Review of the Reserve Bank Act

Release Document – The Reserve Bank Act 1989 and the role and evolution of the Policy Targets Agreement between 1990 – 2012

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This document is an internal Treasury paper which informed the Treasury's analysis and advice on the Policy Targets Agreement.

The Reserve Bank Act 1989 and the role and evolution of the Policy Targets Agreement between 1990 - 2012

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Executive Summary

1. The Policy Targets Agreement (PTA) is an agreement between the Governor of the Reserve Bank and the Minister of Finance that specifies the inflation objectives of the Reserve Bank. The Reserve Bank Act requires a new PTA on the appointment (or reappointment) of a Governor, and provides scope for the PTA to be reviewed and altered "from time to time". All Agreements are public documents. There is no requirement for the policy targets to be set in terms of inflation, but all PTAs have set inflation objectives in terms of the Consumers Price Index (CPI).

2. The first PTA, signed in 1990, closely reflected the intention of the reforms that underpinned the Reserve Bank Act 1989 – to bring inflation down to low single digits and to increase the Reserve Bank's independence and its accountability for the decisions it made in the pursuit of price stability. In the first PTA, it was expected that any departure of inflation from the target range would trigger a formal process of review of the Governor's performance – in this sense the PTA played a key role as an accountability document.

3. The PTA has been amended frequently since 1990. It has become common practice for a new PTA to be established not only with a Governor's (re)appointment but also with a change in Government. Amendments to the PTA have typically reflected New Zealand's economic developments and challenges as well as technical changes in the measurement of inflation and in the specification of the inflation target. The target has always been specified in terms of a range for the Consumers Price Index (CPI), although the width of the range has varied and the mid-point of the range was increased twice in the first decade of inflation targeting. In 2002 the timeframe to meet the target was made more flexible and in 2012, the mid-point of the 1-3% range was explicitly recognised as the objective for inflation over the medium-term. The desire to promote a more flexible framework is also reflected in the addition of secondary objectives "to avoid unnecessary instability in output interest rates and the exchange rate" and "to have regard to the efficiency and soundness of the financial system".

4. Overall, periodic refinements to the PTA have supported a more flexible and forward-looking monetary policy while preserving the broad conception of the PTA as a public accountability tool.

Introduction

5. The Policy Targets Agreement (PTA) is an agreement between the Governor of the Reserve Bank and the Minister of Finance that makes the price stability objective of the Reserve Bank Act into an operational target for monetary policy.[1] It is a public document conceived of as central to the Governor's responsibility to independently determine monetary policy and to be accountable for the inflation outcomes generated.

6. This paper explains how the Policy Targets Agreement came about, and how it has evolved.[2] Section 2 outlines the historical context that lead to the first PTA, and the key economic challenges and debates that have shaped subsequent amendments to the PTA. Section 3 details the changes made in each Agreement and the rationale for these.

The Reserve Bank Act 1989 and the role of the Policy Targets Agreement

Historical context – economic transformation

7. Inflation targeting arose from widespread dissatisfaction with the performance of the economy over the decade to 1984. The inflation rate averaged over 10 per cent for more than a decade and New Zealand's economic growth rate was the lowest in the OECD. Political and public recognition that New Zealand's high inflation did not result in faster growth was critical to pushing the new framework forward.

8. Prior to the mid-eighties, the Reserve Bank provided advice to the Minister of Finance, but was obliged to act as directed by the Minister in its regulation and control of money, credit, interest rates, foreign exchange and so on.[3] The objectives of monetary were:

   > "…the maintenance and promotion of economic and social welfare in New Zealand 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".

9. Reform of the Reserve Bank Act was an integral part of the major economic reform programme that, in its initial stages, was strongly influenced by the economic situation surrounding the change of government in July 1984. In the lead up to the 1984 election, existing policy settings created rising fiscal and current account deficits, which had driven speculation that the previously-pegged exchange rate would be devalued.

10. The change of government brought with it an immediate devaluation in the currency and within days, interest rate controls were largely removed. An extensive range of financial and economic reforms followed soon after. These included the floating of the New Zealand dollar and the assignment of monetary policy oriented to the primary objective of reducing inflation. The 1984 Budget set an objective to reduce the fiscal deficit over the next three years.

11. A year or so later, the Minister of Finance sought advice on options for reforming the Reserve Bank's legislative framework. The Minister had a desire to reduce the scope for

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[1] There is no requirement for the policy target to be an inflation target, although all PTAs have expressed the target in terms of inflation targeting.

[2] This paper builds on a number of similar accounts including, most recently, Lewis and McDermott (2016).

[3] New Zealand is cited as a prime example of political business cycle behaviour in Alesina et al (1993).

active political involvement in monetary policy decisions. In the 1988 Budget the Minister of Finance, Roger Douglas, announced his intention to reform the Reserve Bank Act in a way that was consistent with the general thrust of broader public sector management reforms introduced by the government. The objectives of the Reserve Bank reforms were to:

- further slow the pace of inflation and ensure that it remained low, and to "make certain that no future politician can interfere with the Bank's primary purpose of ensuring price stability, or manipulate its operations for their own purposes, without facing the full force of public scrutiny";

- increase the Bank's accountability for the decisions it made in the pursuit of price stability; and

- to separate the management of the Crown accounts from the operation of monetary policy.[4]

Independence, accountability and policy targets

12. The proposed institutional arrangements supported independence and reflected a desire to constrain the political involvement in monetary policy, within the framework of the convention that it was the prerogative of the government of the day to determine economic policy.[5] There was broad acceptance that price stability was an appropriate objective for monetary policy.[6] Moreover, there was a belief that policy credibility, and thus the net benefit of disinflation, would likely be enhanced by a clear and unambiguous objective that would better shape inflation expectations.

13. To focus the Bank on achieving the desired objective, the accountability mechanisms in the Act were strengthened. The Bank's monetary policy powers and responsibilities were vested in the Governor (rather than the Board), reflecting the principal-agent relationship underpinning wider state sector reform, and the responsibilities of the Governor, the Board, and the Minister were clarified and reshaped. One of the primary mechanisms for enhanced accountability was greater public transparency of policy decisions. The Governor was required to report regularly to the Minister, and to Parliament, on how the Bank would meet its (inflation) policy targets.

14. In addition, to enable the government to impose sanctions for poor performance, the Act made provision for the Governor to be dismissed from office. However, for clarity and accountability "stability" and the "general level of prices" need to be defined. The Policy Targets Agreement (PTA) fulfils that role. Thus the PTA is central to the Governor's employment contract. It provides the basis for assessing performance against public targets for inflation outcomes over the five-year employment term.

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[4] The Minister also announced a number of other landmark reforms to public sector management including the move to accrual accounting, enhanced financial reporting standards and a major programme of public asset sales.
http://www.vdig.net/hansard/archive.jsp?y=1988&m=07&d=28&o=55&p=55

[5] As reflected in the long title of the Reserve Bank Act.

[6] The Act allows the Government to direct the Bank to conduct monetary policy for a purpose other than price stability, for a period not exceeding 12 months, to be effected by Order in Council and tabled in Parliament. This would require a new PTA to be set for the duration of the Order in Council This provision has never been used.

15. The CPI was chosen as the price level measure because it was the most widely used and best understood measure. The PTA recognises that the CPI is only a partial measure of prices and requires the Bank to monitor a range of other price indices. The development of a specific price stability target was an organic process. It centred on a desire by the Minister of Finance to convey a commitment to low inflation that would influence inflation expectations, which led to a public announcement of his intention to direct monetary policy towards reducing inflation to the 0 to 1% range.[7]

16. Subsequently the Reserve Bank's analytical efforts concluded that price stability, in terms of the CPI, was likely to be "in the order of around 0-2%, as a result of several problems in the construction of the index". Although this was expressed as a range of uncertainty, it recognised that "price stability" was not something capable of exact definition. When coupled with the identification of shocks, such as the immediate effects of exchange rate movements on tradable prices and ongoing economic reforms, that could limit the desirability of achieving a given inflation targets, it was clear that the targets for monetary policy could best be considered as conditional. In 1988 the Bank concluded that:

> "a range rather than a point should be used to specify the objective. This recognised the imprecision of the whole business but also provided some guidance on the extent of likely fluctuations in the exchange rate. A band of 0-2% would strike a middle ground between the information value of the target range and the likely ability to actually manage the inflation rate".[8]

17. The first Policy Targets Agreement reflected a desire to focus policy on the end-goal (price stability by 1992), and the desire to tie the Governor's employment contract to that goal. This meant a requirement to renegotiate the PTA if events (including any change in GST, and large moves in the terms of trade) were to force monetary policy off track. It soon became apparent that not all contingencies could be well specified in advance, and that moreover, frequent renegotiation of the PTA could undermine the effort to build credibility and reduce inflation expectations.

18. The second PTA, agreed between the Governor and the incoming Minister of Finance In December 1992, removed the requirement for the PTA to be renegotiated in the event of a price shock, which had quickly proved to be unsatisfactory given events at the time such as volatile oil prices.[9] Instead, it provided a number of examples (or caveats) of the types of events (including increases in GST and large changes in the terms of trade) that the Reserve Bank should initially accommodate. The Bank was required to determine the impact of those events and explain how it would ensure inflation remained consistent with the objective.

19. The broad structure of the PTA signed by the incoming government in 1990 has proved enduring.[10] In particular, the inflation targeting concept, the caveats to achieving the

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[7] This reflected estimates of "true" price stability that omit bias in measuring CPI inflation of up to 1%.

[8] Reddell, M., (1999) "Origins and early development of the inflation target" RBNZ Bulletin Vol. 62 No.3

[9] Reddell 1999

[10] In 1995 Carl Walsh observed that "the similarity between an optimal dismissal rule and the Reserve Bank Act of 1989 suggests that New Zealand may, in fact, have achieved an optimal central banking structure". However, he expressed two reservations. First, while the Governor may achieve the price stability target, the weight the Governor places on inflation volatility relative to output volatility may not be the socially optimal weights. Second, there was scope to renegotiate in the event the Governor mis-judged the impact of shocks. JMCB vol. 27 No. 4.

target and the accountability structures have been broadly stable. However, there have been a number of changes to the PTA over time, generally in the direction of providing the Governor with greater flexibility in responding to shocks. At the same time the sharp focus on the Governor's accountability for achieving the target has been diminished.

Refining the framework

20. With "caveats" to achieving the target in place the Bank began to calculate a measure of "underlying inflation" that adjusted for these one off events (as well as for interest rates and housing cost movements in the CPI). However, this calculation was arbitrary, complex and non-transparent. The publication of a CPI excluding credit series (CPIX) afforded the Bank the opportunity to discontinue the publication of this measure.

21. The subsequent period leading up to the 1996 PTA was characterised by a very strong upswing in economic activity. Following a significant recession in the early 1990s, growth accelerated to 6.6% per annum in 1994 and averaged over 5.0% in the three years ending December 1996. Short-term interest rates rose from a low of 4.9% in late 1993 to 9.3% in early 1995 and continued to average over 9.0% through to the end of 1996. The exchange rate was similarly volatile, appreciating by 25%.

22. These movements were associated with a slowdown in export growth and a widening current account deficit that fuelled popular concern around the costs of keeping inflation within the 0-2% range. Political criticism of the Reserve Bank's performance led to calls for reform. As part of the discussions around the formation of a coalition government between the New Zealand First and National parties following the 1996 general election, New Zealand First proposed amending the Act to add an objective that monetary policy should support growth, and changing the target from 0-2% to target an inflation rate below New Zealand's trading partners.

23. The proposed change to the Act was resisted by the National Party[11] but the Minister of Finance and the Governor of the Reserve Bank agreed to widen the inflation target to 0 to 3%, and to add the growth objective to the PTA:

> "..the Bank shall formulate and implement monetary policy with the intention of maintaining a stable general level of prices, *so that monetary policy can make its maximum contribution to sustainable economic growth, employment and development opportunities within the New Zealand economy*". (New wording in italics).

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[11] The Treasury advised:

> "Adding this new objective to the Act runs very serious risks. People would expect that by changing the objectives of the Act [there would be] some change in the operation of monetary policy...The letter of the law would lead the Governor to make no changes in the operation of monetary policy because the evidence suggests that maintaining price stability is the best thing he or she can do to support high rates of *sustainable* economic growth". (italics in original).
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> The Treasury concludes that "New Zealand's monetary policy framework under the Reserve Bank Act…is superior to other frameworks around the world because it minimises the potential for following inconsistent policy objectives".
>
> Regarding the inflation target, the Treasury observed that "internationally and domestically there is some debate about whether targeting price stability on 0-2% inflation is better than some slightly higher or wider range (say by 1%)".

24. Concerns with the exchange rate and monetary management persisted as the economy experienced a shallow recession in 1998.[12]

25. Dissatisfaction with the experience over the 1990s, particularly the volatility of the exchange rate and interest rates influenced the 1999 PTA, which broadened the Bank's responsibility in meeting its inflation target to "…seek to avoid unnecessary instability in output, interest rates and the exchange rate", and gave rise to an external review of monetary policy.

26. The external review, conducted by Lars Svensson in 2001, examined the conduct of monetary policy (among other matters required by the terms of reference).[13] He found that while policy may have had shortcomings in the past "monetary policy in New Zealand is currently entirely consistent with the best international practice...". Consequently, "only some marginal changes, mostly of a technical nature, are recommended". One of these recommendations was that the inflation target be modified to "increases in the CPI of 1.5 percent over the medium-term".

27. The appointment of a new Governor in late 2002 provided an opportunity to negotiate a new PTA and consider Svensson's recommendations. The Government wanted to move New Zealand's monetary policy framework closer to Australia's,[14] which had a higher mid-point and narrower range than that advocated by Svensson. In addition, an increase in the floor of the target range could be justified by measurement issues and a concern that low average inflation could restrict the ability of monetary policy to stimulate the economy.

28. The 2002 PTA revised the policy target to be

> "to keep future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium-term".

29. Svensson also recommended the Bank's accountability arrangements be strengthened. Subsequently, legislative changes saw the Governor removed as chair of the Board and a non-executive chair as a replacement. Among other changes, the non-executive members of the Board were required to publish their assessment of the Bank's performance.

30. Concern with the impacts of monetary policy on the real economy did not abate following these changes. Between 2002 and late 2005 the exchange rate appreciated 30% and, with some respite in 2006, held at historically elevated rates until 2008. Short-term interest rates rose from under 6% to almost 9% as the Bank sought to achieve its inflation mandate.

31. Rapid house price inflation and associated growth in credit and consumption were considered significant drivers of inflationary pressure. In response to these concerns the

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[12] Lars Svensson's review would later conclude "[monetary policy over the 1997 and 1998 period] certainly involved more interest rate volatility than necessary and possibly some unnecessary output volatility too".

[13] See Appendix A Svensson, E.O., (2001) Independent Review of the operation of monetary policy in New Zealand: Report to the Minister of Finance http://www.treasury.govt.nz/publications/reviews-consultation/monpolreview

[14] Governor-General's speech, at the opening of the 47th Parliament, 22 August 2002, http://www.vdig.net/hansard/archive.jsp?y=2002&m=08&d=27&o=5&p=5

Bank continued to investigate the use of instruments other than interest rates that might impact house prices and consumer demand and take pressure off the exchange rate. These included exchange rate intervention powers[15], and “supplementary stabilisation instruments”.[16] However, these were generally considered either ineffective or undesirable.

32. In 2007 a Parliamentary Inquiry into the future monetary framework was established. The inquiry reflected public concern that despite increases in interest rates and an exchange rate that was historically high “inflationary pressures were expected to persist and monetary conditions to remain firm".[17] The findings of the inquiry were generally supportive of the current framework.[18] However, there was some support to consider whether greater use could be made of prudential instruments.

33. The role of the housing market in the build-up of financial market imbalances and the subsequent credit contraction over the 2000s was reflected in the 2012 PTA with the incoming Governor, which required him to monitor asset prices and “have regard to the efficiency and soundness of the financial system” when implementing monetary policy. It also gave rise to a Memorandum of Understanding between the Minster and the Governor on macro-prudential policy.

34. The 2012 PTA also reflected some discomfort with the higher average inflation rate over the 2000s than the previous decade, and sought to better anchor inflation expectations by adopting a focus on the 2% mid-point of the target.

> “keep future CPI inflation outcomes between 1 per cent and 3% per cent on average over the medium-term, *with a focus on keeping future average inflation near the 2 per cent target midpoint”* (2012 addition in italics)

Description of main changes

35. This section summarises the main changes, and the rationale for these, in each agreement since the first PTA in 1990. There have been minor variations in almost all new PTAs. Some changes to PTAs have been made for technical reasons (e.g. reflecting changes in the calculation of the CPI) whereas others have been more substantive (e.g. reflecting changing preferences or in response to economic developments). Collectively, all of the amendments resulted in a significant shift from stricter inflation targeting towards more flexible inflation targeting over time.

36. All PTAs have set out the following basic features:

- the policy objectives (price stability, and sometimes the Government’s economic objectives). Consistent with the RBNZ Act, all PTAs are based on the underlying assumption that the so-called long-run Phillips curve is vertical (in the long run,

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[15] The Governor’s letter to the Minister of Finance, 30 March 2004, details the Bank’s foreign exchange market policy http://www.rbnz.govt.nz/markets-and-payments/foreign-reserves/intervention/letter-to-dr-cullen-on-foreign-exchange-market-intervention-policy

[16] See http://www.treasury.govt.nz/publications/informationreleases/monetarypolicy/ssi and http://www.treasury.govt.nz/publications/research-policy/conferences-workshops/testingstabilisationpolicylimits

[17] Report of the Finance and Expenditure Committee (2008) “Inquiry into the future monetary policy framework” 48th Parliament.

[18] The findings were published in September 2008, in the midst of the global financial crisis.

monetary policy can only affect inflation and not real variables like output and employment).

- The target itself (the range as well as the index to be targeted, usually CPI inflation). All PTAs have recognised that there is a cost of targeting inflation too precisely, and therefore have had a target band for inflation rather than a point.

- Shocks that might cause inflation to vary from the target. All PTAs have recognised that the Bank should not respond to temporary supply-side or cost-push factors that affect the economy, unless these feed through into inflation expectations, because doing so would have a large output cost. Examples of these factors have often been mentioned explicitly.

- A range of "implementation" issues (which has often include clauses around communication, transparency and accountability).

37. Over time there has been greater recognition in the PTA of the short-run trade-off between the variability of output and the variability of inflation. This has implicitly allowed the Bank to vary the time horizon over which to return inflation to target following a shock. In achieving price stability, the Bank must:

    - avoid unnecessary instability in output, interest rates and the exchange rate. This trade-off is usually minimised by aligning the policy horizon to the lags with which monetary policy can influence inflation. A very short policy horizon risks unnecessary output volatility, while too long a horizon risks destabilising inflation expectations; and

    - take into account soundness and efficiency of the financial system (targeting a longer time horizon allows for more "leaning" against credit/asset price pressures).

38. In the first Policy Targets Agreement in 1990, it was expected that any departure of inflation from the target range would trigger a formal process of review of the Governor's performance, and so the PTA was expected to play a key role as an accountability document. In the early 1990s when there were two breaches of the 0-2% annual target band, there was a formal exchange of open letters between the Board of the Bank and the Minister of Finance regarding the adequacy of the Governor's performance. Later PTAs were more tolerant of inflation breaching the target range, and subsequent breaches resulted in fewer questions being asked about whether the Bank was failing to meet the PTA.[19]

39. The average level of the inflation target has shifted up over time, bringing the target more into line with inflation targets subsequently adopted in many other countries. Lifting the lower bound of the target from 0 to 1 percent partly recognised that at extremely low or negative rates of inflation, the volatility trade-off probably worsens,[20] and concerns about downward nominal rigidities.

40. The Reserve Bank Act requires a new PTA only on the appointment (or reappointment) of a Governor. Although it is not required by the Act, it has become common practice for a new PTA to be established on the appointment of a new Minister (at least upon a change of government).

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19 See White (2013).

20 See Hunt (2004).

March 1990 PTA

(Minister of Finance, Hon David Caygill, and Governor Dr Don Brash)

41. The first PTA was signed by Don Brash as Governor. This PTA was signed at a time when actual inflation (excluding interest rates) was over 7%, and had been in double digits for much of the previous decade. It required the Bank to achieve price stability by the end of December 1992. This PTA was very prescriptive and did not permit any deviations of inflation from target, which is now characterised as a "strict inflation targeting" regime.

42. The PTA was structured into four categories:

- Inflation Targets – which included a range of 0-2% to be achieved by December 1992. After taking into account measurement bias inherent in the construction of the CPI of around 1%, this target was considered consistent with true price stability.[21]

- Measurement of inflation – the formal target was for the Consumers Price Index because it is the most visible and widely understood price index monitored by the public. However, because New Zealand's CPI measure at the time included some investment prices (notably related to housing), the Bank was required to calculate an alternative measure of consumer prices based on an internationally comparable approach.

- Variations to Targets – this section outlined a list of events that would trigger a renegotiation of the targets (e.g. changes in indirect taxes, the terms of trade, a crisis or natural disaster).

- Implementation – a list of the considerations the Bank must take into account when implementing monetary policy, including the efficiency and soundness of the financial system. It also included a clause that said if the actions of any other party (including Government) may have an adverse effect on the achievement of the policy targets, or may increase the economic or social costs of achieving the policy targets, or may prejudice the efficiency or soundness of the financial system, the Bank shall consult with that party in an attempt to change that party's actions as necessary to reach the desired policy outcomes at minimum cost.

December 1990 PTA

(Minister of Finance, Hon Ruth Richardson, and Governor Dr Don Brash)

43. The second PTA was signed following a change of governing party in Parliament.[22] The new agreement recognised that inflation might move outside of the 0-2% range in response to particular shocks.[23] Rather than requiring a re-negotiation of the target in the

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21 See Mayes and Riches (1996), and White (2013).

22 Although a new agreement is required whenever a Governor is appointed or reappointed, it may be revised or replaced by mutual consent of the two parties. In practice, incoming governments have often sought a new agreement.

23 The principal shocks were significant changes in the terms of trade, a change in indirect tax rates, a crisis such as a natural disaster, changes to government or local authority levies, or a divergence between the CPI and the Bank's calculated housing-adjusted CPI (reflecting issues with the calculation of the CPI at the time).

event of one of these shocks, the Bank would need to be fully accountable for its handling of the price effects of shocks that caused inflation to move outside of the band. It was required to detail its estimate of the direct price impact of any such shock, and the measures it has taken, or proposed to take, to ensure that the effects of such shocks on the inflation rate are transitory.

44. The date for achieving price stability was also pushed out to December 1993.

45. The long section on implementation from the first PTA was dropped, and replaced with two separate sections:

- Renegotiation of the targets – which stated that the targets are established on the understanding that the monetary policy instruments available to the Bank are adequate to achieve the objective, and that the Governor shall inform the Minister if he considers that any changes in these policy instruments impair the effective conduct of monetary policy, which may lead to new policy targets being set. This clause enabled the Bank to request agreement on a new policy target if the Governor felt that his ability to deliver the agreed target had been impaired by some change in the availability of policy instruments. At the time, there was concern that the Crown Settlement Account might move to a private sector bank and that this might impair the Bank's ability to influence monetary conditions.

- Implementation, which included “The Bank shall implement monetary policy in a sustainable, consistent and transparent manner” (which is still in the current PTA), and that each MPS should contain a statement of how the Bank will maintain price stability over the succeeding five years.

1992 PTA

(Minister of Finance, Hon Ruth Richardson, and Governor Dr Don Brash)

46. The CPI inflation target was achieved more quickly than expected – in September 1991. A new PTA was signed in December 1992, on the Governor’s re-appointment, requiring that price stability now be maintained. There were some minor changes in this PTA, including:

- The Bank was no longer required to calculate a Housing Adjusted Price Index, as the price indicator for dwellings in the CPI was adjusted to reflect the price of constructing a new dwelling only (with the land price being excluded). Prior to the revision, the price changes of previously occupied dwellings and the cost of the land on which new houses are built were also included.

- Wording around when targets might be reset was adjusted to “The Governor shall inform the Minister if he considers that any changes in the availability or effectiveness of these policy instruments impair the conduct of monetary policy”

- Other wording updates to reflect that price stability has now been achieved.

1996 PTA

(Minister of Finance, Rt Hon Bill Birch, and Governor Dr Don Brash)

47. The PTA was amended following negotiations over the formation of the first coalition government in New Zealand, following the first election under MMP. The PTA was signed

by the Rt Hon Bill (now Sir William) Birch, Minister of Finance, on behalf of the Rt Hon Winston Peters (Treasurer-elect). Two main changes were:

- Extending the range to 0-3% (previously 0-2%).

- Adding an explanation of why the Bank shall maintain price stability … "so that monetary policy can make its maximum contribution to sustainable economic growth, employment and development opportunities within the New Zealand economy". This makes clear that price stability is the best contribution that monetary policy can make to economic growth and employment, and not simply an end in itself.

48. The expansion of the target range resulted in a widening of the range as well as an increase in the midpoint of the target. This is despite the two largest parties in Parliament advocating a mid-point of 1 percent during the election campaign. The change was criticised by those who thought the increased midpoint was inconsistent with the intent of the requirement for price stability in the Reserve Bank Act, and also by those who thought the focus of monetary policy remained too narrow and the target too low.[24]

49. In explaining the changes, Governor Don Brash argued:

- Regarding the level of the inflation target, there is currently no consensus between the "low positive" inflation school of thought and those arguing for a lower level of inflation. The arguments for a "low positive" rate included measurement bias, nominal wage rigidities, and the risk of the zero lower bound. The arguments for a lower target were based on the costs of inflation through exacerbating bias in the tax system, and proponents of this view disputed the benefits of "low positive" inflation. Nevertheless, reflecting the experienced economists on each side of the debate, Governor Brash thought that a 0-3 percent target seemed to be consistent with the intention of the legislation

- There may be some benefits from a wider inflation target through allowing less activist monetary policy, but only if inflation expectations remain well anchored. To this end, Brash emphasised that the Bank intends to aim to have inflation as close to the middle part of the range as possible.

1997 PTA

(Treasurer, Rt Hon Winston Peters, and Governor Dr Don Brash)

50. A new Policy Target Agreement was signed following the re-appointment of the Governor. The major change is that the 0 to 3 per cent inflation target would now be measured using the CPIX measure of inflation — CPI inflation excluding credit services (principally mortgage interest rates). Given that most of the difference between headline inflation and underlying inflation is due to interest rates, the Bank would no longer need to calculate its "underlying inflation" measure.[25] Other minor changes included:

- Updating references to sections in the Reserve Bank Act.

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[24] Brash (1997)

[25] The RBNZ used to calculate 'underlying inflation', deducting interest rates and some other significant changes from the official CPI, consistent with the intent of the PTA (e.g. `significant changes in the terms of trade', changes in the rate of GST or a `significant change in other indirect tax rates', and `a significant price level impact arising from changes to government or local authority

- Referring to the Governor's next term, to expire on 31 August 2003.

- Noting that future changes to the target index may be needed depending on further proposed changes to the CPI to be introduced in 1999.

- Shortening the section around unusual events that might cause inflation to deviate from the target and the requirement for the Bank to detail its estimate of the direct price impact of significant shocks. This was replaced with a requirement for the Bank to react to shocks "in a manner which prevents general inflationary pressures emerging". The heading was changed from "Deviations from the targets" to "Unusual events". This was intended to show that these events were illustrative of the kind of factors which might produce such a result, and are not intended to be a complete list of such factors.

- The section "Renegotiation of the Targets" was dropped as it was no longer relevant.

- The requirement for the MPS to state how the Bank proposes to formulate and implement monetary policy to ensure that price stability is maintained over the succeeding five years was removed, and replaced with two new clauses: "The Bank shall constantly and diligently strive to meet the policy target established by this agreement", and "The Bank shall be fully accountable for its judgements and actions in implementing monetary policy". These changes make the Bank's responsibility for the implementation of monetary policy, and its accountability for the judgements and actions taken, unambiguous.

1999 PTA

(Treasurer, Hon Dr Michael Cullen, and Governor Dr Don Brash)

51. A new PTA was signed following the election of a new Government. The major change is the introduction of a new clause 4(c): In pursuing its price stability objective, the Bank shall implement monetary policy in a sustainable, consistent and transparent manner and shall seek to avoid unnecessary instability in output, interest rates and the exchange rate.

52. This PTA also changed the target from CPIX to CPI, following the introduction of a revised CPI regime from the September quarter, 1999 by Statistics New Zealand.

2002 PTA

(Minister of Finance, Dr Hon Michael Cullen, and Governor Dr Alan Bollard)

53. A new PTA was signed following the appointment of Alan Bollard as Governor. This PTA introduced some reasonably significant changes towards a more future/medium-term focus.

    - The target itself was changed from annual inflation between 0-3% to "future CPI inflation outcomes between 1-3% on average over the medium term". Wording throughout was changed to this "medium-term" language, to make clear that the Bank would return inflation to the target gradually following a shock. The medium-term

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levies'). However, this led to a perception in some quarters that the Bank was potentially able to manipulate the measure of inflation on which the Bank's, and the Governor's, performance was judged. It was also difficult to measure the impact of some supply shocks.

focus implies somewhat ‘softer edges’ to the target band, with the Bank able to tolerate inflation outside the band if this does not compromise price stability over the medium-term.[26] The clause requiring the Bank to constantly and diligently strive to meet the policy target was dropped. The lower bound was raised to 1% to recognise that at extremely low or negative rates of inflation, the volatility trade-off probably worsens.

- The statement “so that monetary policy can make its maximum contribution to sustainable economic growth, employment and development opportunities” was removed, and replaced by a Statement of the Government’s economic policy objective: “The objective of the Government's economic policy is to promote sustainable and balanced economic development in order to create full employment, higher real incomes and a more equitable distribution of incomes. Price stability plays an important part in supporting the achievement of wider economic and social objectives.”

2007 PTA

(Minister of Finance, Hon Dr Michael Cullen, and Governor Dr Alan Bollard)

54. A new PTA was signed when the Governor was re-appointed, but no changes were made from the previous PTA. However, it was signalled that changes might arise from the select committee inquiry into monetary policy.

2008 PTA

(Minister of Finance, Hon Bill English, and Governor Dr Alan Bollard)

55. A new PTA was signed following the election of a new Government, to update the statement of Government policies: “The Government's economic objective is to promote a growing, open and competitive economy as the best means of delivering permanently higher incomes and living standards for New Zealanders. Price stability plays an important part in supporting this objective”

2012 PTA

(Minister of Finance, Hon Bill English, and Governor Graeme Wheeler)

56. A new PTA was signed when Graeme Wheeler was appointed as Governor. Three changes were made in 2012. These changes drew on advice from the Treasury and the RBNZ to reflect lessons from New Zealand's last economic cycle and the Global Financial Crisis. The changes were:

    - Adding to the 1-3% medium-term target “a focus on keeping future average inflation near the 2 per cent target midpoint”, to help better anchor inflation expectations

    - Explicitly mentioning asset prices as being among the range of price indices the Bank should monitor

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[26] Hunt 2004

- Adding “have regard to the efficiency and soundness of the financial system” to clause 4(b) (which had appeared in the very first PTA but not subsequent PTAs, although it is included in the RB Act).

57. The addition of the midpoint attempted to better anchor inflation expectations following a period where inflation and inflation expectations had drifted up over the past decade and averaged near the top of the target band. It recognises that well anchored inflation expectations can assist monetary policy by ensuring that wage demands and price setting behaviour are more likely to be consistent with the target and/or will respond more quickly to the signals provided by a change in the OCR. Thus, monetary policy is able to be less aggressive, and the transmission mechanism quicker/more effective with less monetary intervention required.

58. The increased focus on financial stability makes it clearer that it may be appropriate to use monetary policy to lean against the build-up of financial imbalances, if the Reserve Bank believes this could prevent a sharper economic cycle in the future. This will help to ensure that should a situation arise again in the future where credit growth is rising rapidly while CPI inflation is subdued, the Bank should be explicitly cognisant of the potential risks that could be building when setting its monetary policy. This is separate from and regardless of any potential use of macro-prudential tools to lean against credit growth. Although the previous PTA did not prevent the Bank from taking this approach, it was thought that a new clause would give the Bank a clearer mandate to allow monetary policy to lean harder against credit growth in advance of stronger activity appearing in the CPI inflation. This could help achieve greater stability over a longer time frame.

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