THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Appointment of a New Governor: Policy Targets and Relationship Expectations

Date:	14 August 2002	**Treasury Priority:**	Medium
Security Level:	In Confidence	**Report No:**	T2002/1068

Action Sought

	Action Sought	**Deadline**
Treasurer/Minister of Finance	Read and discuss with officials	Before a new PTA is signed
Associate Minister of Finance (Hon Trevor Mallard)	Read	None
Associate Minister of Finance (Hon Paul Swain)	Read	None

Contact for Telephone Discussion (if required)

Name	**Position**	**Telephone**		**1st Contact**
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Enclosure: **No**

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Treasury Report: Appointment of a New Governor: Policy Targets and Relationship Expectations

Executive Summary

The appointment of a new Governor of the Reserve Bank provides an appropriate and timely opportunity for the Government and the Governor (designate) to set out clearly their mutual understanding of the operation of monetary policy in New Zealand.

You have expressed some concern that the Reserve Bank is interpreting the Policy Targets Agreement (PTA) in a manner that differs from your understanding. You have signalled your intention to revise the PTA in a way that makes clear your intentions with respect to the flexible management of monetary policy, consistent with the maintenance of price stability, so as to be supportive of maximising growth.

This report considers how the PTA could better incorporate these features and limit the potential for differences in interpretation to arise in the future.

This report makes the following points:

- Price stability is important for sustained economic expansions.
- Considerable gains have been made in generating broad acceptance that price stability will be an enduring feature of the New Zealand economy.
- The optimal degree of price stability is generally considered to be consistent with average inflation rates of between 1 and 3 percent per year.
- In practice, most inflation targeting central banks have inflation targets, or target mid-points of either 2% or 2½% per year.
- When inflation expectations are firmly held, or well anchored, the central bank has some latitude to allow inflation to deviate from its target in the short-run without an immediate or large response. A gradual and measured policy response to disturbances helps to reduce variability in the real economy.
- The measure of CPI inflation the Reserve Bank targets has averaged around 2% over the last 10 years. Available evidence suggests that medium-term inflation expectations are also around 2%.
- Greater specificity of the expected average inflation rate than provided by the current 0 to 3 range may provide a better anchor for inflation expectations. This may enable a less active approach to monetary policy.

We understand that you wish to retain the 0-3% range for inflation outcomes but make it clear that the full range will be used. One way this could be achieved is to make explicit the medium-term nature of the target. This would make it clear that the benchmark for accountability is inflation outcomes over a run of years and would reduce the significance of single outcomes outside the range.

However, there may be advantages in more clearly identifying the average rate of inflation that monetary policy should seek to achieve. In practice the Bank will choose an operational target from within the agreed range that best enables it to meet its medium-term objective of delivering inflation outcomes within that range. Financial markets will also choose a point from within the range that reflects their expectations of inflation outcomes.

By shifting the focus of the target more clearly to a medium-term average level of inflation you will reduce the risk of a divergence between the Bank's medium-term accountability and its operational target. For example, in Australia the benchmark for performance is whether the Bank has achieved 2-3% inflation on average, over the cycle. In the UK the operational target, as specified by the Chancellor, is an underlying inflation rate of 2½% per year.

A clear focus on the medium-term average inflation rate can be achieved while also retaining the 0-3 percent range of acceptable inflation outcomes, and there is a range of specifications of the PTA that can achieve this. These include emphasising the medium-term nature of the current target and the "soft" nature of the edges of the range.

The Treasury's preferred specification of the target is:

- An explicit "medium-term" horizon for achieving the inflation target. This will encourage flexibility by ensuring that accountability is for inflation outcomes over a run of years.

- The medium-term inflation objective be focused on an explicit rate. An explicit medium-term average of around 2% would be consistent with medium-term inflation expectations and may provide a stronger anchor for inflation expectations.

- The medium term target have bounds of +/-1 per cent that encompasses the outcomes for inflation that are most likely to occur and where the Bank must give particular attention to reporting on outcomes, or expected outcomes, outside the range and what it intends to do to bring inflation back to target, so that the public can be assured that inflation is on track to achieve its objective.

There is a risk that financial markets and the public perceive a change to the PTA as leading to higher average inflation rates. If inflation expectations are raised this will be reflected in higher nominal interest rates. This risk can best be managed by reaffirming the Bank's operational independence in pursuit of its inflation objective and by demonstrating the Government's commitment to price stability.

The Policy Targets Agreement is an important step in helping to build your relationship with the Governor. There is a limit though to what a PTA can achieve. It is hard to specify in a PTA document those aspects of monetary policy that are qualitative and judgemental. This means that both the PTA and operational independence should be seen to support a broader relationship that enables you and the Governor to discuss and consider the medium-term objectives of monetary policy. They also support a relationship that encompasses the other functions of the Bank.

Developing opportunities for discussion on monetary policy, and economic developments more generally, outside of the current *Monetary Policy Statement* briefings may help facilitate this kind of interaction. We suggest a number of other actions that could you help build an effective and productive relationship while maintaining the Bank's independence.

The Reserve Bank Board of Directors has an important role in monitoring the performance of the Bank and ensuring that the Governor is held accountable for her/his performance in meeting the policy targets. Clearly the Board needs to also share the interpretation of the PTA if the Governor is not to receive mixed signals. Regular discussions with the Board will help minimise the possibility of mixed signals.

The Treasury can assist you in building and maintaining these relationships in a number of ways. We can monitor and provide alternative advice on issues and developments relevant to monetary policy, provide advice on Board appointments, and prepare briefings to facilitate your meetings with the Board.

There are a number of practical steps required to finalise a new PTA and formally appoint a Governor. These include consultation with the Board about when you can expect a recommendation for appointment, discussion about the PTA with the Governor designate, and informing your Cabinet colleagues of the person you intend to appoint as Governor. Appending the new PTA to the Cabinet paper on the Governor's appointment would be one means of keeping your colleagues informed of your intentions. We suggest that you or your office discuss with the Board the process you intend to follow.

We have discussed the views in this paper with the Reserve Bank.

Recommended Action

We recommend that you:

i) **note** the contents of this report;

ii) **agree** to discuss this report with the Treasury and how we can assist you further in the process for agreeing a PTA and appointing a new Governor; and

agree/disagree

iii) **agree** that you or your office discuss with the Board the process you intend to follow.

agree/disagree

Struan Little
For Secretary to the Treasury

Hon Dr Michael Cullen
Treasurer/Minister of Finance.

Treasury Report: Appointment of a Governor: Policy Targets and Relationship Building

Purpose Of Report

1. The purpose of this report is to advise you of the possible benefits and risks of a revised Policy Targets Agreement (PTA). We also consider the desirability of building a relationship with a new Governor that fosters a shared understanding of the objectives of monetary policy and reaffirms the Governor's duty to exercise independent authority.

Introduction

2. At present there appears to be some concern that the Reserve Bank is interpreting the Policy Targets Agreement in a manner that differs from your understanding. You have announced your intention to seek to revise the PTA so that it clearly expresses the Government's intentions with respect to the flexible management of monetary policy, consistent with the maintenance of price stability, so as to be supportive of maximising sustainable economic growth.

3. This report tries to give some practical content to this policy. It considers a range of factors that emphasise the importance of maintaining inflation expectations at their present levels. We also emphasise the importance of reaffirming the Governor's independence in building and maintaining an effective and productive relationship with the new Governor.

Price Stability And Monetary Policy

4. Monetary policy in New Zealand is governed by the Reserve Bank Act 1989. This Act, while recognising the Crown's right to determine economic policy, provides for the Reserve Bank to be responsible for implementing monetary policy that promotes price stability.

5. Section 9 requires the Treasurer/Minister of Finance, before appointing a Governor, to agree with the Governor designate, "policy targets for the carrying out by the Bank of its primary function during that person's term of office, or next term of office, as Governor".

6. The Policy Targets Agreement makes the price stability objective operational. The PTA is a public document that forms a central component of the Bank's mandate and accountability. The Governor's responsibility to independently determine monetary policy that is consistent with the PTA promotes public confidence in the Bank's ability to deliver on its mandate.

7. Since the Act came into effect in 1989 the policy targets have been expressed in terms of a target for inflation. An increasing number of other countries have adopted the "inflation targeting" approach to price stability. There are alternatives to an inflation target but it is not clear that they are superior, and some alternatives, such as monetary targets, are likely to be inferior.

8. There is broad agreement that over long time horizons the economic impact of monetary policy is largely confined to the prices of goods and services. By seeking to

stabilise prices monetary policy contributes to a stable environment for businesses and households to make saving, investment, and consumption decisions. An inflation target contributes to a stable environment for the real economy by providing a nominal anchor: an anchor for prices and wages; and expectations of future prices.

9. Equally, there is broad agreement that over shorter time horizons monetary policy has a significant economic impact on real factors such as the quantity of goods and services produced and sold. This means that monetary policy can also help to stabilise the real economy.

10. An environment of stable prices will help to maximise the length of economic expansions. There is considerable evidence that countries can only have sustained expansions if they are accompanied by low inflation. Thus another way of expressing the aim of monetary policy is to say that its aim is to maximise the length of the economic expansion and delay and reduce the size of any subsequent recession.

11. In the past, particularly over the 1970s and early 1980s, New Zealand's monetary policy contributed to the boom and bust cycle that characterised the economy. This experience showed that monetary policy that is expansionary or contractionary for too long requires a larger adjustment than would otherwise be necessary.

12. In contrast, recent research by the Treasury suggests that over the 1990s monetary policy has helped to stabilise the economy[1]. The experience over the 1990s showed that monetary policy best achieves its goal of prolonging expansions by responding early to clear signs of inflationary or deflationary pressure. That is, monetary policy will be tightened earlier if monetary policy is aiming to prolong the expansion than if it is only seeking higher growth for a year or so.

13. Responding early, or pre-emptively, to inflationary pressures needs to be tempered where there is uncertainty about the outcomes. In this case a more gradual approach may be beneficial. Over the 1990s the Reserve Bank has enhanced its credibility and reputation for delivering low and stable inflation, which has led to reduced inflation expectations. With inflation expectations low and firmly anchored the Bank has been able to take an increasingly gradual and moderate approach to monetary policy, aiming to achieve its inflation target at longer horizons. It also accepts that inflation will sometimes be away from its target, sometimes by quite a bit.

14. We agree with conclusion of the *Independent Review of the Operation of Monetary Policy in New Zealand* that the Reserve Bank's current approach is "entirely consistent with the best international practice of flexible inflation targeting"[2]. Many financial market commentators also support this conclusion.

15. However the *Independent Review* did make a number of recommendations for improving further the operation of monetary policy. On the PTA Svensson argued that:

- The policy target should be interpreted as a medium-term target, consistent with flexible inflation targeting;

- A point target provides a superior anchor for inflation expectations;

[1] *Trade, climate and financial influences on macroeconomic fluctuations: Analysis using an open economy SVAR model of the New Zealand economy*, R. Buckle, K. Kim, H. Kirkham, N. McLellan, J. Sharma, Treasury working paper forthcoming.

[2] *Independent Review of the Operation of Monetary Policy in New Zealand: Report to the Minister of Finance,* Lars E. O. Svensson, Institute for International Economic Studies, Stockholm University, 2001.

- The policy target in the PTA should be interpreted as a point-target of 1.5%; and

- The edges of the target should be interpreted as "soft", in the sense that they do not constitute thresholds for policy adjustment.

16. Svensson could not find any strong evidence suggesting that 1.5% might not be an appropriate level for the inflation target. He saw a risk that an increase in the target level for no good reason might easily be interpreted as lessening the commitment to price stability and be detrimental to the credibility of the monetary policy regime.

17. We agree in large measure with Svensson but in our judgement aiming to maintain average inflation at around 2% would be more credible and enduring. We detail the reasons for this below.

The Inflation Target

18. The appropriate level of inflation to target can be motivated by considering the costs and benefits of inflation. Changes to the target may also impose costs and benefits and it is important to consider these.

19. There are a wide range of expert opinions and a long literature about what the optimal degree of price stability is. Views range from the undesirability of any inflation to there being little real harm of rates of stable inflation up to about 8%. However, the weight of opinion appears to be that aiming to achieve average rates of inflation of between about 1 and 3 percent appropriately balances both the costs and benefits of inflation.

20. In practice most countries that have adopted explicit inflation targets have chosen targets centred on either 2% (Canada, Israel, and Sweden), or 2½% (Australia, UK, Iceland, and Norway) [3]. Within these targets there is considerable variation on whether a band or point is specified, and whether the target applies continuously or over the medium term.

21. The three most commonly cited reasons for an inflation target above zero are:

- Inflation is difficult to measure accurately and is thought to overstate the true rate of inflation. Improvements in the quality of goods and services over time and the ability of consumers to substitute away from goods whose prices have risen, or towards shops with lower priced goods are difficult to capture in CPI measures. Recent work in New Zealand suggests that the CPI may overstate the true rate of inflation by about 1% per year[4]. Past estimates have suggested a figure of about 0.5% per year.

- Nominal wage reductions are relatively unusual so some inflation may allow employers to lower real wages. Without a mechanism for lowering real wages in times of economic stress employers would have to lay off workers. The implication is that some inflation may assist the operation of the labour market and permit a higher level of output and employment to be sustained. There is

[3] The European Central Bank targets "increases of less that 2%", which in practice is thought to represent a target of 1.5%. The US Federal Reserve does not have an explicit target but average inflation in the USA of 2.5% over the last ten years implies a target level similar to other central banks.
[4] *Are we growing faster than we think? An estimate of `CPI' bias for New Zealand,* John Gibson and Grant Scobie, New Zealand Association of Economists Conference paper, June 2002.

some New Zealand evidence to support the view that money wage reductions are relatively infrequent [5].

- Low average rates of inflation accompanied by low nominal interest rates may restrict the ability of the central bank to stimulate an economy out of recession. Because nominal interest rates cannot fall below zero the Bank may find it difficult to engineer negative real interest rates and so promote demand in the economy.

22. In New Zealand the probability that the zero bound on nominal interest rates would prove binding is at present quite low. Nominal interest rates are currently considered to be neutral at rates of around 5.5% to 6.5% providing substantial room for interest rate cuts to stimulate the economy. The exchange rate also has a powerful influence on aggregate demand in the economy and provides an additional means for stimulating the economy. Nonetheless, monetary policy becomes more difficult when interest rates hit zero because the normal channels for policy are no longer operative.

23. The importance of inflation for helping the labour market to adjust is more difficult to assess in New Zealand. We have a reasonable degree of product and labour market flexibility; generally considered to be less than the US, about the same as Australia, and more than the EU[6]. This suggests that while it may be an important factor to consider we should not overstate its importance.

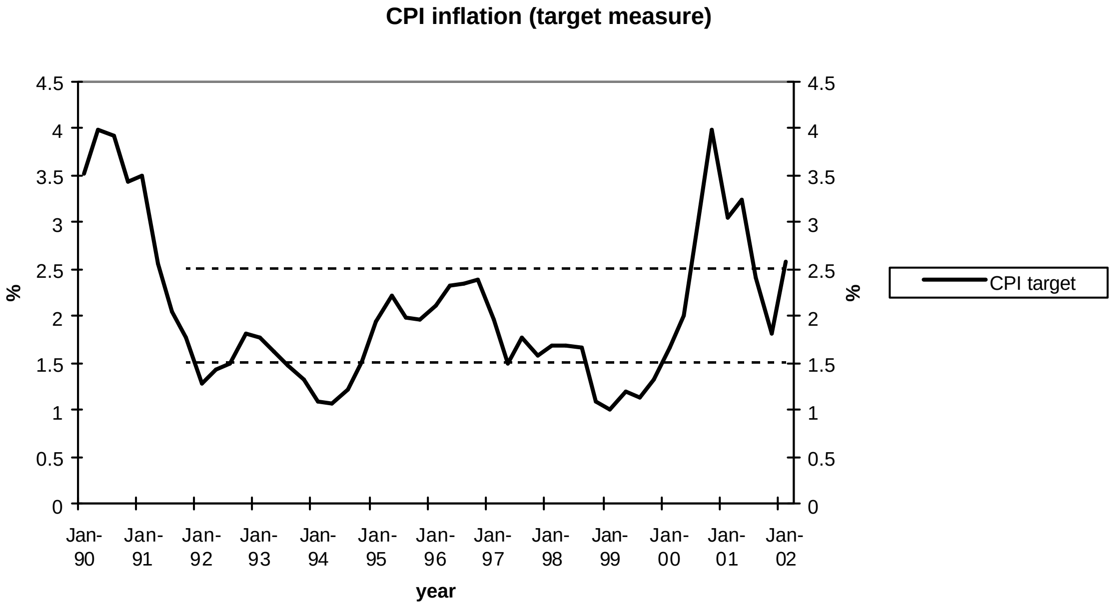
24. This leads us to concur with the international evidence that an appropriate average for an inflation target in New Zealand is probably between 1 and 3 percent. Within the 1 to 3 percent range there is no strong evidence to suggest any substantive differences in long-term economic performance arising from different average levels of inflation.

25. This does not mean that we should be indifferent about rates of inflation within this range. There is no reason to accept higher average rates of inflation than at present if there are no benefits. Rather having regard to the past costs of achieving current low levels of inflation we should continue to seek ways to ensure that we remain in a position to reap the benefits.

Locking in expectations

26. The following graph shows that since inflation fell below 2% at the end of 1991 the targeted rate of inflation (which has not always been headline CPI) has never been below 1%, it has sometimes been below 1.5%, and most of the time it has been between 1.5% and 2.5% per year (over 60% of the time). Inflation has been between 1% and 3% per year about 90% of the time. The average inflation rate over the period 1992-2002 is around 2%. Since 2000 the average has been about 2.5%.

[5] *The distribution of price and wage changes in New Zealand,* Vincenzo Cassino, RBNZ Discussion paper G95/6, and *Money wage rigidity in New Zealand,* Simon Chapple, Labour Market Bulletin 96:2.
[6] See for example *Summary indicators of product market regulation with an extension to employment protection legislation,* OECD Economics Department, Working paper 226, April 2000.



27. Medium-term measures of inflation expectations, which look though the impact of business cycles on inflation, such as *Consensus* and the Aon 7-years-ahead inflation expectations survey show inflation expectations to have been around 2% since 1997. However these surveys only measure the expectations of financial market analysts and may not be representative of the expectations of the wider population.

28. Broader shorter horizon surveys such as the National Bank 12-month ahead survey show that inflation expectations tend to move in the same direction as the inflation rate. Inflation expectations in this survey have averaged about 2.5% since the start of 1997. Although not too much can be read into these survey measures together they suggest to us that medium-term inflation expectations are probably anchored at around 2%.

29. When inflation expectations are firmly held, or well anchored on the inflation target, the central bank has some latitude to allow inflation to deviate from its target in the short-run without an immediate or large response. This is because expectations of low inflation create a strong tendency for actual inflation to revert back to target and, everything else equal, means that monetary policy needs to be less active. When inflation expectations remain stable interest rates and output need to move less to bring inflation back to target. A gradual and measured policy response to bring inflation back to the target helps avoid unnecessary variability in the real economy, particularly when the economic outlook is uncertain.

A flexible inflation target

30. We understand that you wish to retain the 0-3% range for inflation outcomes but make it clear that the full range will be used. One way this could be achieved is to make explicit the medium-term nature of the target. This would make it clear that the benchmark for accountability is inflation outcomes over a run of years and would reduce the significance of single outcomes outside the range. This may reduce the proclivity for a monetary response whenever inflation threatens to go above the target.

31. By explicitly shifting the focus of accountability to the medium-term, greater flexibility in terms of the desired time horizon for bringing inflation back to target, may also be encouraged. Consistent with current practice it would better recognise that the desired horizon balances risks to both output and inflation and it would reinforce the incentives on the Governor to operate policy in this way.

32. Because there is no clearly specified horizon for meeting the inflation objective a medium-term focus could be seen to weaken the accountability of the Governor. But to a large degree this change would reflect current practice although it would help to make clear that practice. It would also be more consistent with the length of the Governor's term of office, when performance must taken into account when considering reappointment.

33. One difficulty with a broad range is that in practice the Bank will choose an operational target from within the agreed range of acceptable outcomes that best enables it to meet its medium-term goal. This is the primary reason the Bank currently targets the mid-point of the range.

34. Being more specific about the average rate of inflation that the Bank should aim to achieve will reduce the risk of a divergence between the Bank's medium-term accountability and its operational target. For example, in Australia, the benchmark for performance is whether the Bank has achieved 2-3% inflation on average, over the cycle. In the UK the operational target, as specified by the Chancellor, is an underlying inflation rate of 2½% per year[7].

35. Another good reason for providing greater specificity of the inflation goal than provided by the 0 to 3 percent range is that it would, at the margin, provide a better anchor for inflation expectations. As noted above, the better anchored are inflation expectations on the target, the less quickly monetary policy needs to respond to inflationary shocks and the more gradual and measured its response to return inflation to target.

36. In our view explicitly aiming for average inflation outcomes of around 2% over the medium-term has a number of advantages:

- It would be in line with current inflation expectations. This would overcome the concern that monetary policy needs to continue to work through higher interest rates and lower output to achieve inflation expectations anchored on the current mid-point;

- It would be consistent with inflation targets in other countries, reducing the risk that it is seen as "too low";

- It might enhance the ability of the Bank to anchor inflation expectations and permit a less active approach to policy; and

- It would reduce the risk of a divergence between the Bank's medium-term accountability and its operational target.

37. The key disadvantage is that it would be higher than the mid-point of the current range creating a risk that inflation expectations increase. This is particularly likely if this change creates a perception that further upward revisions will be made in the future. Reaffirming the duty of the Governor to act independently, and the accountability of the Governor for achieving the target can help mitigate these risks. Demonstrating the

[7] In the UK the inflation target used to be expressed as a range of 1-4%, but a point target of 2½% was instituted in response to problems with the range that manifested itself in 1995. In this instance the Chancellor was able to resist the Governor's recommendation to raise rates even though inflation was over 1 percent above the mid-point of the range and forecast to rise further. In 1997 a point target was implemented when the Bank gained operational independence, which should prevent these problems from occurring again.

Governments commitment to price stability, such as by maintaining an appropriate fiscal policy, may also be beneficial.

Some options for the inflation target

38. Adopting the goal of maintaining medium-term inflation at around 2% in each case, there are a number of options for specifying the target:

a 12 monthly increases in the CPI of between 0 and 3 percent over the medium term.

In practice the Bank would operationalise this by choosing a specific operational target. The mid-point is the natural target although an asymmetric operational target such as 2% is feasible. But an asymmetric target would indicate a preference for outcomes above 1%. The argument could then be made that, in the interests of transparency, it would be better if the “true” range of 1% to 3% were explicit.

b 12 monthly increases in the CPI of between 1 and 3 percent over the medium term, with an explicit operational target of 2% (as in Canada). Alternatively, expressed as an Australian style thick point, the target would be inflation between 1½% to 2½% on average, over the cycle.

Both approaches increase the focus on 2% as the medium-term outcome and may therefore better anchor inflation expectations. They exclude inflation below 1% as an appropriate medium-term rate of inflation. In the Canadian approach the bounds around the central point should be interpreted as encompassing the range of inflation outcomes that are likely to occur most of the time. They should the seen as expressing the inherent uncertainty in forecasting inflation and not as a measure of indifference to inflation outcomes within the range. The Australian approach de-emphasises the mid-point and does not say much about the variance of inflation but can be interpreted as meaning that inflation will fluctuate around a stable mean of somewhere around 1½ and 2½ percent.

One disadvantage with the expressing the target as medium-term or as an average is the potential for confusion about whether this means that inflation outcomes above target need to be offset with outcomes below target. This is unhelpful; the target should always be considered in a forward-looking context as something that monetary policy is constantly striving to achieve regardless of past undershoots or overshoots.

c 12 monthly increases in the CPI of around 2% over the medium-term.

This has similar advantages to b) in that it provides a clear anchor for expectations, encourages flexibility and conveys some of the imprecision associated with inflation targeting. It also has the advantage of eliminating the current bands and the potential for policy changes as inflation nears the edges of the band.

It may be helpful though to specify a range of +/-1% either side of the central target (similar to that in the UK) where the Bank must give particular attention to reporting on outcomes, or expected outcomes, outside the range and what it intends to do to bring inflation back to target. The purpose of the range and the reporting requirement is to provide a mechanism to reassure the public that inflation is on track to achieve its medium-term objective. The requirement to report on large divergences from the target is different from the present range because it puts the appropriate focus on the average inflation rate rather than on the edges of the band.

The main disadvantage of a point target is that it may appear to limit the flexibility of policy. By emphasising the medium-term uncertainty of inflation forecasting the necessary flexibility should be provided.

39. The Treasury prefers the third option for the reasons detailed in paragraph 36 above.

Relationship and Communication

40. The appointment of the new Governor will also have important implications for the operation of monetary policy. The qualitative and judgemental nature of many monetary policy decisions provide some scope for short-term differences in monetary policy actions even with the same medium-term objectives. The communication style of a new Governor may also influence public perceptions of monetary policy. A different Governor may emphasise different aspects of the decision (or the same aspects differently), and may adopt a different public profile.

41. The PTA provides the framework that guides the Governor's decisions but cannot capture all that is important or relevant to the operation of monetary policy. Both the PTA and the operational independence embedded in the Act support a broader relationship that enables you and the Governor to discuss and consider the medium-term objectives of monetary policy and the Reserve Bank more generally. To build this relationship with a new Governor it will be important for you to affirm and respect the Governor's duty to act independently while also making him/her aware of your expectations for the conduct of policy.

42. At present we believe there is a good flow of information between you, the Reserve Bank, and the Treasury across the range of the Bank's activities. This is facilitated by the transparent flow of formal information from both the Treasury (e.g. Budget Policy Statements and six-monthly Treasury economic and fiscal forecasts) and the Reserve Bank (the PTA and Monetary Policy Statements), and is built upon by other less formal arrangements, such as meetings between officials from the Treasury and Reserve Bank. The transparency of information ensures that both fiscal and monetary policies are formulated in the knowledge of their interdependencies.

43. There is room to improve on current process though. Much of your current interaction with the Governor takes place through formal processes such as those surrounding the release of the Bank's *Monetary Policy Statement.* By developing opportunities for interactions that are less constrained by concerns about immediate policy decisions a broader and deeper discussion of economic and financial issues could emerge.

44. The Reserve Bank Board has an important role in monitoring the performance of the Bank and ensuring the Governor is held accountable for her/his performance in meeting the policy targets. Clearly the Board needs to also share the understanding of the policy targets agreement if the Governor is not to receive mixed signals. Regular discussions with the Board will help minimise the possibility of mixed signals.

45. The Treasury can assist you in building and maintaining these relationships in a number of ways. We can monitor and provide alternative advice on issues and developments relevant to monetary policy, provide advice on Board appointments, and prepare briefings to facilitate your meetings with the Board.

Specific expectations

46. We have identified a number of practical actions that you may wish to discuss with an incoming Governor and the Bank's Board:

- The Reserve Bank inform you of the release of material into the public domain that may be likely to cause public comment. This may include speeches, responses to FEC, working papers, Bulletin articles and *Monetary Policy Statements*;

- To minimise the scope for surprises the Governor, where a policy decision is likely to surprise, inform you of the decision as soon as is practical;

- Opportunities for you to discuss with the Governor issues relating to monetary policy, and economic developments more generally, outside of the current MPS briefings;

- Opportunities for you to meet with the Reserve Bank Board from time to time to discuss matters relating to the Bank;

- The Reserve Bank and the Treasury should regularly exchange views on the economy, its current performance, the outlook and developments in the structure of the economy; and

- The Reserve Bank should provide timely briefings or reports to you on other matters of interest, particularly on financial market activity.

47. The development of this level of interaction is consistent with the principles of good relationship management for agencies in the state sector with a responsibility to exercise independent authority, and with the practice of other central banks. It should help build the trust and understanding necessary to maintain a constructive and effective relationship.

48. These relationship expectations could form part of the Governor's performance agreement. You could request the Bank's Board to review performance against these expectations and advise you and the Governor of the outcome of that review.

Consultation

49. We have discussed the recent performance of monetary policy with a number of economic commentators. In general they consider the Bank to have performed very well over the past two to three years or so. We believe that changes that reinforce the current operation of monetary policy and bring New Zealand's inflation target into line with other central banks would not be widely perceived as negative. Nevertheless any change that is seen as weakening the Government's commitment to price stability and leading to a materially higher average inflation rate, would be likely to be received negatively.

50. We have discussed the views in this paper with the Reserve Bank.

Next steps on the PTA and appointment process

51. There are a number of practical steps that will be required to finalise a new PTA. You or your office may wish to ensure that the Board is aware of the process that you intend to follow.

52. Prior to the process of formally agreeing with a Governor the details of the PTA you may wish to consult with your Cabinet colleagues and coalition partners on the general principles you will be seeking to incorporate. The Treasury can also provide more detailed PTA drafts if that would be useful. You may wish to inform the Board of these principles so that they can make potential candidates aware of your objectives before they make their final recommendation.

53. A Cabinet paper informing other Ministers of your intention to appoint a Governor will be required. A copy of the agreed PTA could be appended to this to ensure your Cabinet colleagues are informed before a public announcement is made. The Treasury can provide you with a draft of this Cabinet paper.

54. Closer to the time that a new Governor and PTA are publicly announced you will need to consider how to communicate to the public the impact of the new PTA on the operation of monetary policy.

55. We would welcome the opportunity to discuss and where necessary clarify any of the points in this report with you.