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New Zealand's Monetary Policy Experiment

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"New Zealand's Monetary Policy Experiment"

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SEMINAR PRESENTATION

"NEW ZEALAND'S MONETARY POLICY EXPERIMENT"

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INTRODUCTION

Monetary policy in New Zealand is aimed at the achievement of price stability. That in itself is not so unusual, as price stability is the stated objective of the monetary policy of many countries around the world. The uniqueness lies in the specification of the target, which is unusually well defined.

This address:

1. explains the reasons for adopting this policy in New Zealand;

2. describes the main features of the framework;

3. explains how we implement monetary policy;

4. describes the behavioural changes that have resulted from the approach; and

5. describes what has happened to inflation and the economy since the approach was adopted.

1. REASONS

(a) History

Firstly, a lot of the impetus for the new framework derived from having had many years of inflation well in excess of our trading partners. Between 1970 and 1988, the cumulative increase in consumer prices in New Zealand was 797 per cent, nearly five times that of Japan over the same period and significantly higher than any of our other main trading partners. A brief, but temporary, fall in inflation to below 5 per cent occurred in the early 1980s, but only as a result of a distortionary wage, price, dividend, exchange rate and interest rate freeze. As a result of this experience, inflation expectations were deeply entrenched in New Zealand society.

Throughout the period, monetary policy faced multiple and varying objectives which were seldom clearly specified, and only rarely consistent with achievement of inflation reduction. The wording of the Reserve Bank Act of 1964, which was the statutory basis for monetary policy throughout this period, said monetary policy:

"shall be directed towards the maintenance and promotion of economic and social welfare, having regard to the desirability of promoting the highest level of production and trade, and full employment, and of maintaining a stable internal price level."

These are all laudable objectives but they are not all capable of being achieved by monetary policy - certainly not simultaneously.

Alongside our poor inflation performance, and ultimately providing the catalyst for change, was an equally dismal growth performance. Over the decade and a half from 1974 to 1988, growth in New Zealand averaged only 1.4 per cent per annum, while public sector and overall external indebtedness rose dramatically.

(b) The Reform Approach

Changes to monetary policy did not occur in isolation from other major changes. Eventually, New Zealand's poor economic situation provoked a reorientation of Government policy across a wide range of economic activities, affecting both the public and private sectors. This process began slowly, with the beginnings of deregulation in the transport sector, the breaking down of tariff barriers between New Zealand and Australia and the opening of the foreign exchange market to newcomers in the late 1970s and early 1980s. By the time of the general election in 1984 there was quite widespread public support for a significant change in policy approach and following the election of a new government in 1984, the agenda for reform took on an all-encompassing character.

At an early stage in this reform process, New Zealand's financial markets were deregulated, with the abolition of interest rate controls and a wide range of other direct controls over the country's banking system. Exchange controls were removed, and the New Zealand dollar was floated in March 1985.

In keeping with the spirit of this process of reform, the operation of monetary policy was also subject to a complete review which culminated in a new Reserve Bank of New Zealand Act in 1989. Part of this review was based on the underlying principles applied in a major shake-up of the whole public sector which was aimed at specifying clear objectives for government agencies and holding them accountable for achieving those objectives.

(c) Theory

There was also a growing acceptance internationally that the most that could reasonably be expected of monetary policy was medium term control over inflation. We believe there is an international consensus that output and employment effects of monetary policy actions were neither predictable nor permanent enough for output and employment "management" to be a realistic objective of monetary policy. The end result of trying to achieve these objectives with monetary policy tended to be inflation but little or no sustained growth.

For some years prior to passing the 1989 legislation, monetary policy was aimed primarily at inflation, but while inflation was reduced, inflation expectations stayed high as people thought the authorities might renege on the price stability objective. After two decades of high inflation it was, unsurprisingly, not very easy to make people believe in a price stability commitment. This inconsistency between the monetary authorities' determination to reduce inflation and the public's scepticism about that determination had an impact on prices, wages and interest rates and contributed to a recession in output and employment. It was decided to change the institutional framework to make it quite clear that monetary policy was to be targeted at "achieving and maintaining stability in the general level of prices" and, in the interests of consistent medium-term policy making, to give the Reserve Bank independence in operating monetary policy.

2. THE MAIN FEATURES OF THE FRAMEWORK

The key elements of the 1989 legislation are:

(a) The price stability goal is now entrenched in law. The statute says "the primary function of the Bank is to formulate and implement monetary policy directed to the economic objectives of achieving and maintaining stability in the general level of prices".

(b) Secondly, the Bank now has effective independence to implement monetary policy in pursuit of its statutory objective, without limitations on the technique except that the choices made must "have regard to the efficiency and soundness of the financial system". This means that while the objective of monetary policy is specified in a manner akin to a rule, the monetary authorities have been given (and use) discretion in monetary policy implementation. No intermediate targets - in the form of monetary aggregates or any other financial variable - are required or used.

(c) The legislation recognises that any choices on the tradeoffs between monetary policy and other economic policy objectives are and should be the prerogative of the government and mechanisms are provided in the legislation for these choices to be exercised. In this way, the legislative framework is consistent with a Westminster approach to democracy. The government sets the target, and can change it through legislatively specified procedures. But in stark contrast with earlier legislation, the way in which the tradeoff choices must be effected means that all choices on the objectives for monetary policy must be made public and are therefore transparently obvious to the community.

(d) The Reserve Bank cannot change the target that it has been given. But it has independence in implementing monetary policy.

(e) Along with the operational independence goes accountability for monetary policy implementation decisions. The main mechanism is a requirement to publish a detailed monetary policy statement at least every six months. A Select Committee of Parliament examines the Bank following the publication of each statement. The main sanction for poor performance in relation to the objective is the explicit provision for the Minister of Finance to sack the Governor for failure to meet the agreed policy targets.

(f) For clarity and accountability, "stability" and the "general level of prices" need definition. They are not defined in the legislation, but the Act requires the Governor of the Bank and the Minister of Finance to agree on the definition, and to set this out publicly in a Policy Targets Agreement. The Agreement, in effect, sets the boundaries of the Bank's independent action and specifies clearly what it is the Governor is to be held accountable for. The Governor is accountable for the outcome of monetary policy in relation to the quantified inflation targets in the Policy Targets Agreement. These agreements should be set for the Governor's term of office - usually five years - in order to give more medium term certainty about what monetary policy is trying to achieve.

(g) The current Policy Targets Agreement defines price stability as 0-2 per cent annual increases in the Consumers Price Index. The CPI is used, not because it is any more perfect a measure of changes in the "general price level" than other indices, but because it is the most widely known and best understood index. However, the Agreement also requires the Bank to monitor a range of other price indices. The above-zero rate of inflation specified reflects index number problems, the survey methodology, and the difficulty of adjusting for new goods or for improvements in quality. Effectively, a judgement has been made that around 1 per cent CPI measured inflation is consistent with stability in the general level of prices.

(h) Provision is made for inflation outcomes outside the 0-2 per cent band. Large exogenous supply shocks, such as oil shocks, or direct shocks to the price level arising from indirect tax changes by the government, would force a shift in monetary policy to offset them if there were no caveats that provided for departures from the target. Forcing monetary policy to offset the effects on the price level of such shocks so that the Bank could keep the measured inflation rate within the 0-2 per cent band at all times would be likely to prevent large relative price shocks feeding through and would, it is believed, cause real costs that would be out of all proportion to the benefits of short-run price stability. But it is clearly important that caveats to the price stability target are not so all encompassing, or so loosely defined, as to let domestically sourced inflationary pressures be accommodated.

(i) Because inflation was over 5 per cent at the time that the legislation was enacted, the Policy Targets Agreement had to specify a time frame for the achievement of price stability. The choice of that time frame represents one of the points at which the government can exercise its ultimate right to determine the tradeoffs between monetary policy and other policy objectives. The initial Policy Targets Agreement signed in March 1990 called for achievement of 0-2 per cent inflation by December 1992 and maintenance of price stability thereafter. Partly as a result of a view that the output and employment costs of the speed of adjustment implicit in this time frame were too high, the new government elected in October 1990 deferred the target date by one year.

(j) The Bank set out in its first six monthly statement a set of indicative inflation ranges that it believed would be consistent with arrival at the target by the PTA due date. These indicative ranges were changed when the Government extended the target date to 1993. These publicly-announced ranges then became 2.5-4.5 per cent for the year to December 1991 and 1.5-3.5 per cent for the year to December 1992.

3. MONETARY POLICY IMPLEMENTATION

The Bank's monetary policy stance and policy reactions are guided directly by the forecast path for underlying inflation over the following two years or so. The success of this approach is therefore critically dependent upon our ability to forecast inflation with reasonable accuracy. This approach is now well recognised by financial market participants, who examine our forecasts of inflation, and their own, for a guide to the future stance of monetary policy. We have no intermediate targets. The role of monetary and other indicators is only to provide information on whether economic conditions are, in fact, consistent with this targeted inflation path.

Consequently, there is scope under the New Zealand framework for the various monetary indicators to move relative to their recent values, and relative to each other, and still remain consistent with the Reserve Bank's price stability goal.

The Bank implements its monetary policy by giving clear signals of its intentions and by being actively involved in New Zealand's wholesale financial markets on a daily basis. Through daily float tenders, open market operations and twice-weekly Reserve Bank bill tenders, the Bank aims to keep the supply and price of banking system liquidity at levels consistent with the stance of monetary policy.

New Zealand's commercial banks settle their daily transactions with one another and with the Government in their accounts at the Reserve Bank. As we do not permit the trading banks to go into overdraft on these accounts, they are compelled to maintain positive balances of settlement cash at the central bank.

The commercial banks must therefore compete daily for settlement cash. The average supply of settlement cash is determined by the settlement cash 'target', which the Reserve Bank has currently set at $20 million.

We are able to 'hit' this target, or at least get near to it, on most days through our open market operations.

These financial arrangements are the 'key' to our monetary policy these days. We do not have the power in the Reserve Bank of New Zealand Act 1989 to impose reserve or liquidity requirements or other direct controls for monetary policy purposes. We did not seek to have those powers. We believe an effective monetary policy can be implemented by operating in the markets. The current arrangements ensure that the Reserve Bank is able to ease or tighten short-term monetary conditions. A lowering of the cash target or an increase in our discount margin, for example, by compelling banks to compete more aggressively for what settlement cash is available and putting upward pressure on interest rates in the wholesale money markets, constitutes a tightening of conditions, and vice versa in the case of a raising of the target or lowering of the discount margin.[1]

These short-term rates are, in reality, the only ones over which the Reserve Bank has any direct influence. But by signalling a change in our policy stance via a change in our settlement cash 'target', and thereby altering short-term interest rates, the policy impact is passed down to the economy's 'real' sector through a number of transmission channels. These include retail interest rates and the exchange rate.

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[1]We set our discount rate as a margin over market rates, not as a specified interest rate.

In practice, though, the settlement cash target is adjusted only at infrequent intervals. We last changed the target in September 1991, when it was raised from $15 million to $20 million. It was felt then that inflationary pressures were significantly weaker than had been previously forecast and that without action we were likely to undershoot our inflation ranges for 1991 and 1992.

We seem to have been able to get away with such infrequent explicit changes to our policy settings as a form of self-stabilising behaviour has developed in the financial markets because the Bank's policy framework is transparent, consistent and well understood by market participants. Key monetary indicators such as interest rates and the exchange rate tend to move in the desired way with little or no nudging from the Reserve Bank. For example, if the TWI moves down towards where the market believes the limit of our 'comfort zone' for the TWI is, short-term interest rates begin to rise. The markets anticipate our reaction function and react first.

4. THE IMPACT ON BEHAVIOUR

It was quite clear at the outset that the mere enactment of the legislation was not enough to establish monetary policy credibility, especially when the poor history of monetary policy in New Zealand is taken into account. There did not seem to be a large 'announcement effect' on the passing of the legislation. Ultimately, credibility is derived from results. A thousand reiterations of the Reserve Bank's adherence to the objective would mean little compared with the doubts that would arise if inflation did not track in a manner consistent with getting to the target. But behaviour has adapted in the almost three years the legislation has been in place.

Financial markets have for some time been reflecting expectations of falling rates of inflation, consistent with the target path. Interest rates fell by as much as 7 percentage points over the 2 years to May 1992, more often than not with financial markets leading and the Reserve Bank accommodating. Quite frequently now, the commentaries of brokers and analysts compare their inflation forecasts against the Reserve Bank's forecasts and our target ranges. From such comparisons, analysts can make informed judgements as to the likely nature, of monetary policy settings over the quarters ahead. And, as I said in the previous section, a degree of self-stabilising behaviour is now evident in our financial markets.

Other evidence in support of behavioural change comes from the reaction of the trade union movement to policy over the last couple of years. After watching policy tighten when the Bank became concerned that inflation was not tracking down as desired, the head of the union movement wrote an article in 1990 that said (and I paraphrase here): "I don't like what they are doing but we have to plan on the basis that they will be doing it." There is evidence that the union movement entered that round of wage negotiations with a completely different inflation outlook than previously. That was illustrated in 1990 in a short-lived "growth agreement" between the unions and the then government, in which the unions stated a willingness to accept 2 per cent wage increases (plus any productivity adjustments) when recorded inflation was still over 5 per cent. The agreement itself was short-lived, but the low wage rises were nevertheless secured, not only in that year but in the following year as well. This has allowed monetary policy to accommodate substantial reductions in nominal interest rates and around a 10 per cent depreciation in the nominal trade-weighted exchange rate without reigniting inflationary pressures.

More direct evidence on the relatively rapid acquisition of monetary policy credibility is also available in a variety of inflation expectation surveys. One, a reasonably wide-ranging survey of business and financial market professionals, shows year-ahead inflation expectation of 2 per cent. A second, covering leading economists only but looking 7 years ahead, has inflation staying at 2 per cent throughout. In contrast, New Zealand's inflation rate averaged 12 per cent in the 1970s, and 11.4 per cent in the 1980s.

But by far the most significant and important behavioural change has taken place inside the policy making machine, i.e. in the Reserve Bank. The clear target and the announced downward path for inflation have provided a structure for internal discussions and debates with the Reserve Bank about the appropriate stance of policy. It has also provided the impetus for a number of politically sensitive decisions, notably the tightenings of policy in May and August 1990 (in the run-up to the 1990 New Zealand election), a reluctance to accelerate the market-led loosening in monetary conditions through 1991, and the willingness explicitly to ease policy in September 1991. In each case the critical deciding factor behind the tightenings, and the more recent eventual acceleration of the easing trend, was the outlook for inflation relative to the way-point target ranges over the 1-2 years ahead.

5. HOW HAS IT WORKED OUT IN PRACTICE?

Has the new framework been successful? I attach a set of the Reserve Bank's latest forecasts. Inflation in New Zealand has been steadily reduced since the redirection of policy in the mid-1980s, and since implementation of the Reserve Bank Act 1989. From an average of around 15 per cent in the mid-1980s, inflation dropped to 7.0 per cent in the year to March 1990, to 4.5 per cent in the year to March 1991, and to a 30-year low of just 0.8 per cent in the year to March 1992. It will rise back to around 2 per cent (on an underlying basis) this calendar year as the impact of the exchange rate depreciation that occurred over the previous years feeds through into prices. But at 2 per cent, inflation will still be comfortably within our indicative range for 1992 of 1.5-3.5 per cent. We forecast that the inflation rate will then fall back to 0.9 per cent for 1993, which is very close to the middle of our target range. We have gone, therefore, from having one of the highest rates of inflation in the OECD to having one of the lowest.

The critics who said initially that the framework wouldn't achieve price stability have largely been silenced. A second criticism was that we may achieve price stability but only by having permanently high real interest rates and exchange rates and thus at the expense of a stagnant economy. This criticism is now also losing its force.

Five-year Government bond rates have fallen from over 16 per cent in 1987 to 12.5 per cent in 1990, 10.0 per cent last year and around 7.2 per cent at present. More significantly, these falls have also brought a significant drop in New Zealand's risk premium - defined as the difference between our real long-term interest rates and those of our main trading partners - from an average 3.5 per cent in 1989, to around 1.5 per cent in the first eight months of 1992. Mortgage interest rates, which were just over 20 per cent in 1987, are now around 9 per cent.

The Trade Weighted Exchange Rate Index (TWI) which averaged 63 in 1987, 64.5 in 1988, and 60.5 in 1990, is now fluctuating between 53 and 54. As our inflation rates have been below those of our trading partners over the latter part of this period, our real exchange rate has improved even more than the nominal.

These substantial falls in both interest rates and the exchange rate have been able to be accommodated because domestic inflationary pressures have been very weak.

And we are now seeing the start of what we believe will be a sustainable economic recovery. GDP has risen for three consecutive quarters since the economy bottomed in the June 1991 quarter. Our September forecasts project GDP in the March quarter of 1993 to be 3.0 per cent higher than it was in the first quarter of this year and the growth in 1993/94 is anticipated to be 3.1 per cent. By past New Zealand standards, growth rates of this magnitude are very good and are especially pleasing given the sluggishness of the world economy.

Despite this sluggishness internationally, the principal driving force behind this recovery in New Zealand is the export sector, particularly manufactured exports.

The current account, which has been in deficit continuously since the early 1970s (with the deficit peaking at 8.8 per cent of GDP), is now close to balance and we forecast it to remain close to balance as the economy recovers. There appear to be few significant downside risks to our growth forecast, as it has taken into account a conservative outlook for the major world economies, and makes no allowance for a successful conclusion to the latest GATT negotiations.

We are now seeing major signs of a stability psychology taking root in New Zealand. The downward trend of inflation expectations over the last two years suggests that New Zealanders believe that inflation will remain low in the foreseeable future, and they have adjusted their behaviour accordingly. New Zealand is therefore moving into a recovery which, in contrast with earlier recoveries, should not be accompanied by a resurgence of inflation pressures.