SUBMISSION TO

THE

INDEPENDENT REVIEW OF MONETARY POLICY

BY THE

NON-EXECUTIVE DIRECTORS

OF THE

RESERVE BANK OF NEW ZEALAND

TABLE OF CONTENTS

EXECUTIVE SUMMARY

1. This submission is made by the Non-executive Directors' Committee of the Board of the Reserve Bank of New Zealand (NEDC). (See Appendix I for the current membership of the Committee.) A summary of our conclusions on the matters raised by the Terms of Reference for the Review follows.

Governance of and decision-making by the Reserve Bank

2. For the NEDC, the questions concerning whether the present governance and decision-making structures for monetary policy promote the best possible outcomes are central. Our **conclusions** are that:

   - The existing single decision-maker model should be retained. Under this structure, all decisions that fall within the scope of the Bank's operational autonomy are the Governor's decisions.
   - The Chair of the Board of Directors of the Bank should be a Non-executive Director, in place of the Governor, and that the Chair of the Board should be elected by the Non-executive Directors from amongst their number.
   - The Governor and Deputy Governor(s) should remain members of the Board, but that the Board should always include a majority of Non-executive Directors.

3. We have concluded that the single decision-maker model should be retained after weighing its advantages and disadvantages against those for alternative committee decision-making structures. The principal, and we think considerable, advantages of a single decision-maker structure model are the strong accountability and the coherence in decision-making and policy communication that it makes possible.

4. Possible weaknesses in a single decision-maker model are exposure to single person risk, possible capture of policy by a single train of thinking, and questioning by the public about the legitimacy of vesting what appears to be a lot of power in a single individual. However, these possible weaknesses are already addressed within the existing structure, through:

   - rigorous procedures for appointing a Governor, which substantially mitigate the risk of the "wrong person" being appointed;
   - constraints on the Governor from legislation and the Policy Targets Agreement (PTA), which mean that he/she does not have goal independence;
   - constant monitoring of the Governor by the Board, which provides a check against a Governor choosing not to respect the formal constraints, or failing to make full use of the wide range of information and analysis available from within and outside the Bank.

5. Our recommendation that the Chair of the Bank's Board should be a Non-executive Director reflects the fact that one of the primary roles of the Board is to monitor the performance of the Bank, and of the Governor in particular. This

makes it rather incongruous that the Governor, who is also chief executive of the Bank, should chair the Board. (This matter has been addressed to date by the Board having delegated formal monitoring of the Governor's performance to the Non-executive Directors committee of the Board.)

6. Putting the chairmanship of the Board of the Bank in the hands of a Non-executive Director would better ensure that the on-going monitoring by the Board is unambiguously independent – and is seen to be unambiguously independent – of the Governor.

7. If the chair of the Board is to be an independent director, the question arises how the chair should be elected or appointed. Our clear view is that the chair should be elected by the Non-executive Directors from amongst their number.

8. Appointment of a non-executive chair directly by the Minister could be seen as undermining the monitoring independence of the Board and, indirectly, the operational autonomy of the Bank. It would likely be seen as creating a mechanism by which a government, through its own appointee, could bring influence to bear on the Governor. Under the statutory framework established for the Reserve Bank, that would be wholly inappropriate. The appropriate way for the Crown to influence monetary policy is through the Policy Targets Agreement (PTA) or, if necessary, by using the override mechanism in section 12 of the Act.

Interpretation and application of the inflation target, with a view to achieving medium-term price stability consistent with avoiding undesirable instability

9. We make two main points on this issue.

10. First, the Bank, from the outset under the 1989 Act, has operated monetary policy in a manner that has taken account of the desirability of avoiding unnecessary instability in financial markets and in the real economy. The mandate for so doing has been provided in all PTAs to date. Specifically, the inflation target has been expressed as a range (which was widened from 0 to 2 per cent to 0 to 3 per cent in late 1996) and by consistent acknowledgement in those PTAs that unusual events may cause inflation to breach the target range.

11. Clearly there is always a potential tension between the weight to be given to avoiding instability in financial markets and the real economy, which calls for **flexibility** in inflation targeting, and the desirability of establishing an effective **anchor** for inflation expectations, which suggests less scope for flexibility.

12. This tension has manifested itself in various ways during the last decade. One example was the need to grapple in the mid-1990s, simultaneously, with concerns about the amplitude of the exchange rate cycle, and with concerns that internal inflation pressures would result in inflation becoming less well anchored. Another was the volatility in short-term interest rates induced in 1997 and 1998 by managing monetary conditions with reference to a Monetary Conditions Index. The Bank gave considerable attention to, and was responsive to, these issues.

13. Second there exists no single measure (akin to the inflation target) that can be used to evaluate whether fluctuations in output, interest rates and the exchange rate have, or have not, been necessary. A potential consequence of these dimensions having been added to clause 4(c) of the most recent PTA, therefore, is a blurring of the objective of, and accountabilities for, monetary policy.

14. The Board is examining ways in which it can, in its on-going monitoring, evaluate more formally the performance of the Bank in avoiding unnecessary instability in financial markets and the real economy. In this context we also note that it is “In pursuing its price stability objective …” that the PTA requires the Bank to seek to avoid unnecessary instability in output, interest rates and the exchange rate. In other words, we see the primacy of the price stability objective, rightly, as having been maintained.

Monetary policy instruments

15. It is primarily for the Governor to satisfy him/herself that he/she has the instruments needed to achieve the policy targets agreed with the Minister in the PTA. But the NEDC has a review role and, clearly, if the instruments available to the Governor were thought to be inadequate, that would be a concern. Overall, we have not had cause for concern to date.

16. Changes made in the design of the instruments used by the Bank, notably the change from a cash quantity operating regime, to a cash rate regime, have been essentially technical in nature. They were not motivated by a concern about instrument effectiveness in the more fundamental sense that the Bank was finding it not possible to alter monetary conditions in the desired direction.

17. The principal issue that has arisen in recent years with respect to the available policy instruments has concerned the Bank’s inability to influence the “mix” of monetary conditions, as between the level of interest rates and the level of the exchange rate. Analysis of this issue has indicated that there exists little, if any, scope for monetary policy initiatives themselves to influence this “mix”. The preferred responses lie in the area of policy initiatives that would make the more sheltered domestic sectors of the economy more open to international competition and more flexible. Where it has seemed that the Government could take initiatives that would be helpful to monetary policy in this way, the Governor has referred the matter to the Government. The NEDC endorses this approach.

The data used by the Bank

18. The data used by the Bank is one of the matters that the NEDC keeps under review as part of its on-going monitoring activities. We have been generally satisfied that the data available to, and used by, the Bank has been adequate.

19. But we also identify this as a matter that requires on-going attention. We live in a period of rapid change that is affecting the structure of the economy and business practice. Statistical frameworks need to continue to be kept under constant review so as to provide assurance that the information used by the Bank

accurately reflects developments in economic activity and pricing behaviours that bear on inflation trends.

The co-ordination of monetary policy with other elements of economic policy, including the Bank's prudential policy function

20. Co-ordination of other elements of Government policy with monetary policy is very important, in the sense that the thrust of other policies can either substantially help, or substantially hinder, monetary policy in maintaining medium-term price stability. In making this point, we are not advocating short-term fine-tuning in other areas of policy, but rather that the medium-term thrust of the Government's policy framework should be supportive of what it is asking monetary policy to achieve. Specifically, this indicates a need for:

- on-going fiscal discipline;
- competitive markets that are not hampered by unnecessary regulation;
- exposure to the competition that comes with openness to international trade; and
- a competitive and flexible labour market.

21. We observe that if recent Government policy changes with respect to the labour market, and the freeze on tariff reductions, result in less flexible and open markets, that could make it more difficult for monetary policy to maintain price stability. Similarly, if fiscal policy in the period ahead turns out to be more expansionary than currently is projected, that would not be helpful to monetary policy. We mention these matters in part because the recent policy changes well illustrate the general point, and also because they are of particular relevance at the present time. If monetary policy is to maintain medium-term price stability in the face of the recent increase in oil prices and the fall in the exchange rate, without causing a loss of output and an increase in unemployment, it will need all the help it can get from other Government policies.

The communication of monetary policy

22. The communication of monetary policy by the Bank comprises two elements: the statements by which it announces its monetary policy decisions, and a range of publications and speeches in which the Bank makes available the thinking and analysis that goes into its policy work.

23. The move from a cash quantity to a cash rate regime for implementing monetary policy resulted in a significant change in the way policy decisions are communicated. Previously, the Bank communicated changes in policy stance mostly by commenting on market conditions (in a way designed to move the markets). Now the centrepiece of the communication of a change in policy is a movement in the Official Cash Rate itself. The NEDC endorses this change.

24. The Bank's wider publications and communications programme is particularly comprehensive and, in the view of the NEDC, of high overall quality. Indeed, it is one of the standout features of the Reserve Bank of New Zealand.

PART I: INTRODUCTION AND BACKGROUND

Introduction

25. This submission is made by the Non-executive Directors' Committee (NEDC) of the Board of Directors of the Reserve Bank of New Zealand. An outline of the current governance structure of the Bank, including with respect to the roles and responsibilities of the NEDC, is set out in Box 1.

26. In preparing this submission, the NEDC has liased with the Governor and Deputy Governors of the Bank, who are members of the Bank's Board of Directors. However, the views expressed are those of the NEDC.

27. Our submission is organised into three parts:

    Part I: Introduction and background.

    Part II: Decision-making and governance structures for monetary policy (Term of Reference 4).

    Part III: Other matters raised in the Terms of Reference.

28. A particular focus in our submission is on the issues that are raised in the Terms of Reference concerning the decision-making and accountability structures for monetary policy. These matters relate most directly to the role and responsibilities of the NEDC. Our submissions on the other matters raised in the Terms of Reference also reflect our perspective as a non-executive body charged with monitoring the performance of the Bank.

BOX 1
Governance of the Reserve Bank: present arrangements

The main elements of the governance structure for the Reserve Bank, and the place of the Non-executive Directors' Committee in it, are as follows.

The Governor, rather than the Board of Directors, is "the Bank", in that the Act vests all the Bank's powers, and responsibilities, in the Governor. Thus the Governor is responsible for deciding the policies to be adopted by the Bank, subject to the constraints imposed by the Act, as well as for their implementation. (The more recognised corporate model is for the Board to determine strategy and policy and to delegate responsibility for implementation to the chief executive.)

The primary roles of the Board relate to the process for appointing the Governor (and Deputy Governor(s)) and to monitoring the performance of the Governor, which in practice means monitoring the performance of the Bank. Central to the process for appointing the Governor is a requirement that the appointment, which is made by the Treasurer, must have been recommended by the Board. (More detail is provided in Box 2.)

The monitoring of the performance of the Bank by the Board occurs in the context of a reporting relationship with the Treasurer, which involves the Board both in reporting to the Treasurer, and the Treasurer enquiring of the Board. Should the Board satisfy itself that the Governor is not performing adequately, then it is required to inform the Treasurer, and it may recommend the removal of the Governor. The Board may also give advice to the Governor on any matter relating to the performance of the Bank's functions and the exercise of its powers.

The Board comprises the Governor (as chair), Deputy Governor(s) (up to two) and between 4 and 7 non-executive directors. This means that the Board always comprises a majority of non-executive directors. It has established two committees: the Audit Committee, which currently comprises three Non-executive Directors, and the Non-executive Directors' Committee, which comprises all Non-executive Directors.

The Board has delegated to the Non-executive Directors' Committee formal responsibility for monitoring the performance of the Governor. This is to avoid the obvious conflict of interest that would arise if this function were performed by the full Board, given that the Governor chairs the Board. It conducts the Governor's annual performance appraisal, and advises the Treasurer in relation to the Governor's terms of employment, including remuneration. The Non-executive Directors meet with the Treasurer typically about twice yearly, and/or as circumstances require.

The monitoring and advisory roles of the Board cover both the Bank's policy functions and its use of resources. The latter means that the Board has a review and advisory role in relation to the management of the Bank. In this area the Board plays a governance role more akin to that played by a conventional corporate board. That governance role includes keeping under review the financial management, risk management and human resource management of the Bank. The Audit Committee has particular responsibilities in relation to the monitoring of financial and risk management.

The Reserve Bank of New Zealand Act 1989

29. The background to the Review, as given in the Terms of Reference, is as follows:

    "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".

30. The basic purpose of the Act is stated (in its long title) as being:

    "To provide, while continuing to recognise 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".

31. The Act was designed to put in place, within the framework of New Zealand's parliamentary democracy, an institutional structure for monetary policy designed to deliver enduring low and stable inflation. The foundations of that structure were seen as being:

- Clear and consistent specification of the price stability objective by Parliament;
- Operational independence for the Reserve Bank to pursue that goal; but with
- Strong accountability to a Board of Directors, to Parliament and to the public; and
- A high level of transparency.

The following paragraphs elaborate on each of these foundations.

A clear and consistent objective

32. The price stability objective for monetary policy was incorporated into s.8 of the Act on the basis of a conviction – taken from experience, and supported by economic theory – that:

(a) inflation distorts the economy and hence inhibits economic growth over the longer term;

(b) while inflation has many proximate causes – for example, monopoly pricing, increased prices for imported goods and services, wage and salary escalation, excessive demand arising from fiscal expansion, or too much credit growth - ultimately inflation is a monetary phenomenon in the sense that, whatever the proximate cause, it can persist only if allowed to do so by an accommodating monetary policy;

(c) monetary policy is unable to make an enduring contribution to economic growth other than by maintaining price stability; and

(d) an expansionary monetary policy aimed at achieving faster growth without regard to the implications for inflation may generate faster growth in the short term, but will result in higher inflation and slower growth over the longer term.

33. In the view of the NEDC, those judgements remain as valid today as they were in 1989 and, as envisaged by the Terms of Reference, in this submission we take s.8 of the Act as the cornerstone of the framework for monetary policy in New Zealand.

34. A further notable feature of the Act is the incorporation of an "override mechanism". This mechanism provides that, if the Government wishes to override the price stability objective established by s.8, it is able to do so, but not for more than 12 months without renewing the override, and provided always that it follows a formal and transparent statutory process. This mechanism serves as a short-term "safety valve". As such, it adds to the robustness of the

framework. It provides the Governor with protection against political pressure to "bias" monetary policy operations toward an alternative objective, by making it incumbent on the Government, should it wish to pursue an alternative objective, to use the "override" mechanism that is available to it. In the absence of that step being taken, the Treasurer and the Governor remain bound by the expression of the policy objective contained in s.8 of the Act and in the Policy Targets Agreement made pursuant to that section of the Act.

Operational independence

35. Operational independence for the Reserve Bank is established in the statutory framework in a number of ways.

36. First, all decision-making powers on monetary policy operations are vested in the Bank, which, under the governance structure established by the Act (see Box 1), means the Governor of the Bank. Thus, while the goal for monetary policy is determined at the political level – by way of s.8 of the Act as passed by Parliament, or, should a Government choose to use it, by way of the override mechanism described in para. 34 above – decisions on how to achieve the prescribed goal through monetary policy operations are outside the political decision-making process. Charging the Reserve Bank with responsibility for independently implementing monetary policy helps establish a stronger basis for public confidence that the objective will be achieved.

37. Second, while the Treasurer appoints the Governor, and also appoints the Non-executive members of the Board of Directors, the appointment process has been carefully structured to constrain the Treasurer's ability to undermine the Bank's operational independence by simply appointing his or her "own people". The details of the checks and balances in the appointment regime are given in Box 2.

38. Third, the Treasurer and the Governor are required by the Act to enter into an explicit Policy Targets Agreement (PTA). The terms of this Agreement, which bind both parties, are required to be consistent with the s.8 objective (unless the override has been used).

39. Fourth, there is a five-year Funding Agreement between the Treasurer and the Governor, which obviates the need for annual appropriations from Parliament to cover the Bank's operating expenses. (The Bank operates under financial arrangements that effectively result in seigniorage income being passed to the Crown, and the Crown, in turn, providing funding to cover the cost of the Bank's operations.)

BOX 2
Processes for the appointment and removal of the Governors and of Non-executive Directors

Appointment and removal of the Governors

The Governor is appointed by the Treasurer on the recommendation of the Bank's Board of Directors. This means that a person cannot be appointed without the mutual agreement of both the Board and the Treasurer.

The Governor is appointed for a five-year term of office. He or she can be removed from office only on a limited number of statutory grounds relating to, inter alia, incapacity, serious mis-conduct, ineffective management of the Bank, or for inadequate performance in relation to the Policy Targets Agreement. Removal from office is by Order-in-Council, made on the recommendation of the Treasurer.

One of the primary duties of the Board of Directors is to monitor the performance of the Governor, and the Board may recommend his or her removal where it is satisfied the Governor's performance has been inadequate. While it is not a prerequisite that the Treasurer be in receipt of such a recommendation before being able to recommend removal of the Governor, it would likely be difficult for the Treasurer to recommend removal on the ground of "inadequate performance" without such a recommendation from the Board. It would likely be even more difficult if the Treasurer was in receipt of advice from the Board that the Governor's performance had been adequate.

Deputy Governors (up to two) are appointed by the Board, on the recommendation of the Governor. If there are two Deputy Governors, one is designated by the Board as Deputy Chief Executive. A Deputy Governor may be removed from office either by the Board on the recommendation of the Governor, or by Order-in Council, made on the recommendation of the Treasurer. Statutory grounds for removal must be satisfied under both scenarios.

Appointment and removal of Non-executive Directors

Non-executive Directors are appointed by the Treasurer. In making appointments, the Treasurer is required to have regard for the candidate's knowledge, skill and experience, and the likelihood of conflicts of interest.

The term of appointment is five years. Removal from office is by Order-in Council, on the recommendation of the Treasurer. The grounds for removal from office relate to inability or failure to perform the duties of a director, misconduct, and hindering the Governor.

The expiry dates for Non-executive Directors' terms are staggered so as to limit the extent to which the composition of the Board can be changed in a short period. This establishes a significant degree of monitoring independence for the Non-executive Directors and, combined with the interposition of the Board between the Treasurer and the appointment of a Governor, is also one of the sources of the Bank's independence.

Transparency

40. New Zealand has been a pioneer in introducing greater transparency to monetary policy. When the Reserve Bank Act was passed in 1989, the explicit inflation target was viewed internationally as novel. Another major initiative introduced by the Act was the inclusion of a requirement that the Bank publish at least twice a year a *Monetary Policy Statement.* (Current practice is to publish four such *Statements* a year.) These *Statements* are required to specify the means by which the Bank intends to achieve the policy targets and the reasons for adopting those means. They are also required to include a review and assessment of the implementation of policy since the last *Statement.*

41. Just as significant in the Bank's efforts to be transparent is its broader communications programme. A feature of this programme is its scope and reach, and its particular emphasis on communicating to the wider community. In addition to occasional formal speeches, the texts of which are made widely available, Governors make themselves readily available to speak with smaller audiences. Indeed, Governors talk with some 70-80 such groups around the country each year. Also, in addition to publishing much of its policy and research work in its quarterly *Bulletin* and in Discussion and Research Papers, the Bank has a pamphlet series in which it makes the key ideas and results accessible to the wider public. Virtually all the material published by the Bank is posted on the Bank's web site, which is visited about 4,000 times, on average, each week. This communications effort underscores a very strong commitment to transparency at the Bank.

Accountability

42. The key accountability mechanisms in the monetary policy framework established by the Act comprise the following.

    (a) The Board of Directors is charged with keeping under constant review the performance of the Bank and of the Governor.

    (b) *Monetary Policy Statements* are referred automatically to the Finance and Expenditure Committee of Parliament, and typically the Committee chooses to examine the Governor on these documents. These hearings are conducted in public.

    (c) An *Annual Report* is required to be delivered to the Treasurer within three months of the end of each financial year, and this too is referred automatically to the Finance and Expenditure Committee of Parliament.

    (d) The high level of transparency maintained by the Bank means that it is subject to the scrutiny of the financial markets, of other economists, and of the public. This scrutiny often results in the Bank being called to account for its policy actions by financial commentators, by interest groups, and by the media.

Has this framework been effective?

43. From the coming into force of the Act until December 1996, the target range for the year-on-year increase in the Consumers Price Index (CPI) was set at 0 to 2 percent. Inflation exceeded the upper bound of that range by small amounts in mid-1995 and throughout 1996; that is, the movement in the CPI even after adjusting for credit service cost changes and “one off” price shocks slightly exceeded 2 percent. However, those breaches of the target range were not viewed as indicative of a weakness in the framework. On the contrary, they underscored the value of the framework in that the accountability and transparency it requires helped to ensure that monetary policy was adjusted to prevent a more sustained inflation process from developing. Since end 1996, when the target range for inflation was widened to 0 to 3 percent, inflation has ranged between 1 and 2 percent. In sum, inflation, after having been at double-digit levels for most of the 1970s and 1980s, was reduced in the early 1990s to a level consistent with “price stability”, and has been held at, or very close to, that level since.

44. Given these achievements, the issues we raise in the remainder of this submission are directed not to what might need to be done to repair the existing framework, but rather to how an already successful framework might be made even better. In considering possible improvements, however, it is important that the foundations outlined in this section, on which the achievements so far have been built, should be reinforced, not undermined.

PART II: DECISION-MAKING AND GOVERNANCE STRUCTURES

45. This part of our submission addresses the decision-making and accountability structures for monetary policy. Our **recommendations** on these matters are that:

    (a) responsibility, and accountability, for monetary policy decisions should remain with the Governor of the Bank; that is, the NEDC supports retention of the existing “single decision-maker” model;

    (b) the Chair of the Board of Directors of the Bank should be a Non-Executive Director (instead of the Governor as at present), and should be elected by the Non-executive Directors;

    (c) the Board should continue to comprise a majority of Non-executive Directors; and

    (d) the Governor, as chief executive officer, and the Deputy Governor(s) should remain members of the Board.

Monetary policy decision-making structures

46. We have considered, but strongly recommend against moving to, a committee decision-making structure for monetary policy. Our view on this matter has been reached after giving careful attention to balancing what we see as the considerable strengths of the single decision-maker model against its potential weaknesses.

BOX 3
Current internal decision-making regime for monetary policy

The current arrangements for monetary policy decision-making within the Bank comprise the following elements:

A Monetary Policy Committee. The Committee acts in an advisory capacity to the Governor.   It comprises the Governors and senior members of the Economics and Financial Markets Departments, together with other staff as the agenda requires. The Committee is chaired by the Deputy Governor responsible for monetary policy, and meets weekly. It has a wide brief, which covers information exchange, analysis of monetary policy related issues, monetary policy instrument design, the preparation of the economic projections for incorporation into *Monetary Policy Statements*, and consideration of drafts of each *Statement*. All decisions, explicitly or implicitly, are the Governor’s.

An Official Cash Rate (OCR) Advisory Committee. This Committee comprises a sub-set of the Monetary Policy Committee, namely the Governor and Deputy Governors, the heads and one other senior member from the Economics and Financial Markets Departments, and the managers of the Forecasting and the Monetary Policy Implementation units from those two departments respectively. The Committee is chaired by the Deputy Governor responsible for monetary policy. The Committee acts in an advisory capacity to the Governor, who has sole decision-making authority. No votes are taken, though each member is invited to express their view on where the OCR should be set and the reasons for that view.

47. We see three main strengths in the existing single decision-maker regime:

 (a) clarity of accountability;

 (b) clarity of policy and of the communication of policy; and

 (c) clear and efficient management of the Bank.

 The following paragraphs elaborate on each of these points.

48. First and foremost, the present single decision-maker regime provides for clear accountability. Monetary policy by its nature involves making difficult judgements. Placing those judgements in the hands of a committee opens up the possibility that the decision-makers “hide behind the committee”. We see this as a problem not so much because we think strong accountability is good for its own sake – although to some extent strong accountability is a necessary quid-pro-quo for operational independence – but because weak accountability tends to result in weak decision-making.

49. Second, a single decision-maker structure facilitates clarity of communication in monetary policy. Under the existing structure, *Monetary Policy Statements,* and Official Cash Rate decisions, are, ultimately, the Governor’s statements and decisions. While the internal advisory processes (see Box 3) are highly collegial, and involve in-depth analysis and debate, where a shared view does not emerge by consensus (which mostly it does), it is the Governor who, having heard, and having participated in, the debate, is required to make the final judgements. Thus, policy is more likely to be based on a view that is internally consistent. This, in turn, assists coherent communication of the reasoning for policy decisions.

50. With a committee decision-making structure, policy decisions, and the justifications given for them, are more likely to represent a “committee average” view, and not necessarily a coherent view. An alternative would be for decisions to be made, and communicated, on the basis of majority vote, with dissenting votes being recorded. But this too could result in a loss of clarity and coherence, particularly in policy communication. A risk is that there would be a shift of public and market focus away from the reasoning for the policy decisions to the personalities involved.

51. Third, a single decision-maker structure makes for clear and efficient management of the Bank. We consider that management of the Bank has been assisted by the fact that the Governor has been unambiguously chief executive officer in respect of all the Bank’s functions. Compartmentalising monetary policy, or one part of monetary policy (that is, the setting of the policy instrument, as distinct from the design of the policy instrument(s)), from the Bank’s other functions would complicate and potentially compromise effective management of the Bank.

52. The <u>potentially</u> negative features of a single decision-maker model include:

    (a) Exposure to single person risk.

    (b) Decision-making may be captured by a single train of thinking and result in inferior decisions.

    (c) A public perception may develop that a single individual has excessive power whether or not that is actually the case. If such a perception were to develop, the "legitimacy" of the central bank's operational independence may come to be questioned by the public.

    (d) A single decision-maker may be insufficiently in touch with what is actually happening in the economy. The concern is that an individual decision-maker may be excessively guided by theoretical models and aggregate data that do not adequately capture what is "really" happening across different industries, sectors and regions.

53. We agree that these are possible weaknesses, but disagree that the best way to address them would be to move to a committee decision-making structure. Three lines of reasoning lie behind this conclusion.

54. First, the superior accountability, coherence of communication and effectiveness of management features of the existing structure bear reiteration. We are concerned that these should remain core features of the decision-making arrangements for monetary policy in New Zealand.

55. Second, we believe that there are alternative ways to address the potential concerns identified with single decision-maker structures. Indeed, the current framework already includes elements that significantly mitigate the main concerns that some might have about the single decision-maker structure. Specifically:

    (a) There is a rigorous process for appointing a Governor, which substantially mitigates the risk of "the wrong person" being appointed.

    (b) The Governor's decision-making power is, in fact, quite constrained. In particular he or she does not have "goal independence", given that the goals are prescribed by statute (section 8) and in the Policy Targets Agreement agreed with the Treasurer.

    (c) The process for appointing a Governor – in particular the role of the Board of Directors in the appointment process – provides substantial protection against a Governor being appointed who might be minded not to respect those constraints.

    (d) The monitoring of the Governor by the Board provides a check to ensure that the Governor acts in a collegial manner, and has proper regard for the wide range of input that is obtained from sources internal and external to the Bank.

56. Third, a committee approach to monetary policy decision-making would give rise to its own difficulties. While one of the attractions of a committee approach is that it would open up the possibility of bringing "external" people into the decision-making process, we can also see some issues that would likely arise with a decision-making group of this nature. For example, in a small country like New Zealand there is a question as to whether there are sufficient people to draw on with the necessary skills and experience and for whom conflicts of interest would not be a serious problem.

57. There would also be the potential for management complications to arise. If, to overcome conflicts of interest, "external" members of a monetary policy decision-making committee were to be offered positions with the Bank, there is a question as to whether the role would be a full-time one. Having senior people in full-time positions without full-time roles could be disruptive.

58. An alternative might be to form a committee comprising full-time internal executives, say, the Governor and two or three of the next most senior Bank executives. This may resolve the issue just mentioned, but would sacrifice, at least to some degree, the additional external input being sought. On that score, there would probably be little, if any, advance relative to existing arrangements, given that the Bank already, from time to time, fills senior policy positions with external candidates.

59. The principal benefit of an internal committee over a single-decision maker would be mitigation of the risk associated with decision-making resting in the hands of a single individual. However, we have reservations about formal structures that are designed to enable "next level" senior executives to place constraints on a chief executive's decision-making capacity. Our view is that if a chief executive is not performing appropriately, that is a matter for the Board, not the chief executive's subordinates, to deal with. We are concerned that if a situation were ever to arise where the Governor was being consistently outvoted by his/her subordinates, the credibility of the Governor, inside and outside of the Bank, would be undermined.

60. Against this background, we observe that in the case of central banks that do have voting committees, the Governor typically is regarded as "first amongst equals", and virtually always carries a majority of the committee. Of course, in some instances, a Governor may fall into line with a majority. But our clear sense is that central bank decision-making committees operate, in practice, in a manner that preserves a critical role for the Governor in the making of policy decisions.

Reserve Bank governance – the structure of the Reserve Bank Board of Directors

61. We address under this heading two issues: the executive/non-executive structure of the Board, particularly with respect to who chairs the Board, and the nature and scope of the Board's role in monitoring monetary policy.

62. On the first matter, our view is that the chair of the Bank's Board of Directors should be drawn from its non-executive members. This view is based on a

general principle of corporate governance that there should be a separation between governance and executive management. This does not mean that the separation need be absolute, and indeed most corporations include one or more executives (at least the chief executive) on their Board.

63. Moreover, in some cases the chief executive serves as chair of the Board. However, there is much debate about whether this can be regarded as best practice. In some countries, particularly those with a British tradition, and certainly in New Zealand, the weight of thinking is in favour of separating the executive management and governance roles. However, in other countries, notably the United States, combining the roles into the position of executive chairman is common. The evidence, in terms of corporate outcomes, is mixed. There are numerous examples of overseas corporations that have operated very successfully under an executive chairman, but other examples where having an executive chair has proved to be severely problematic.

64. In considering whether the governance and executive management roles should be separated in the particular case of the Reserve Bank, account needs to be taken of the Board's statutory role, which is a limited one. A primary role of the Bank's Board is to monitor the performance of the Governor. This makes it somewhat incongruous that, as currently, it is the Governor who chairs the Board. Though at no time has the current NEDC felt that the Governor has in any way constrained the Board from performing its monitoring, or any other, role, and we are not aware of it having ever been an issue for our predecessors, we do see this as an aspect of the Bank's governance that would benefit from being changed.

65. In proposing change, to a non-executive chair, however, we do not wish to be seen as advocating an elevation of the role of the Chair of the Board. Indeed, we envisage that the non-executive chair would maintain a relatively low profile, much as have NEDC chairs to date.

66. If it is accepted that the Chair of the Board should be a Non-executive Director, then there is the question as to how the Chair should be elected or appointed. Our clear view is that the position should be filled by the Non-executive Directors electing one of their number. Essentially, we see the selection of the Chair as an internal working matter for the Board, rather than something that should be formalised in statute. (Our thinking would be for the term of election to be relatively short, say two years, so as to facilitate rotation if that was the wish of the Non-executive Directors at the time.)

67. We have considered the alternative of the Treasurer directly appointing the Chair, and are firmly of the view that that would be inappropriate. If the Government were directly to appoint the Chair of the Board, this could be seen as something that would undermine the monitoring independence of the Board, and, indirectly, the Bank's operational independence. It would likely be seen as creating a mechanism by which the Government, through its own appointee, could bring influence to bear on the Governor.

68. We appreciate that, in the case of Crown Entities and State Owned Enterprises, it may be appropriate for the Crown to have a reasonably direct channel by which it can exercise its role as a stakeholder. But under the statutory framework established for the Reserve Bank, it would be wholly inappropriate for the Government to exercise its rights as stakeholder in such a way. Explicit, and transparent, mechanisms have been incorporated into the Reserve Bank Act by which the Government establishes the policy to be implemented by the Bank. It is of overriding importance that those mechanisms should be respected, and should be seen to be respected.

69. It is also important that the Chair should enjoy the confidence of his/her Board colleagues. The surest way to ensure that this is the case is for the Non-executive Directors to choose their own Chair. Unless there are good reasons to depart from this practice – and in the case of the Bank the opposite is the case – we think it is a practice that should be adhered to. It is also the practice that has been followed by governments and the Non-executive Directors' Committee of the Board to date, and, in this sense, would not be something new to the Bank's governance arrangements.

70. Finally, following normal corporate practice, we recommend that the Governor, as Chief Executive Officer, should remain a member of the Board. We also see value in the Deputy Governor(s) remaining as Board members, given their key roles in the Bank, the fact that the powers of the Governor pass to the Deputy Governor designated Deputy Chief Executive in certain circumstances, and the desirability of Non-executive Directors being exposed to senior executives other than the Governor. Their membership of the Board also enables Non-executive Directors to obtain the information they need for monitoring from more than a single executive source.

Reserve Bank governance – the monitoring role of the Board of Directors

71. In preparing this submission, we have reviewed the Board's role in monitoring the Bank's monetary policy function. This has included a focus on how our monitoring buttresses the overall framework, particularly against the potential weaknesses in a single decision-maker structure. In this regard, we seek to ensure that:

    (a) the decision-making process is an appropriately collegial one, with the full range of issues relevant to each policy decision being exposed and debated; and

    (b) that the Bank makes use of the wide range of information and analysis available to it from both internal and external sources. Further detail on the monitoring processes we use are contained in Box 4.

BOX 4
The role of the Board in monitoring monetary policy

The role of the Board is prescribed in s.53 of the Act. In addition to being charged with keeping under constant review the performance of the Bank in carrying out its functions, and of the Governor in discharging the responsibilities of that office, the Board has specific responsibilities to:

- keep under constant review the performance of the Governor in ensuring that the Bank achieves the policy targets in the PTA;
- determine whether *Monetary Policy Statements* are consistent with the price stability objective of the Act and with the policy targets in the PTA.

The Board generally meets once per month, and at such other times as may be necessary. With respect to its monitoring of monetary policy, there is a discussion at each monthly meeting on economic, financial and inflation developments. For these discussions, a regular report is provided by the Economics and Financial Markets Departments of the Bank, as well as papers on monetary policy related issues.

In the case of Board meetings that follow the release of a *Monetary Policy Statement,* the *Statement* itself has served as the basis for Board discussion. Additionally, since joining the Board in 1992, Professor Viv Hall (Macarthy Professor of Economics at Victoria University of Wellington) has provided a formal critique of the *Statement.* Professor Hall generally has also attended the media "lock-up" and the press conference given by the Governor with the release of each *Statement.* On the basis of his critique and observations, and following Board discussion, Professor Hall has moved a formal resolution on whether or not the *Statement* in question meets the statutory requirements.

More recently, this process for evaluating *Monetary Policy Statements* has been broadened and strengthened. The Non-executive Directors are now provided by Bank staff with a comprehensive briefing on the *Statement* after its public release but ahead of the Board meeting. This briefing covers:

- the processes followed;.
- the information used;
- the issues considered;
- the analysis of those issues;
- the policy deliberations that lead to the conclusions contained in the *Statement.*

Following the briefing, the NEDC has met separately (without Governors present) to review and discuss what they have heard. Following this discussion "in committee", the full Board has considered the formal resolution on whether or not the *Statement* has satisfied the statutory requirements.

72. The Board takes a close interest in the information the Bank uses in developing its policy views, particularly the information that can be gleaned from the business community and market commentators.

73. A range of such information is used. For example:

- Ahead of the preparation of each *Monetary Policy Statement*, Bank staff undertake a programme of visits to, typically, 40 to 50 representative firms across the country, to gauge business and economic conditions "on the ground". These are drawn from a survey population of about 400 firms in all, covering all the major sectors. Consideration is also being given by the Bank to augmenting this programme of business visits with more high level consultations with sector groups and market economists.
- Close attention is paid to the wide range of commentary and analysis that is published by other economic forecasters, market economists and economic commentators.
- Senior management of the Bank have extensive interaction with a wide range of actors in the New Zealand economy.
- Non-executive Directors provide intelligence drawn from their various business and other connections. Also, the Board meets in centres outside Wellington, generally three times each year. On those occasions, the Board and senior management host a function for business and community representatives from the local area, to enable input to be received from those sources, as well as to provide an opportunity for the Bank to explain its current thinking.
- The Bank has contracted economic consulting staff from an external organisation to provide quarterly presentations to Bank staff and Governors on current economic conditions and issues, and on the economic outlook.

PART III: THE OTHER TERMS OF REFERENCE

In this section we address the matters raised in the Terms of Reference other than those relating to governance and decision-making. We do so from our particular stand-point as Non-executive Directors.

Interpretation and application of the inflation target, with a view to achieving medium-term price stability consistent with avoiding undesirable instability in output, interest rates and the exchange rate

74. The Board has a direct interest in this matter from the standpoint of its role in monitoring the performance of the Governor in achieving the targets set in the Policy Targets Agreement. That interest has taken on a broader focus since December 1999, when the PTA was amended to make explicit reference to avoiding unnecessary instability in output, interest rates and the exchange rate while pursuing the price stability objective. Prior to December 1999, the desirability of avoiding unnecessary instability in output, interest rates and the exchange rate was reflected in successive PTAs by the fact that the inflation target was expressed as a range, and by acknowledgement of the likelihood that the initial impact on inflation of a range of events would result in inflation outcomes outside the target range. Those events included, by way of example, exceptional movements in primary commodity prices, changes in indirect taxes, government policy changes that directly affect prices, and a major natural disaster.

75. It is useful to review, against this background, how output, interest rates and the exchange rate have evolved in the 1990s under the inflation targeting regime. In the early 1990s, the environment within which the Bank was formulating monetary policy appeared relatively benign. Inflation, on the Bank's then "underlying inflation" target measure, remained comfortably within the then 0 to 2 percent band until mid-1995. This was at a time when the economy was recording good output growth, following a lengthy recession in the late 1980s and early 1990s. In this environment, interest rates were maintained, at least until early 1994, at a relatively low and stable level, while the exchange rate appreciated gradually from a near historical low in 1992. Most macroeconomic assessments at the time were generally very positive: New Zealand was viewed as achieving robust, stable and non-inflationary growth.

76. Subsequently, however, it became evident that output growth during this period was being underestimated, in part due to GDP data that was subsequently revised upward. Also, the sustainable non-inflationary growth rate was over-estimated by the Bank as well as by other economic commentators and analysts. The result was inflation pressures that became apparent in 1995/96, when inflation breached the upper edge of the 0 to 2 percent band. A quite aggressive tightening of monetary policy commenced in early 1994, which saw short-term interest rates increase from less than 5 percent in early 1994 to nearly 10 percent by the end of that year, and the exchange rate appreciate by about 30 percent in TWI terms over the period 1993 to early 1997.

77. The breach of the inflation target in 1995/96 triggered formal reviews of the Governor's performance by the NEDC and the communication of its conclusions to the Minister. The correspondence between the Minister and the NEDC was also released to the public, in the interests of transparency and to underscore the accountability features of the overall framework. Copies of that correspondence are attached to this submission.

78. You will see that the NEDC on those occasions concluded that a misjudgement had been made, and that, with the benefit of hindsight, monetary policy should have been tightened more than it was in 1994. However, the NEDC also outlined the context within which it considered the breach should be understood. It was noted that the 0 to 2 percent inflation target had been adopted as a deliberately tight target which inevitably meant that inflation would fall outside the range from time to time. Accordingly, the NEDC's understanding was that "0 to 2 percent was always intended to be a target towards which the Bank would be *constantly aiming*, not necessarily a target which could, given the inevitable uncertainties in forecasting and lags in the effectiveness of monetary policy, always be certain of attainment". (Letter from the NEDC to the Minister of Finance dated 29 June 1995.) On this basis, the Governor's performance as a whole was assessed as having been entirely appropriate.

79. The more recent issues relating to whether the Bank has been "avoiding unnecessary instability" relate to the increase in volatility in short-term interest rates under the Monetary Conditions Index (MCI[1]) regime that operated in 1997/98 and whether the macroeconomic judgements made by the Bank in the context of the Asian crisis were appropriate from the stand-point of maintaining low inflation without unnecessary output instability.

80. Neither of these events gave rise to the same formal review of the Governor's performance as occurred at the time inflation breached the target range in 1995 and 1996. They are matters different in nature from a breach of the inflation target, and were addressed as part of the NEDC's on-going monitoring activities, as described in Part II above. They were raised and discussed in a number of Board meetings.

81. With respect to the use of an MCI, our primary focus, as Non-executive Directors, was on how effectively monetary policy was being communicated to the financial markets and to the public. As experience was gained with using an MCI within announced bands, we developed mis-givings about how it appeared to be complicating, and starting to undermine, the effectiveness of the Bank's communication of monetary policy. From this stand-point, the NEDC was pleased when the Governor decided that, for technical as well as communications reasons, an Official Cash Rate regime should be adopted.

82. Regarding the Bank's response to the East Asian crisis, we did not have cause to raise concerns, either at the time or subsequently. To be sure, the crisis had a

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[1] The MCI regime entailed monetary conditions being managed so as to maintain the combination of the 90-day bank bill interest rate and the trade-weighted exchange rate index (combined in a formula that equated a 2 percent movement in the exchange rate with a 1 percent movement in the 90-day interest rate) within a specified band.

larger impact on the New Zealand economy than initially anticipated, but our assessment is that the Bank took a serious view of the ramifications of the crisis at an earlier stage than many other economic analysts and commentators in New Zealand. In this regard, the Bank benefited from its well-established relationships with many of the central banks in the East Asian region.

83. Less well anticipated by the Bank was the seriousness of the droughts that afflicted the rural sector of the economy during early 1998 and again in early 1999. The timing of these droughts was such that their adverse economic effect was felt close to the time of the Asian crisis. The underestimation of their impact by the Bank caused us to raise questions about the adequacy of the Bank's information and data on the rural sector. (We discuss in more general terms the adequacy of the Bank's data and information later in this submission, and have already outlined how in our monitoring we have a focus on data and information issues.)

84. An issue that the Board has recently been giving attention to is the framework within which it can best evaluate the Bank's performance in avoiding unnecessary instability in output, interest rates and the exchange rate. This has become a focus for our attention as a result of the amendment to clause 4(c) in the PTA in December 1999, to include that "in pursuing its price stability objective…, the Bank shall seek to avoid unnecessary instability in output, interest rates and the exchange rate".

85. One thing that seems clear is that there is no single measure or threshold that can be used to identify when instability in output, interest rates and the exchange rate has been unnecessary. Rather, we think that a range of measures, and a number of trade-offs, need to be considered. Also, any evaluation of how monetary policy has contributed to, or helped to lessen, instability in the economy needs to take account of the range of other factors that will have contributed. These can be especially significant in the case of New Zealand, given the small size of the economy, its primary sector and external exposures, and relative lack of diversification of those exposures. For these reasons, it is not envisaged that the NEDC will arrive at simple instability "benchmarks" akin to the target range for inflation, but rather will base its assessments on a wider range of indicators[2].

86. A potential consequence of this difficulty in defining and benchmarking unnecessary output, interest rate and exchange rate instability is a blurring of the objective of, and accountabilities for, monetary policy. The foundation on which the overall framework for monetary policy has been built is a single and unequivocal focus on price stability, and an active regime for accountability for the achievement and maintenance of price stability. In this regard, we underline the fact that clause 4(c) provides it is "In pursuing its price stability objective" that the Bank is to seek to avoid unnecessary instability in output, interest rates and the exchange rate. In other words, we see the primacy of the price stability

[2] We note that whereas the PTA refers to "unnecessary" instability in output, interest rates and the exchange rate, the Terms of Reference refer to "undesirable" instability. This difference in wording could lead to further ambiguity in the intent of clause 4 (c) of the PTA and blurring of the objective of monetary policy.

objective as uncompromised, and we think it important this point should be widely understood. If the PTA were to come to be read as establishing dual objectives for monetary policy, then the credibility of the inflation target could be weakened, and inflation expectations could become less well-anchored. Paradoxically, that would make it more difficult to maintain price stability without causing unnecessary instability in output, interest rates and the exchange rate.

Monetary policy instruments

87. The NEDC does not propose to make a substantive submission on whether the Bank has an adequate range of instruments. We view this as mostly a technical issue, and one that it is primarily for the Governor to satisfy him/herself on. In particular, the Governor has to be satisfied when signing a PTA that the instruments required to achieve the target are available. Indeed, a standard provision in PTAs up until that signed in December 1997 was that the Governor would inform the Minister if he felt that the monetary policy instruments available to the Bank were not adequate to achieve the agreed objective. We think this has been implicit in subsequent PTAs.

88. The NEDC's role has been to confirm from time to time that the Governor is satisfied that he has available the tools required. The question has been discussed in Board meetings, including in relation to how the instruments used by the Bank compare with those used by other central banks. Additionally, the Bank maintains close contact with other central banks on these matters, both bilaterally and through high level policy and academic conferences.

89. An issue that arose in the mid-1990s, when the New Zealand dollar was very strong, was that monetary policy was having an uneven impact on the economy. At that time, a firm monetary policy was required to restrain aggregate demand pressures. But whereas most of the demand pressures originated within the domestic economy, the effect of the monetary policy tightening included substantial exchange rate appreciation. As a result, the externally exposed sectors of the economy were subject to severe restraint (from the high exchange rate), while the domestic economy was subjected to scarcely sufficient restraint (from interest rates). Consideration was given within the Bank to whether the Bank, or the Government, could use "non-monetary" policies to help re-orient the effect of policy to the source of the excess demand. In other words, we asked whether it might be possible to create a wedge between the New Zealand dollar interest rates facing overseas investors, and those facing local borrowers. Additionally, attention was given to possible ways by which the Government could help to counter the excess demand pressures more directly.

90. It proved not possible to identify instruments or policies to create the desired wedge, at least not ones which the Governor felt would be effective, or would not have substantial costs in terms of financial market efficiency. However, the Governor did raise with the Government some policy initiatives aimed at dealing with domestic cost and price increases at source. The main ones related to parallel importing, electricity pricing, and potential restraints on land availability for housing caused by the Resource Management Act.

The data used by the Bank

91. The sources, availability, type and timeliness of data used by the Bank in its forecasting and decision-making are matters that are kept under review as part of the NEDC's monitoring activities. This happens in a number of ways.

92. As already outlined in Part II of this submission, the normal process of enquiry and scrutiny undertaken by Non-executive Directors includes a focus on the adequacy of the information and data used by the Bank.

93. Additionally, on those occasions when there has been a need for particular attention to be given to an aspect of the Bank's monetary policy performance, the data and information used has been a focus of attention. As part of its review of the breaches of the inflation target in 1995 and 1996, the NEDC asked Bank staff for, and was provided with, comprehensive details of the data and information that had been used in its analysis and forecasting in the period leading up to those breaches. We were satisfied with what was provided to us, and with the professionalism with which the data had been used.

94. Non-executive Directors also have their own connections with the economy, such as through other board memberships and business interests. Through these channels, Non-executive Directors receive information independently from that they are provided by the Bank, and develop a perspective on the data and information being used by the Bank. Overall, the NEDC has been satisfied with the nature and range of the information used by the Bank.

95. We are also mindful, however, that the economy is rapidly evolving in response to new technologies, changing consumer tastes and preferences, changes in business practices, and the increasing impact of global influences on the New Zealand economy. These considerations mean that economic and financial statistics need to be kept under on-going review, to ensure that they continue adequately to reflect the underlying economic, financial and inflation trends. At the same time, new information technologies may be providing opportunities to obtain higher quality data in a more timely manner.

96. We also attach importance to what traditionally has been described as "soft" economic data, for example, business outlook and opinion surveys, and business liaison information. These categories of information may become even more important than in the past as capturing economic information in "hard" numbers becomes more challenging.

The co-ordination of monetary policy with other elements of the economic policy, including the Bank's prudential policy function

97. The NEDC's view is that co-ordination of other elements of economic policy with monetary policy is very important. By this we mean it is important that other elements of government policy work in the same direction as monetary policy, not against it. Other elements of government policy that are relevant here include:

- fiscal policy;
- labour market policies;
- regulatory policies that affect competitiveness within markets and the ability of resources to move flexibly in response to price signals;
- import (tariff) protection policies.

98. Our concern with respect to fiscal policy is that if a government decides to spend more without raising the taxes to cover the increased spending, then that amounts to an increase in total demand. Unless there has been a corresponding increase in the economy's capacity to meet that demand, monetary policy is left with the job of applying the restraint required to reduce private sector spending, so as to prevent aggregate demand pressures from spilling over into inflation. In other words, monetary policy gets the blame for a fiscal problem.

99. In making this point, we are not advocating short-term, activist, co-ordination of monetary and fiscal policy. Attempts to "fine-tune" either monetary or fiscal policy in this way would as likely as not contribute to more, not less, instability. Rather, we are suggesting that the stance of fiscal policy over the medium term needs to be consistent with the monetary policy objective. Or put differently, it needs to be recognised that fiscal expansion requires monetary policy settings, over the medium term, to be tighter than otherwise if price stability is to be maintained.

100. In recent years, fiscal policy has generally been consistent with monetary policy, insofar as fiscal surpluses have been recorded in every year since 1993/94. In this regard, we see the Fiscal Responsibility Act as having been a valuable complement to the Reserve Bank Act. The medium-term orientation of that legislation, particularly the requirement to establish medium-term goals for the level of public debt, has been a positive feature. So too has been the requirement that the Government publish medium-term (three-year) fiscal projections, and twice yearly *Economic and Fiscal Updates.* These provide the Bank with advance information on the likely fiscal environment within which monetary policy will have to operate.

101. Looking forward, on-going fiscal surpluses are forecast by the Government, although, as alluded to by the Bank in its latest (August 2000) *Monetary Policy Statement*, these surpluses are based on adherence to stringent fiscal parameters governing new spending initiatives. If those forecasts were not to be achieved, and fiscal policy were to become expansionary, that would create a new set of pressures for monetary policy. Already monetary policy is having to contend with the potential inflationary effect of the recent increase in oil prices and the very considerable fall in the exchange rate. If fiscal policy were to become expansionary, then maintaining price stability in the period ahead will almost certainly require the level of economic activity and employment in the private sector to be lower than would otherwise have been possible.

102. The recent change to labour market legislation, with the enactment of the Employment Relations Act, is another example of how new pressures can arise from the interaction of other government policies with monetary policy. Income restraint will be vital if the oil price increase and exchange rate depreciation are

not to spill over into on-going inflation. If the changes that have been made to the regulatory framework for the labour market result in salary and wage escalation in excess of productivity growth, maintaining a low on-going level of inflation in the period ahead will be made that much more difficult, and potentially costly in output and employment terms.

103. The relationships between monetary policy and other elements of economic policy are also recognised in s.10(b) of the Reserve Bank Act, which provides that the Governor shall "consult with and give advice to the Government and other such persons and organisations as the Bank considers can assist it to achieve and maintain the economic objective of monetary policy". We have already mentioned examples of where the Governor has addressed policy issues that have had a bearing on the environment within which monetary policy operates: the Resource Management Act, parallel importing, and electricity pricing. The NEDC considers it is appropriate that the Governor should continue to draw to the attention of the Government and others the implications of their policies for inflation and, thus, for monetary policy.

104. This Term of Reference also makes specific reference to the relationship between monetary policy and the Bank's responsibility for prudential supervision of the banking system. (The Bank's responsibility for prudential supervision is limited to registered banks, although it does have a broader policy advisory role in relation to the financial system more generally (s.33).) As in the case of the other areas of policy just discussed, monetary policy and banking supervision policy should be supportive of each other.

105. Good monetary policy which maintains price stability contributes to a healthy banking system, by, for example, lessening the prevalence of speculative borrowing that is motivated by the prospect of realising "inflation gains". Experience indicates that where such borrowing has become widespread, and lenders have relied on (inflated) real estate as collateral, re-establishing price stability can be damaging to the banking system. This is because the high interest rates needed to achieve dis-inflation almost inevitably create debt servicing problems for some borrowers and shortfalls on collateral realisations for lending banks. If monetary policy can maintain price stability, and with it, stable inflation expectations, credit financed boom-bust cycles, and the instability they can cause in the banking system, are less likely.

106. Similarly prudential policies geared to promoting financial discipline have a role to play in helping monetary policy. They can do this by countering tendencies for lending cycles of the sort just described to originate in the banking system, as might be the case, for example, where a lending boom occurs because of a decline in credit standards. Such credit expansions make it more difficult for monetary policy to maintain price stability. An example of this was the lending boom that occurred in New Zealand in the 1984-87 period.

107. In recent years, however, all the indications have been that New Zealand banks have maintained sound credit standards. We attribute this, at least in part, to the effectiveness of the banking supervision policies that are applied in New Zealand. These include strong disclosure obligations for banks, and strong

obligations on the directors of banks to ensure that, amongst other things, their banks are maintaining adequate risk management systems for the business they are conducting.

108. We also note that our monitoring of the Governor's performance covers all the Bank's functions, including banking supervision. This enables us to maintain an overview of, and to take account of the relationships between, the Bank's monetary policy responsibilities and its banking supervision responsibilities just described.

The communication of monetary policy

109. There are two elements to the Bank's communication of monetary policy. The first concerns how monetary policy is communicated to the financial markets. This is done primarily by way of the Bank's *Monetary Policy Statements.* As already mentioned, the Board subjects these *Statements* to close scrutiny, and our evaluations include a close focus on how effectively the policy has been communicated.

110. The other elements of the Bank's communications effort are directed to communicating monetary policy to wider audiences. This takes a number of forms. Much of the Bank's economic research and analysis is published in a range of publications directed to different audiences. These include discussion papers for academic audiences, the Bank's quarterly *Bulletin* for the informed but non-expert reader, and pamphlets for the general public.

111. This publications programme serves two purposes. One is to act as an important quality control mechanism, in that exposure to public scrutiny generally helps to create incentives to get things right. The other is to serve as a vehicle to establish the "legitimacy" of the Bank's policies, in the financial markets, in the economics profession, and amongst the public.

112. Since 1994 the Bank has also supported through the Victoria University Foundation, a Professorial Fellowship in Monetary Economics at Victoria University. The objectives of the Fellowship are to enhance the development of monetary policy in New Zealand to the advantage of New Zealand's long-term welfare by: (1) promoting wider discussion of and constructive challenge to the Reserve Bank's thinking in the area of monetary economics; and (2) encouraging debate among university academics and policy advisers in the monetary and macroeconomics fields. Under this programme, a distinguished academic from abroad spends a period, generally up to about three months, at the University and the Bank. One element of the programme has been for the visiting Fellow to give a public lecture on some aspect of monetary policy in New Zealand and also to hold discussions with business and financial sector leaders. In these ways, the various audiences get to hear an independent assessment of how monetary policy is conducted in New Zealand.

113. Another very significant element of the communications effort is the speaking programme of the Governors which was outlined in section I of this submission **(para 41)**.

114. Overall, the NEDC assesses the Bank's public communications effort to be first class. It is perhaps one of the standout features of a central bank, and of a policy framework, which the NEDC considers has served New Zealand very well since the Reserve Bank Act came into force in 1990.

APPENDIX I

Non-executive Directors of the Reserve Bank of New Zealand

Paul Baines	Company director: Chairman, Enterprise NZ Trust, Tower Investment Savings Ltd; Director, Comalco NZ Ltd, Fletcher Challenge Ltd, Gough, Gough & Hamer Ltd, Greenstone Fund Ltd, NZ Post Ltd, South Eastern Utilities Ltd, Telecom NZ, Wrightson Ltd; Trustee, Barnardos Children's Trust, Victoria University of Wellington Foundation; Advisory Board member, NZ Institute for the Study of Competition & Regulation. First appointed 1 July 1999 - current term expires 30 June 2004. Mr Paul Baines is based in Wellington.
John Goulter	Managing Director and Chief Executive Officer, Auckland International Airport Limited; Director, HMSC-AIAL Ltd Trustee, NZ Business & Parliament Trust, Auckland International Airport Life Education Trust. First appointed 9 February 2000 – current term expires 8 February 2005. Mr John Goulter is based in Auckland.
Professor Viv Hall	University professor: Macarthy Professor of Economics, School of Economics and Finance, Victoria University of Wellington; Board Member, New Zealand Institute of Economic Research (Inc). First appointed 1 March 1992 - current term expires 28 February 2002. Professor Viv Hall is based in Wellington.
Alison Paterson	Chartered accountant: Consultant, Beattie Rickman; Chairman, Crown Health Association, Waitemata Health Ltd, Landcorp Farming Ltd; Director, Biomed Trading Ltd, Health Benefits Ltd, Tower Insurance Ltd, Wrightson Ltd; member, Market Surveillance Panel New Zealand Stock Exchange; Trustee, Barnardos Children's Trust, Donny Charitable Trust, Wrightson Retirement Plan. First appointed 1 February 1995 - current term expires 31 January 2005. Mrs Alison Paterson is based in Auckland.
Hon Ruth Richardson	Economic policy consultant: Principal, Ruth Richardson [NZ] Ltd; Chairman: Cardinal Pty Ltd, Morningstar Pty Ltd, Kula Fund; Director, Aoraki Corporation Ltd, Centre for Independent Studies, Immuno-Chemical Products Ltd, Oyster Bay Marlborough Vineyards Ltd, TransAlta NZ Ltd, Wrightson Ltd. First appointed 4 February 1999 – current term expires 3 February 2004. Hon Ruth Richardson is based in Christchurch.
Sir Gil Simpson	Computer programmer: Chief Executive Officer, Aoraki Corporation Ltd; member, New Zealand Business Roundtable, joint venture partner in Canterbury Technology Park; Chairman, Christchurch City Mission Foundation. First appointed 9 June 1997 - current term expires 8 June 2002. Sir Gil Simpson is based in Christchurch.
Bill Wilson (Chair)	Company director: Chairman, Property Leaders Australia Ltd, Property Leaders New Zealand Ltd, Property Leaders Australia and New Zealand Ltd, New Zealand Guardian Trust Company Ltd, New Zealand Guardian Trust Funds Management Ltd. First appointed 1 February 1990 - current term expires 31 January 2003. Mr Bill Wilson is based in Auckland.

APPENDIX II

Letter from Peter Elworthy, Chair, Non-executive Directors of the Reserve Bank to the Minister of Finance, the Right Honourable W F Birch
29 June 1995

You have asked the Non-executive Directors of the Reserve Bank to advise you whether, in our judgement, the Governor's performance as measured against the objectives set out in your contract with the Governor (the Policy Targets Agreement, or PTA) has been 'inadequate' within the terms of Section 53 (3)(c) of the Reserve Bank of New Zealand Act 1989. You have made this request in the light of the likelihood that inflation as defined in the PTA will exceed 2 percent in the year to June.

In view of your earlier comments to us on this issue, giving Directors advance notice of your intention to ask for our views in the event of underlying inflation exceeding 2 percent, Non-executive Directors have already given careful consideration to this matter. This enables me to respond promptly to your request on their behalf.

As we have reported to you at six-monthly intervals, our unanimous conclusion is that the Governor's performance has been professional, focused and very competent, with total commitment to his task as set by Parliament through the Reserve Bank Act. We believe that, as a result, the Bank's performance has been outstanding and continues to be so.

In reaching this judgement, we have addressed the following issues:

1. The nature of the target established by the Policy Targets Agreement

   It is our understanding (and four of us were Non-executive Directors of the Bank at the time) that the intention of those who framed the first Policy Targets Agreement between the Minister and Governor in early 1990 was to set a 'tight' target for monetary policy because of the need to impress upon both the Bank and the public that the Government was directing the Bank to achieve stable prices, not just a moderate rate of inflation. There was concern that expressing the target as a wider range would lead people to expect inflation to be towards the top end of the wider range, with resultant social and economic cost. But it was recognised that specifying a narrow target would inevitably mean that the actual outcome for inflation as defined in the PTA may fall outside the range from time to time.

   It is our understanding that 0 to 2 percent was always intended to be a target towards which the Bank would be *constantly aiming*, not necessarily a target which could, given the inevitable uncertainties in forecasting and lags in the effectiveness of monetary policy, always be certain of attainment.

2. The Governor's performance under successive Policy Targets Agreements

   In expanding on the Non-executive Directors' conclusion that the Governor's performance has been very successful, it is appropriate to look at his record over the period since the first Policy Targets Agreement was signed. The first PTA called for inflation as defined in the PTA to be reduced to between 0 and 2 percent not later than the end of 1992. The second PTA, signed shortly after the change of Government at the end of 1990, extended the date by which underlying inflation had to be brought into this range by one year, to 1993. In the event, underlying inflation fell into the target range in 1991, and has remained there.

	Underlying Inflation (percent)
1991	1.7
1992	1.8
1993	1.3
1994	1.5

Given the inevitable uncertainties in forecasting to which we have already referred, we regard this result as outstanding.

3. The extent and nature of the likely 'breach'

At this stage, we do not yet know the extent to which inflation as defined in the PTA will exceed the top of the target range. Nor can we know for how long this breach will persist. Indeed, it is not absolutely certain that it *will* exceed the top of the range, though the Bank itself now expects it will, while most private sector analysts are expecting outcomes in a range from 2.1 to 2.5 percent for the year to June and September, and some are forecasting outcomes above 2 percent for as long as four quarters.

It is significant, however, that most of the private sector forecasters believe that underlying inflation will be back within the target range by the December quarter. The Governor advises that that is his view at this stage.

Any outcome above 2 percent is, of course, a matter for regret. If we assume that underlying inflation in the year to June is 2.3 percent, the main reasons for this outcome will include:

(a) The Bank's failure to recognise the extent of inflationary pressures in the construction and housing sector early enough in 1994. In June 1994, the Bank estimated inflation in this sector would be 2.7 percent in the year to June 1995. The actual outcome is now expected to be 11.7 percent. This single forecasting error will result in underlying inflation being around 0.6 percent higher than it would have been if inflation in that sector had been as projected in June 1994. While this error is a large one, the housing sector is by its nature more volatile than most other sectors.

(b) The impact of adverse weather on the price of fresh fruit and vegetables. In May this year, the price of vegetables was some 40 percent higher than in May 1994, and market estimates, with which the Bank agrees, suggest that this single impact will have increased inflation by some 0.4 percent in the year to June (and 0.3 percent in the June quarter). Monetary policy can not, and arguably should not, cope with these essentially unpredictable events.

(c) The effect of changing the way in which interest rates are excluded from the inflation calculation. Prior to December 1994, the Bank made its own calculation of the impact of subtracting changes in interest rates from the official inflation figure, in calculating the underlying inflation figure. In December, the Bank decided to adopt the methodology used by Statistics New Zealand, and indeed decided to adopt the CPI-ex-credit-charges figure from Statistics New Zealand as the basis for calculating the Bank's underlying inflation estimate. This change in methodology added approximately 0.1 percent to underlying inflation.

4. Actions taken by the Bank to contain inflation over the last 18 months

It is clear with the wisdom of hindsight that the Bank tightened too little in early 1994. But even looking back, the decisions taken by the Bank seemed reasonable *at the time the decisions were taken.* These decisions, at that time, had the unqualified support of Non-executive Directors after a review of all relevant information, and after detailed questioning of the Bank's officers.

In 1993 and through March 1994, most private sector forecasters were somewhat more pessimistic about inflation in 1995 than the Bank (by about 0.5 percent), though few if any projected inflation exceeding 2 percent in 1995, and most were more optimistic than the Bank for 1996. Since June 1994, the Bank's forecasts for inflation have been around the centre of, or somewhat above the average of private sector forecasters.

It is also worth noting that, as inflationary pressures began to emerge more clearly late in 1994, the Bank implemented a considerable tightening of monetary conditions in an attempt to prevent underlying inflation extending beyond the target range. Thus, for example, the yields on 90 day bank bills almost exactly doubled between January 1994 and January 1995, while the exchange rate appreciated by 5.8 percent over the same period (on a TWI basis). This was a more marked firming in conditions than occurred in either Australia or the United States (two other countries at a similar stage in their economic cycles) over the same period.

The point we seek to make is that the Bank has responded to increasing inflationary pressures in a resolute and determined way, and in a way which, in our judgement, was appropriate given the information available to the Bank at the time decisions were made.

On balance, therefore, and for the reasons outlined above, we have no hesitation in concluding that the Governor's performance has not only been adequate but committed, able and professional. This performance has won New Zealand considerable international credibility in the conduct of monetary policy.

The Directors are confident that, notwithstanding the current situation, the goal of ongoing price stability for New Zealand will not be compromised.

We understand you may wish to release this letter to the public.

Letter from Sir Peter Elworthy, Chair, Non-executive Directors of the Reserve Bank to the Minister of Finance, the Right Honourable W F Birch
20 December 1995

The Non-executive Directors of the Reserve Bank met independently of the Governor and Deputy Governors on 14 December 1995. The meeting followed the December Board meeting, which was held concurrent with the release of the December 1995 *Monetary Policy Statement.*

The meeting noted that the Bank is forecasting underlying inflation for the years to December 1995 and March 1996 at 2.0 percent and 1.9 percent respectively, and that the projected path for underlying inflation is now expected to remain uncomfortably close to the top of the Bank's 0 to 2 percent target range over the year to September 1996. Thereafter, underlying inflation is projected to re-enter the middle part of the target range, before rising slightly to 1.6 percent in the year to March 1998. There is obviously some risk that underlying inflation will exceed 2.0 percent over the coming months.

The Non-executive Directors wish to re-affirm the view expressed in their letter to you dated 29 June 1995 regarding the nature of the target established by the Policy Targets Agreement. In particular, they wish to re-affirm that it is their "understanding that 0 to 2 percent was always intended to be a target towards which the Bank would be *constantly aiming,* not necessarily a target which could, given the inevitable uncertainties in forecasting and lags in the effectiveness of monetary policy, always be certain of attainment".

They also wish to re-affirm that the Governor's performance is endorsed as being very successful over the period since the first Policy Targets Agreement was signed and that a marginal breach above or below the 0 to 2 percent inflation target is not, in their opinion, considered a matter which should call into question the Governor's performance or his continued employment.

Letter from the Minister of Finance to Sir Peter Elworthy
18 April 1996

As you know, the Reserve Bank announced yesterday that underlying inflation in the year to March 1996 was 2.1%. According to the Bank's measure this appears to constitute a breach of the 0-2% target range outlined in the Policy Targets Agreement (PTA).

I regard any breach of the target range as serious. Our Government is committed to a policy of price stability, and we rely on the Reserve Bank to provide this, under the guidance of the Governor.

Accordingly, following the procedure that we have established in the event of a breach of the target range, I am seeking your views on:

- What factors led to the breach of the target range?

- What action is the Governor taking to direct inflation back to within the target range?
- Are the current actions put in place by the Governor adequate to ensure a return to price stability?

I would like to receive your advice as soon as possible and certainly within the next few days.

I am sending a copy of this letter to the Governor for his information.

Letter from Sir Peter Elworthy to the Minster of Finance
19 April 1996

In response to your press release of 17 April and your letter of 18 April 1996, the Non-executive Directors of the Reserve Bank met independently of the Governor and Deputy Governors on 18 April 1996, following the April Board meeting.

The Non-executive Directors regret the 0 to 2 percent underlying inflation target range has been breached for the second time. We note this breach of 0.1 percent is a very small one, significantly contributed to by Government charges totalling 0.23 percent. This very small breach, on its own, should not call into question the Bank's absolute commitment to ongoing price stability for New Zealand. Nevertheless, we regard any breach of the 0 to 2 percent range as a matter for considerable concern, no matter how small nor how temporary the breach.

The meeting also noted that the Bank's March 1996 *Economic Projections* are for underlying inflation to decline to 1.3 percent by March 1997, to 0.9 percent by March 1998, and to 0.6 percent by March 1999. In this context, Non-executive Directors expect the Bank to continue to respond to the still strong inflationary pressures in a vigilant and determined way.

You will recall that Non-executive Directors advised you on 20 December 1995 that "there is obviously some risk that underlying inflation will exceed 2.0 percent over the coming months". We also noted in our letter to you that it continues to be our "understanding that 0 to 2 percent was always intended to be a target towards which the Bank would be *constantly aiming*, not necessarily a target which could, given the inevitable uncertainties in forecasting and lags in the effectiveness of monetary policy, always be certain of attainment".

Non-executive Directors further re-affirmed then that "the Governor's performance is endorsed as being very successful over the period since the first Policy Targets Agreement was signed and that a marginal breach above or below the 0 to 2 percent inflation target is not, in their opinion, considered a matter which should call into question the Governor's performance or his continued employment".

The Governor's performance must still be regarded as of the highest order by international standards. He continues to have the Non-executive Directors' unanimous and total support.

In your letter of 18 April 1996 you sought our views on three specific questions. The Governor is responding to your first two questions as they are the same as the first two questions addressed to him in your press release of 17 April 1996, and we consider that is appropriate. The Non-executive Directors are aware of the Governor's response and are in agreement with it. Our response to your third question, asking whether current actions put in place by the Governor are adequate to ensure a return to price stability, is as follows:

Based on the evidence available to us at this time, we have no reason to doubt that actions taken to date are adequate to ensure a return to ongoing price stability. It is noteworthy that most market commentators are suggesting that, if anything, current conditions are rather tighter than is required to return the underlying inflation rate to the middle part of the target range during 1997. We would also draw your attention to the implications of the inflation "forecasts" in the *Economic Projections* published by the Bank last month: at that time, the Bank published a track for underlying inflation which was 'uncomfortably close' to the top of the target range throughout the balance of 1996. With the March quarter outcome being 0.1 percent higher than assumed in those projections, the year-to-date underlying inflation figures for the next three quarters will be closer to the top of the range than projected, and there must therefore be a risk of underlying inflation exceeding the top of the 0 to 2 percent range by a small extent in one or more of the next three quarters.

Letter from the Governor of the Reserve Bank, Dr Don Brash to the Minister of Finance
19 April 1996

You have written to the Non-executive Directors of the Reserve Bank seeking their assessment of my performance under the Policy Targets Agreement signed with your predecessor in December 1992. Media reports suggest that you would also appreciate an explanation from me as to why this 'second breach' of the inflation target range has occurred, and for this reason I felt it appropriate to write to you directly. Your letter to Sir Peter Elworthy raised three questions, and I will begin by giving you my own reaction to those questions, before concluding with some further comments.

What factors led to the breach of the target range?

As I have acknowledged publicly on several occasions in the past, the Bank misjudged, during 1994 and early 1995, the degree of monetary policy pressure required to restrain inflation in 1995 and 1996. Despite the fact that we were rather more pessimistic about the inflation outlook than other official advisors (and certainly than most, though not all, private sector commentators), we were in retrospect too optimistic about the non-inflationary growth potential of the New Zealand economy. As a consequence, underlying inflation has been uncomfortably close to the top of the 0 to 2 percent target range since the second quarter of 1995. This has meant that even quite trivial price 'shocks' have been sufficient to push underlying inflation above 2 percent. This is well-illustrated in the latest quarter: had it not been for the increase in excise tax on loose-leaf tobacco by some 38 percent during the quarter, underlying inflation would have been almost 0.1 percent lower than was in fact the case, and the 'breach' would not have occurred. To reduce the risk of such individually -small events pushing underlying inflation outside the range, it is important that we continue to aim to have inflation closer to the middle part of the range.

It is also perhaps worth noting that, over the 12 months to March 1996, some 54 percent of underlying inflation has been on account of the housing-related components in the CPI, with another 11 percent of the total being on account of government charges (principally tertiary fees and tobacco excise). All other price changes over the year totalled only about 0.7 percent, below the middle of the target range. This is not to suggest, of course, that the increase in housing prices should be disregarded: housing constitutes an important part of the consumption 'basket' of all New Zealanders; housing prices are directly susceptible to monetary policy pressure (and are not 'external shocks' which should be disregarded in formulating policy); and rapid movements in housing prices can foreshadow the emergence of wider inflationary pressures. But forecasting the housing-related components of the index is peculiarly difficult, not least because housing prices tend, like other asset prices, to be quite volatile.

What action is the Governor taking to direct inflation back to within the target range?

I think it is important to recognise that no action which the Bank could take now would affect the inflation outcome for this present quarter. Whether there is to be a breach of the target range for the June quarter, therefore, is already decided. There is very limited scope to affect the outcome even for the September quarter at this stage, though I will come back to that point in a moment. The real issue is whether the Bank has tightened conditions sufficiently, over the last 12 months or so, to ensure that you can be reasonably confident that underlying inflation will move decisively below 2 percent during 1997, or whether further tightening is required at this stage.

As you will recall, our *Economic Projections*, published four weeks ago, projected underlying inflation to remain 'uncomfortably close' to the top of the target range through 1996, with a significant risk that inflation would actually turn out to be somewhat higher than projected. Nevertheless, those projections also showed underlying inflation falling well into the middle part of the target range during 1997, and at this stage we have no reason to change that assessment. It is perhaps worth noting that monetary conditions have firmed somewhat from those assumed in *Economic Projections* as the market has reacted to the somewhat stronger inflationary pressures recently seen. Several private sector commentators are arguing publicly that the present configuration of monetary conditions is actually tighter than required to get underlying inflation comfortably back within the middle of the range during 1997.

Are the current actions put in place by the Governor adequate to ensure a return to price stability?

I have by implication made some comment on this point already. It is clear that, given the inflation outlook in *Economic Projections*, and the fact that underlying inflation has turned out to be 0.1 percent higher in the March quarter than we envisaged in that document, there is an appreciable risk that underlying inflation will exceed the top of the 0 to 2 percent range by a small extent in one or more of the next three quarters.

Does this suggest that, by the end of 1996, there may have been five 'breaches' of the target range? I myself disagree with that way of looking at the issue. We are now living through the consequences of the Bank's failure to correctly assess the non-inflationary growth potential of the economy during 1994 and early 1995, as indicated above. That misjudgement is a matter for personal regret, as I have indicated on other occasions. But it is not 'five misjudgements', it is one. There have already been two 12-monthly outcomes where underlying inflation has been just above 2 percent, but the two intervening quarters also saw underlying inflation of 2 percent. What we have in prospect is a continuation of the consequences of that misjudgement in 1994 and early 1995. It is a matter for others to decide whether the performance of the Bank as an institution, and of me as its Governor, has been 'adequate', but I think it is important to see this as a single misjudgement, not a series of two (or potentially five) misjudgements.

I have already mentioned that whether there will be a 'further breach' in the year to June has already been determined, at least insofar as the Bank can influence the outcome. Given the overall macroeconomic context, including the confidence created by the prospect of substantial tax reductions, the only prospect of reducing the chance of a further breach for the 12 months to September would be for the Bank to tighten policy aggressively now, with the specific objective of driving up the exchange rate strongly (perhaps by another 4 or 5 percent) - interest rate effects would simply not produce a reduction in inflation in time to influence the September quarter. In my own considered opinion, such action is both unnecessary and inappropriate - indeed, it would be totally irresponsible - given our present judgement that underlying inflation will return to the middle part of the target range by the middle of 1997. There would be a substantial risk that aggressive further tightening at this stage would have underlying inflation going through the bottom of the target range in 1997.

Thus if you want an assurance that we will experience no further quarters where 12-monthly underlying inflation will exceed 2 percent, I have to say that I can not give you such an assurance for the present quarter or for September, and could only give you such an assurance for December if we were to instigate an immediate and substantial further tightening of conditions. Given our present assessment of the inflation outlook for 1997, I could not recommend this course of action.

I think it is important that everybody recall the words of the Non-executive Directors of the Bank in their letter to you last June, namely that it was their 'understanding that 0 to 2 percent was always intended to be a target towards which the Bank would be *constantly aiming,* not necessarily a target which could, given the inevitable uncertainties in forecasting and lags in the effectiveness of monetary policy, always be certain of attainment.' That is certainly my understanding of what the target means, but I think it would be helpful if the wider public began to understand that also. The sooner this reality is recognised by everybody the better it will be, I believe, for all concerned.

In conclusion, may I assure you of my absolute commitment to continue operating monetary policy towards the goal of maintaining price stability.