

Professor Lars E.O. Svensson

Stockholm University

Media Statement
February 28, 2001

Monetary Policy Review Released

“Monetary policy in New Zealand is currently entirely consistent with the best international practice of flexible inflation targeting,” Professor Lars Svensson, Stockholm University, concluded in his independent report into the operation of monetary policy released today.

The report, released at a joint press conference with the Minister of Finance, Dr Cullen and Reserve Bank Governor, Dr Brash, was initiated by the Minister of Finance in May last year with the release of the Terms of Reference for the review.

“The Reserve Bank compares well with best-practice central banks, like the Bank of England and the Bank of Sweden,” Professor Svensson said. “But this has not always been the case. The period from mid 1997 to March 1999, when the Bank used a Monetary Conditions Index (MCI) to implement monetary policy, represents a significant departure from best-practice inflation targeting.”

Professor Svensson regards the monetary policy instrument currently used (the official cash rate or OCR) as the most suitable instrument available.

“With regard to governance and accountability structures, I have found some weaknesses,” Professor Svensson said. “These weaknesses have not caused any problems because of the qualities of the current Governor, Dr Brash, but they could in different circumstances. Therefore I recommend some substantial changes.”

The report states that the Reserve Bank has achieved a remarkable stabilization of inflation at a low level and successfully anchored inflation expectations on the inflation target. “With hindsight, the timing of policy could have been somewhat better,” Professor Svensson said. “However, hindsight is too harsh a test, and the circumstances at the time of decisions should be taken into account. Aside from the period when the Reserve Bank used the MCI to implement policy, there is no evidence that policy has systematically resulted in unnecessary variability in output, interest rates and the exchange rate.”

Professor Svensson’s report strongly affirms price stability as the appropriate goal of monetary policy. He said that the Reserve Bank, in line with current best international practice, interprets the 0 to 3% target in the Policy Targets Agreement (PTA) as a medium-term target. This interpretation accepts some variation of inflation in the short term and avoids unnecessary variability of the real economy. “I suggest that the next time the PTA is amended, a marginal adjustment be made to explicitly state the target as a medium-term (and hence ‘soft-edged’) inflation target. It would also be desirable to restate the target as a point target of 1.5%. Given a clear medium term horizon, this retains ‘soft edges’ while providing a better anchor for inflation

expectations. There is no reason to make any other changes to the PTA. Furthermore, the long-term credibility of the monetary policy regime would be best served if PTAs were kept intact for the whole term of the Governor, and any significant modifications to the PTA were only made at the beginning of a new term for the Governor.”

Professor Svensson’s report notes the attention that issues of governance and decision-making received in submissions made to the review. “I believe the current arrangement, where the Governor is solely responsible for monetary policy decisions, works very well, largely because of the qualities of the current Governor. To reduce the risks inherent in relying so heavily on a single person’s qualities, I recommend that a formal monetary policy committee, comprised of the Governor and four other Reserve Bank staff, be formed. Named votes and non-attributed minutes should be published. A suitable time for the formation of a committee would be the beginning of the next term of the Governor.”

“I make several recommendations for improving the accountability of the Bank. These include changes to the membership of the Bank’s Board of Directors. I believe the Governor and Deputy Governors should not be members of the Board as they are at present, but that the Board should consist of non-executive directors only. The chair should be selected by the Board members themselves,” Professor Svensson said.

Other recommendations include the publication of an annual assessment and evaluation of monetary policy by the Bank’s Board of Directors, an annual conference evaluating Reserve Bank policy, and enhancing the capability of Parliament’s Finance and Expenditure Select Committee to scrutinise the policy decisions of the Bank.

Professor Svensson also makes a number of more technical recommendations, including additions to the economic statistics collected by Statistics New Zealand, especially monthly series of the Consumer Price Index and industrial production, and some minor technical improvements to the Bank’s modelling and forecasting tools.

“In coming to these conclusions, I have found the public submissions process, and the discussions I had on the review in New Zealand and overseas, extremely valuable. I have also had the benefit of observing first hand the key forecasting and decision-making meetings in the Reserve Bank leading up to the December 2000 *Monetary Policy Statement*,” Professor Svensson said.