). The Act also sharpens the personal accountability and responsibility of the Governor of the Reserve Bank: “it is the duty of the Governor to ensure that the actions of the Bank in implementing monetary policy are consistent with the policy targets fixed under section 9 of this Act” (1989, s11). The Governor can be removed if, among other things, the Governor’s performance in pursuing the specific policy targets has been inadequate (1989, s49). Under this Act, the Board’s role is primarily to act as agent of the Minister of Finance in monitoring the Governor’s performance.⁵

The Act also provides substantial, but to date unused, reserve powers for the Minister of Finance and the government. Section 12 allows the government to override the section 8 objective, and specify another economic objective in its place:

The Governor-General may, from time to time, by Order in Council, on the advice of the Minister, direct the Bank to formulate and implement monetary policy for any economic objective, other than the economic objective specified in section 8 of this Act, for such period not exceeding 12 months as shall be specified in the order (1989, s12).

Imposing a new temporary objective requires negotiating a new Policy Targets Agreement (PTA) for the duration of the override period. The legislation was designed to allow the temporary imposition of a new objective, but to otherwise keep the same relationship between the Governor and the Minister with respect to the implementation of policy as in more normal times. The Act ensures that any action taken by the government under this section is known to the public as it must be tabled in Parliament and published in the New Zealand Gazette (1989, s12).

The 1989 Act also provides the government with significant powers in respect of the exchange rate. Sections 17 and 18 allow the Minister of Finance to direct the Reserve Bank to intervene to influence or even to set the level of the exchange rate. However, section 20 states

that if a direction to intervene contradicts the price stability objective of monetary policy, the Governor could refuse to give effect to the direction unless and until the Minister obtains an Order in Council under section 12 of the Act to proceed with it (1989, s20).⁶

The Reserve Bank also has an ongoing role in providing advice to governments. Section 10 of the Act requires the Reserve Bank to consult with, and give advice to, the government and any other parties whose actions (for example, fiscal policy and related matters) affect the achievement of price stability.

Another important feature of the Act is the emphasis on transparency. The Reserve Bank is required to publish policy statements specifying the policies it intends to use to satisfy the PTA, stating the reasons for using those policies, outlining its thoughts on possible future monetary policies, and reviewing and assessing previous policies (1989, s15). Parliament no longer has any powers to direct the Reserve Bank, but plays an important role in monitoring the performance of the Reserve Bank. The Bank’s *Monetary Policy Statements* are referred, by statute, to Parliament’s Finance and Expenditure Committee.

The 1989 Act, in conjunction with the first PTA, signed between the Minister of Finance and the Governor of the Reserve Bank in 1990, established the seminal inflation targeting regime (Singleton et al, 2006). This monetary policy framework was soon adopted by countries such as Canada, the United Kingdom, Australia, Sweden, and Norway, among others. Key features of this regime that have been widely adopted include an explicit inflation target, central bank operational independence, and a high degree of transparency.

9 The Policy Targets Agreement

The Act leaves considerable discretion to the Minister and Governor as to what specific targets should be agreed upon in the PTA to deliver price stability. As Singleton et

⁶ Section 19 provides a weaker limitation on the Minister. It states that if the direction to intervene contradicts the Policy Targets Agreement, the Minister has to initiate a new agreement with the Governor (1989, s19).

al point out, the particular target that the Bank adopts in pursuing price stability is not a foregone conclusion and the Bank or the Minister could suggest that “a target for the monetary aggregate, exchange rate, or nominal GDP [...] be specified in place of an inflation target, provided it was consistent with maintaining price stability” (Singleton *et al* 2006, p 136).

By the time the Act was passed, however, there was a clear consensus, shared by successive Ministers of Finance and Governors, that the policy targets were best specified in terms of a band within which consumer price inflation should be maintained (Reddell 1999, p 67). In the first few PTAs, the target band for the inflation rate was set between 0 and 2 percent per annum (PTA 1990, s1). The band has been changed twice; to 0-3 percent in 1996 (PTA 1996, s2), and to 1-3 percent in 2002 (PTA 2002, s2). Each of these changes was initiated by the government of the day.

Later PTAs also placed greater emphasis on medium-term inflation as the focus of policy (recognizing that various shocks can affect short-run inflation outcomes). The 1997 PTA noted that “the underlying trend in prices [...] is the proper focus of monetary policy” (1997, s3). The 2002 PTA went further, stating that it is the “medium-term trend of inflation, which is the focus of the policy target” (s3), and specifically that the Bank’s “target shall be to keep future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term” (s2).

Another feature of PTAs since 1999 has been an explicit articulation of the long-recognised understanding that monetary policy can affect aggregate output and the exchange rate in the short run, and that such factors should be taken into consideration by the Reserve Bank: “In pursuing its price stability objective, the Reserve Bank shall implement monetary policy in a sustainable, consistent and transparent manner and shall seek to avoid unnecessary instability in output, interest rates and the exchange rate” (1999, s4). To guard against perceptions that monetary policy might be shaped in a vacuum, successive governments have also added to PTA’s statements about the government’s wider economic objectives and monetary policy’s role in delivering wider economic benefits.

10 Summary

The Reserve Bank’s monetary policy role, and the associated legislation, has gone through substantial change in the decades since the Reserve Bank was founded in 1934. Some of these changes have reflected specific New Zealand circumstances not mirrored elsewhere, such as the political influence of the Social Credit movement in earlier years and the public sector reforms of the late 1980s. Other changes to the monetary policy framework, arguably the more important ones, arose because the international understanding of what makes for good monetary institutions has changed substantially over the last few decades.

While precise legislative specifications differ across countries, there has been a considerable convergence in thinking about monetary policy, with operationally independent central banks pursuing long-run price stability, but with explicit emphasis on the short-run effects that policy can have on real activity, and on other financial prices.

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