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Central bank roles, operations and accountability

The Reserve Bank of New Zealand—regulatory powers

Independence

3.1 Like Australia's Reserve Bank the independence of the Reserve Bank of New Zealand (RBNZ) has bi-partisan support. It is enshrined in the *Reserve Bank of New Zealand Act 1989*.

3.2 Prior to the 1989 Act the RBNZ's powers had rested with the Bank's Board and the Board was charged with implementing the monetary policy of the government of the day. However, the 1989 Act gave the Bank the ability to make adjustments to monetary policy with 'operational autonomy'—no day-to-day political involvement. With the shift to independence the Governor of the Reserve Bank became accountable for the Bank's actions and as a consequence accountability and transparency measures became very important.

3.3 The framework of accountable autonomy is that the Governor is the primary decision-maker with the Board providing a monitoring role and reporting on the Governor's performance. The Board does not direct the Bank's policy. This differs from the Reserve Bank of Australia (RBA) where the Bank's Board is responsible for monetary policy decisions.

Role of the Reserve Bank of New Zealand

3.4 The RBNZ has three major roles. These include operating monetary policy to maintain price stability; promoting the stability of the financial sector and meeting the currency needs of the public.

3.5 The RBA's three major roles are very similar—operating monetary policy; maintaining financial system stability and promoting safety and efficiency of the payments system.

Primary role—monetary policy

3.6 The Bank's primary function is to ensure financial and economic stability through the operation of monetary policy. The RBNZ has been overseeing monetary policy since the Bank's inception in the 1930s.

3.7 Since March 1999 New Zealand monetary policy has been exercised through decisions by the Bank on the state of the official cash rate. The Bank affects the official cash rate by setting the interest rate on overnight loans in the money market, which affects the costs of borrowing and influences the level of demand in the economy.

3.8 The use of monetary policy is defined in the *Policy Targets Agreement* (PTA)[1]. The PTA is an agreement negotiated and signed by the Minister of Finance and the Governor of the Reserve Bank of New Zealand. The current PTA, signed on 24 May 2007, is designed to ensure price stability and it aims to achieve this by containing inflation within a target range of between one and three per cent 'on average over the medium term'.[2] New Zealand was the first of the developed countries to follow an inflation targeting regime, introduced in 1990. The target was initially zero to two percent, which the Bank achieved by 1992.

3.9 The PTA is similar to Australia's *Statement on the Conduct of Monetary Policy*, a statement which records the understanding between the Governor of the Reserve Bank of Australia and the Australian Government on key aspects of monetary policy. Both the RBNZ and the RBA sign a new agreement when a new Governor is appointed however the PTA has been changed intermittently, adopting different inflation target ranges on the

1 Made under section 9 of the *Reserve Bank of New Zealand Act 1989*.

2 Policy Targets Agreement 2007. Website viewed 22 August 2007, <http://www.rbnz.govt.nz/monpol/pta/3027051.html>.

agreement.[3] The PTA forms the basis of the accountability structure of the Reserve Bank of New Zealand. This is not the case in Australia.

3.10 The third Australian statement signed off on 18 September 2006 aims for medium term price stability with 'an objective of keeping consumer price inflation at between two and three per cent, on average, over the cycle'.[4] The RBA has been using this target range since 1993 to achieve the Bank's three main goals of maintaining the stability of the Australian currency; full employment; and economic prosperity and the welfare of the Australian people.[5]

3.11 The RBNZ reviews monetary policy eight times a year, every six weeks, whereas the RBA reviews the official cash rate monthly, excepting the month of January, when it does not meet. The New Zealand official cash rate may be changed at other unscheduled times as a response to economic shocks.[6]

Foreign exchange intervention as an additional monetary policy tool

3.12 The RBNZ has the power under the 1989 Act to intervene in the foreign exchange market to calm disorderly market behaviour or market dysfunction. This sort of intervention can also be used as a supplementary monetary policy pool.

3.13 There is considerable debate in New Zealand about the RBNZ's primary role in foreign exchange intervention and whether foreign currency intervention is an appropriate supplementary monetary policy tool.

3.14 During meetings on the visit the delegation heard views for and against RBNZ intervention in the forex market. This was topical at the time of the visit, the Bank having intervened in the foreign exchange market on 11 June 2007, selling New Zealand dollars to buy foreign reserves. This was the first intervention of this kind since the floating of the New Zealand dollar in March 1985.

3.15 The intervention in June was designed to flatten the value of the rapidly appreciating New Zealand dollar (at an all time high in real terms) which was impeding the competitiveness of price-sensitive New Zealand

3 Under section 12 of the *Reserve Bank of New Zealand Act 1989* the bank has the power to override the PTA for a period of twelve months.

4 *The Third Statement on the Conduct of Monetary Policy*, 18 September 2006. Website viewed 22 August 2007, <http://www.rba.gov.au/MonetaryPolicy/>.

5 Enshrined in the *Reserve Bank Act 1959.*

6 As exhibited by the RBNZ after the 11 September 2001 terrorist attacks in America.

exports.[7] Foreign currency was flooding in to take advantage of the high cash rate in New Zealand—running at 8.00 per cent in June 2007.[8]

3.16 At the time of writing New Zealand has the highest official cash rate in the industrialised world. As a result of this there has been heavy speculative activity in the New Zealand currency market which has inflated the value of the dollar beyond the appreciation accruing from dairy and associated primary industry commodity price increases.

3.17 Much of this speculative activity is coming from high saving countries like Japan (where the Yen has been at five year lows against the US dollar) and from the oil nations where the interest rate differential is significant. This has happened in both New Zealand and in Australia but the New Zealand differential has been greater than Australia's. Both markets are seen as good risks with the Governments' and banks stable and having strong central banks.

3.18 In June 2007 the Reserve Bank of New Zealand decided that the high exchange rate could not be sustained for the medium term. The level of the exchange rate was not analogous with other economic indicators including, inter alia, New Zealand's current account deficit which stood at around nine per cent of GDP in that month. The June action sent a signal to the market that speculation on the New Zealand dollar held risks.

3.19 The conundrum the Reserve Bank of New Zealand faces is how to reign in domestic inflationary pressures through tighter monetary policy but without unduly straining the export sector (particularly non-commodities exports) through an increase in the already high exchange rate.

3.20 The Deputy Governor, Mr Grant Spencer noted about the intervention:

> The Bank's primary monetary policy instrument is the Official Cash Rate (OCR). The foreign exchange intervention framework provides an additional tool for the purpose of trying to moderate the extremes of the exchange rate cycle.[9]

3.21 The RBNZ's foreign exchange intervention seeks to moderate peaks where the exchange rate does not reflect the true economy. The Bank's policy is to intervene only when the exchange rate is at 'exceptional levels'; when it is unjustified by medium term economic fundamentals; when intervention is

7 Although commodity prices have been high, export volumes have not been increasing. This may be linked to reduced investment in businesses.

8 The RBNZ moved the cash rate to 8.25 per cent on 26 July 2007 due to increasing domestic inflationary pressures.

9 Opinion article by Reserve Bank Deputy Governor Grant Spencer, 27 June 2007. Website viewed 24 August 2007, <www.rbnz.govt.nz/speeches/3049397.html>.

seen as consistent with the Policy Targets Agreement; and when market conditions make intervention opportune.[10]

3.22 The RBA has no history of using foreign exchange intervention as a supplementary monetary policy tool. However, since the floating of the Australian dollar in 1983 the RBA has intervened in the foreign exchange market on a number of occasions either to help drive equilibrium in the market, typically where the market has "over-shot" and asset prices have moved to levels 'that do not seem reasonable in the context of a range of economic and financial developments'[11] or where conditions 'threaten to create market disorder'.[12] Akin to the policy of the Reserve Bank of New Zealand this sort of intervention is not designed to achieve a particular level of exchange rate.

Accountability and transparency

3.23 Besides the formal scrutiny by the Board over monetary policy there are a number of other avenues of monitoring performed on the actions of the Reserve Bank of New Zealand. The New Zealand central bank's 1989 legislation has a greater emphasis on providing accountability of the Bank meeting mandated objectives than it does on the Bank's independence. The Bank is therefore subject to a wide degree of formal accountability.

3.24 RBNZ now publishes an annual *Statement of Intent*, a document designed to outline the way the RBNZ intends to operationally carry out its duties over the following three years. It includes the nature and scope of its function, predicted strategies to meet its objectives and resource issues. The Board is expected to consult with and take into account the views of the Minister of Finance when formulating the *Statement of Intent*.

3.25 Both central banks issue a quarterly Statement on the conduct of monetary policy which outlines the analysis behind their monetary policy decisions. However, only the Reserve Bank of New Zealand is required by legislation to publish such a document.[13]

10 Opinion article by Reserve Bank Deputy Governor Grant Spencer, 27 June 2007. Website viewed 24 August 2007, <www.rbnz.govt.nz/speeches/3049397.html>.

11 Reserve Bank of Australia, *Why does the Reserve Bank intervene in the foreign exchange market?* Website viewed 24 August 2007, <http://www.rba.gov.au/MarketOperations/International/ex_rate_rba_role_fxm.html>.

12 Reserve Bank of Australia, *Why does the Reserve Bank intervene in the foreign exchange market?* Website viewed 24 August 2007, <http://www.rba.gov.au/MarketOperations/International/ex_rate_rba_role_fxm.html>.

13 The *Reserve Bank of New Zealand Act 1989* requires statements are issued at least six monthly.

3.26 The RBNZ also provides brief commentary between the quarters, after it has reviewed monetary policy every six weeks. In contrast, the RBA only releases commentary in the interim periods if there has been a decision to alter the official cash rate.

3.27 The RBNZ publishes its forecasts of inflation, GDP, interest and exchange rates. It is also required by legislation to publish a public annual report.

Parliamentary oversight of monetary policy

Parliamentary scrutiny

3.28 The RBNZ's *Monetary Policy Statements* stand referred to the House of Representatives Select Committee on Finance and Expenditure (FEC) under section 15 of the *Reserve Bank of New Zealand Act 1989*. Each quarter, the day after the *Monetary Policy Statement* is released, the FEC meets with the RBNZ Governor to scrutinize the extent to which monetary policy has been conducted within the scope of the PTA. The FEC may have an independent adviser assist in the examination of the statements by briefing the committee before the hearing.

3.29 The FEC have no requirement to report to the House on the examination of the Monetary Policy Statement but this is general practice.

3.30 The Bank's Funding Agreement, which is agreed at five yearly intervals between the Minister of Finance and the Governor on how much of the Bank's income may be retained for operating costs, requires parliamentary approval. Thus, at least every five years the resources of the Bank are scrutinized.

Reviews—inquiry into the future monetary policy framework

3.31 The Finance and Expenditure Committee may inquire into any matter related to its subject areas as identified under the Standing Orders. As there is current debate in New Zealand surrounding what monetary policy instruments should be used by the Reserve Bank of New Zealand, the Finance and Expenditure Committee is conducting an inquiry into the future monetary policy framework.

3.32 Written submissions from the public closed on the last day of the delegation's visit, 19 July 2007.

3.33 The terms of reference for the inquiry are:

- to consider the causes of inflationary pressures;
- to consider the effectiveness of current monetary policy in controlling inflation;
- to examine the interaction of monetary policy with other elements of the economic policy framework including fiscal policy ;
- to examine the New Zealand economy's capacity for non-inflationary growth, and how it can be improved;
- to examine the role of productivity in the economy, how it can be improved, and the constraints upon it;
- to examine the recommendations from recent examinations of monetary policy including the joint Treasury and Reserve Bank of New Zealand's report entitled Supplementary Stabilisation Instruments; and
- to consider additional measures that could enhance monetary policy in New Zealand.

3.34 The inquiry has generated significant interest from the financial and business sectors, manufacturing and primary industries, academics, not-for-profit organisations and the general public. As at 20 August 2007 the FEC had received and authorised almost 100 submissions.