WHO SHOULD CONTROL MONETARY POLICY:

POLITICIANS OR CENTRAL BANKERS?

Two months ago, the New York Times ran a lengthy article on the occasion of the 25th anniversary of the passage into law of the Reserve Bank of New Zealand Act in 1989. The article attributed to that legislation the start of inflation targeting – the policy of central banks targeting a nominated rate of inflation, normally an increase in some version of the Consumer Price Index. And certainly the Reserve Bank of New Zealand has a strong claim to be the central bank which first formally targeted a publically announced rate of inflation. As most of you will know, inflation targeting has since become the almost universal approach to monetary policy implementation of central banks all over the world.

But in fact, the 1989 Reserve Bank of New Zealand legislation did not specifically require inflation targeting, not at least in the sense it has come to mean around the world. That legislation simply required monetary policy to be focused on “achieving and maintaining stability in the general level of prices.” That in itself was somewhat novel, in New Zealand and I suspect in many other countries. In this country, the Fed operates under a so-called dual mandate as you know, asked to deliver both price stability and a high level of employment. In New Zealand prior to the 1989 Act, the law required the central bank to achieve a variety of objectives, including a high level of employment, economic growth, balance of payments equilibrium, and price stability. Many other central banks still operate under legislation which requires them to deliver on a range of economic and social objectives.

The 1989 legislation in New Zealand was formulated of course after the insight of leading American economists such as Milton Friedman and Edmund Phelps that, while a change in the rate of inflation can have a temporary effect on the unemployment rate, in the longer-term the rate of inflation has no enduring effect on the unemployment rate. And since economic growth is typically best when the price mechanism can work effectively, in other words when price changes reflect genuine changes in supply and demand, the best contribution
which monetary policy can make to economic growth is to keep inflation low and stable.

Hence the single focus on achieving and maintaining stability in the general level of prices.

But in some ways the more startling focus of the 1989 Act was on the appropriate relationship between the government and the central bank. Prior to 1989, as again most of you will know, central banks were of two kinds. A small number – like the Fed, like the Bundesbank in Germany, and like the Swiss National Bank – were completely independent of the political process. Fed Governors are appointed by the President, subject to the approval of the Senate, but once they have started their 14 year terms there is no way in which the Administration can bring pressure on them. The President might want the Fed to ease monetary policy, or to refrain from tightening, or even in principle (though much less likely!) to tighten policy more aggressively, but he can only cajole or attempt to persuade, perhaps using the media to do so. He cannot direct.

The other kind of central bank was much more common – it provided advice to the Minister of Finance or Treasurer and it implemented whatever policy the Minister determined, but the Minister could, and frequently did, ignore the central bank’s advice entirely. I refer to this as the old Bank of England model. The Reserve Bank of New Zealand was of this kind, as indeed were most of the central banks in the world – indeed, a great many are still of this kind.

The 1989 Reserve Bank of New Zealand Act pioneered a totally new model. The history of the previous few years explains why. In the seventies and much of the eighties, New Zealand had some of the worst inflation in the developed world. It was never like inflation in Zimbabwe of course, but was frequently into double figures and over almost the entire 20 year period was above the average of developed countries. Despite that, or indeed perhaps because of that, our economic growth had tended to be the slowest of any developed country. So it was difficult for people to argue with a straight face that enduring a bit more inflation would pay a dividend in the form of higher growth.
Not only had inflation in New Zealand been higher than that in other developed countries without any obvious growth pay-off – if anything, a negative effect on growth – inflation had had a tendency to bear an uncanny resemblance to the political cycle, or rather monetary policy had. When the reforming Labour Government came into office in 1984, they revealed that during the previous election year in 1981 the central bank had given explicit warning to the then National Government that inflationary pressures were building strongly, and monetary policy should be tightened. This advice was, of course, provided to the Minister of Finance on a confidential basis; and it was ignored. After the 1981 election, the same Minister (who was also Prime Minister) feigned surprise at the way inflation was increasing and imposed quite draconian controls on prices, rents, dividends and wages.

The Labour Government which came to office in 1984 was the most reforming government New Zealand had ever seen – and none has come close since. It removed quantitative import controls; started a phasing out of most tariffs; radically reduced income tax rates (the top personal tax rate dropped from 66% to 33%, and the corporate rate dropped from 45% to 33%) in return for the removal of umpteen concessions and special tax breaks; introduced a value added tax with virtually no exemptions; abolished export subsidies; floated the exchange rate; provided property rights for fishing quota; scrapped remaining controls on prices, rents, dividends and wages; privatised the telecommunications company, the railroad system, and several other large government-owned companies; and, important for our discussion today, instructed the Treasury and the Reserve Bank to come up with a way whereby never again could monetary policy be manipulated for political purposes.

I was not myself at the central bank at that time, so can take none of the credit for what happened over the next couple of years. Several people from the central bank toured the world, talking to economists and other central bankers, and eventually what emerged was the framework which was incorporated in the 1989 legislation.

What that law required in terms of monetary policy had several features.

First, it required monetary policy to be focused solely on “achieving and maintaining stability in the general level of prices”. There was no reference to
economic growth, or employment, or balance of payments equilibrium, or motherhood, or anything else.

Second, it required that what “achieving and maintaining stability in the general level of prices” meant was to be determined in a written agreement between the Minister of Finance on behalf of the government on the one hand and the Governor of the central bank on the other. And perhaps it was that requirement which could be said to have made inflation targeting, or something like it, inevitable.

The Minister of Finance had already said, in the context of a television interview on 1 April 1988 (exactly five months before I became Governor in September that year), that he would not be content to settle for getting inflation below 10%, or even to 5 or 7%, but wanted inflation at “0 or 0 to 1%”. I don’t now recall exactly how we decided in the end on 0 to 2% as the target, but at least in part we rationalised that, with the recognised upwards bias in the Consumer Price Index – estimated in this country at around 1% I understand – 0 to 2% was effectively genuine price stability plus or minus 1%.

Of course, the first so-called Policy Targets Agreement, like all the subsequent ones, had “caveats” to allow for measured inflation being kicked around by factors over which monetary policy has no influence – changes in indirect taxation, sharp changes in the international oil price, etc. But quite quickly “0 to 2 by 1992” became the mantra and in fact the increase in the CPI fell within that range by the end of 1991.

The third, and in some ways most crucial, component of the new framework was a requirement for a very high level of transparency. The written agreement between Minister of Finance and Governor had to be made public shortly after its signature. In other words, there was to be no scope for the Minister telling the Governor to ease up on monetary policy in the lead up to a general election – or rather, if he did that, the instruction would have to be known to everybody.

In fact, the legislation does provide for a so-called “over-ride” of the agreed Policy Targets Agreement by the Minister of Finance but it requires that to be done in public, and it would be a brave – not to say foolhardy – Minister of
Finance who publically instructed the central bank to increase the inflation rate: the result would almost inevitably be a flight from the New Zealand dollar, an increase in interest rates (at least long-term interest rates), and a decrease in equity prices. Hardly a vote-winning move, and the over-ride has never been used.

The Act also required the Bank to issue a detailed statement about how it saw the inflation outlook at least every six months, and from an early date we issued such monetary policy statements every quarter. In those statements, we projected what monetary conditions would need to do to keep inflation aimed at the centre of the agreed inflation target. So effective were these statements that for the first decade after the Act was passed we did not even attempt to control a single interest rate. For the most part, monetary conditions moved in a way consistent with the delivery of the inflation target because financial markets understood that the Reserve Bank could, and if necessary would, adjust the amount of settlement cash in the clearing accounts held by the banks at the central bank if monetary conditions did not move in the desired direction. It was in a sense the ultimate no hands central banking!

In the 25 years since the first Policy Targets Agreement was signed there have been some changes. The target range has been changed from 0 to 2%, to 0 to 3% (the widening of the range being recognition of the volatility of prices in a very small open economy), to 1 to 3% “over the medium term”. In other words, the centre of the inflation target in New Zealand is now 2%, not 1%, and indeed virtually every other central which has adopted inflation targeting – and in the developed world almost all have, explicitly or implicitly – has a target with the same mid-point.

Once the inflation target has been agreed between Minister and Governor, the Act gives the Governor complete independence over the implementation of monetary policy. In the jargon, the RBNZ was given instrument independence but not goal independence.

Actually, it was the Governor of the RBNZ who was given instrument independence – personally. And this was another important component of the Act. In keeping with the general direction of public sector reform in New
Zealand at that time, the Governor as chief executive of the Bank was given freedom to act without reference to the Minister, but with that greater freedom went increased accountability.

I well recall when the legislation was still being drafted I expressed surprise to the Minister that the legislation provided for an agreement between the Minister and the Governor, not between the Minister and the Bank. The Minister explained that he couldn’t fire the whole Bank; realistically he couldn’t even fire the whole Board of the Bank; but he sure as hell could fire me!

So the 1989 Act provides for all decision-making around monetary policy implementation to be vested in the Governor personally. The Board of the Bank has no involvement in the decision-making, and nor does the Bank’s Monetary Policy Committee. The Monetary Policy Committee meets regularly to advise the Governor, but the decisions are the Governor’s. The Board of the Bank meets regularly to monitor the Governor’s performance against the target laid down in the Policy Targets Agreement, but the decisions are the Governor’s. And if the Governor fails to deliver the inflation which has been formally agreed with the Minister, and can’t provide a reasonable reason for that failure – such as a dramatic change in the international oil price or a change in the indirect tax regime – he is liable to be dismissed.

I believe the structure is a very good one. Everybody – including of course wage and price setters in the wider public – is clear about the inflation rate which should be delivered. Politicians are effectively prevented from meddling in the implementation of policy to achieve a publically announced inflation goal. And the person given the freedom to deliver that goal is held accountable for the outcome.

There are some risks in giving all the power over monetary policy to a single individual. In 2000, the newly-elected Labour Government commissioned a detailed review of the structure by Lars Svensson, a highly respected authority on monetary policy and of course on the faculty of this university for a number of years before he became Deputy Governor of the Swedish central bank in 2007. He was enthusiastic about the structure established by the 1989 Act but said that, while Don Brash had done a great job as Governor(!), New Zealand
couldn’t always expect to be so lucky and should move to have monetary policy decisions made by a committee. Interestingly, both the New Zealand Treasury and the non-executive directors of the Bank recommended against any change in the decision-making structure in the interests of keeping it absolutely clear where the buck stops.

Well, has the structure created by the 1989 Act worked?

There was initially huge scepticism on the part of the general public. The business community was nervous. The unions thought the single focus on price stability was absurd. Many of the staff of the central bank were extremely doubtful whether an inflation target as low as the one I had signed up to deliver was achievable.

But I have no doubt the structure has worked extremely well.

Most obviously, measured CPI inflation continued to fall steadily after the Act was passed until the agreed 0 to 2% target was reached in 1991. I say “continued to fall steadily” because the inflation rate had been falling even before the 1989 Act was actually passed because the Minister of Finance had given the Governor de facto independence to reduce the inflation rate well ahead of the passage of the Act; and indeed the 0 to 2% target had also been agreed before the Act was passed.

Yes, some have argued that the cost in terms of output and employment of achieving that goal was too high. Certainly, by 1991 unemployment had reached 11%, a level not seen in New Zealand since the Depression of the thirties, and at least some of that high level of unemployment must be attributed to the tight monetary policy which the Bank had been running for several years.

But there were undoubtedly many other causes for that high level of unemployment, including the complete removal of import controls and export subsidies, and the extensive loss of employment when several very large government-owned enterprises were privatised.

Tight monetary policy undoubtedly contributed to that high level of unemployment however – I don’t want to deny that. I know of no case where
a country has been able to radically reduce long-entrenched inflation *without* a temporary increase in unemployment.

To me, the key question is: Did the new framework, with a very publically announced inflation rate, with the explicit message that the Governor would be dismissed for failing to deliver that low inflation rate, help to reduce inflationary expectations, and so influence price- and wage-setting behaviour? In other words, did the new framework help to reduce the social and economic costs of achieving a very low inflation rate?

I can’t prove that it did of course, but the anecdotal evidence is reasonably strong. Certainly the head of the trade union movement toured the country not long after the Act was passed deploring the single focus of monetary policy on keeping inflation under control, but pointing out very bluntly that unemployment would rise substantially unless increases in wages quickly became consistent with the new inflation target.

And of course for most of the time since the Act was passed, CPI inflation has been within the agreed target range; inflationary expectations have been consistent with inflation continuing in that range; unemployment has been lower than in most other developed countries; and for a brief time yields on New Zealand Government New Zealand dollar-denominated bonds were actually below those on US Treasuries.

And what of the structure between government and central bank created by the 1989 Act? The essential features of that structure, though not the emphasis on the single decision-maker in the person of the Governor, have since been copied by Australia, Canada, the United Kingdom and Sweden. All have agreements between government and central bank requiring the bank to deliver a particular inflation outcome, with a high level of transparency about the goal which the central bank must deliver and total independence over how monetary policy must be implemented to pursue that agreed goal.

From the central bank’s point of view, that is a very good arrangement. It protects the central bank from criticism from the government – and indeed, from politicians more generally – unless the central bank proves unable to deliver the agreed target. In the almost 14 years during which I was Governor of the Reserve Bank of New Zealand, no Minister of Finance ever attacked the
Reserve Bank or me personally for having monetary policy too tight. They simply could not have done so with any credibility at all. They could only have done so had inflation outcomes – or projected inflation outcomes – been below the agreed inflation target. They never were.

I have no doubt that the extreme tensions which we’ve all seen surrounding the behaviour of central banks in the United States, the Eurozone, and Japan in recent years would have been greatly reduced if the relationship between government and central banks in those regions had been based on the kind of relationship between government and central bank established by the Reserve Bank legislation in New Zealand in 1989.

Let me make one more point in conclusion. Some will say that such a system would not work in the US because of the dual mandate under which the Fed operates. I would argue that the dual mandate itself is a nonsense. As is well understood in the literature, to achieve two goals there is a need to have two instruments, and the Fed has only one monetary policy instrument. In my view, the Fed should focus monetary policy on what monetary policy can sustainably do, namely deliver an inflation rate.

But surely, it may be objected, unemployment is a serious social evil and tolerating a bit of inflation is a small price to pay to keep it low. Certainly unemployment is indeed a serious social evil and governments should do everything in their power to create conditions which help to reduce it. But as most of you know, only an unexpected increase in the inflation rate can, by reducing real wages, lead to a temporary reduction in the unemployment rate. Increasing the inflation rate can never produce a permanent reduction in unemployment.

And of course keeping the inflation rate low and stable – which means preventing inflation falling below the floor of the agreed target as well as preventing it from exceeding the ceiling of the target – has the effect of avoiding situations where a lack of demand leads to unnecessary unemployment. So once low inflation has been achieved, a central bank which is trying to keep inflation within the agreed target range will look very much like a central bank which is also trying to keep unemployment low.
In short, in answer to the question “Who should control monetary policy – politicians or central bankers?” I say that politicians should establish what inflation they want for their country, be obliged to tell the public and financial markets what that target is, and then leave central bankers free to deliver that target – holding them to account if they fail to deliver!

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