

Practical Experiences in Reducing Inflation: The Case of New Zealand

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**Paper prepared for the NBER Conference on the Great Inflation
Woodstock, Vermont
25-27 September 2008**

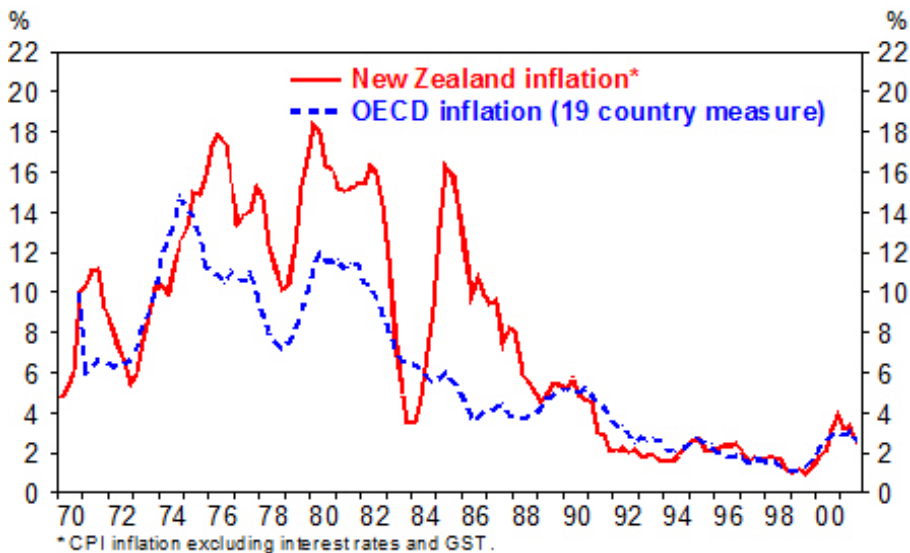
Introduction

It is a privilege and a pleasure to address this illustrious audience this evening: a privilege because I am all too conscious that I left the rarefied world of central banking for the anything-but-rarefied world of politics more than six years ago now, and a pleasure because so many of you became old friends during the time I was Governor at the Reserve Bank of New Zealand from 1988 to 2002 – old friends who added enormously to my understanding of the monetary policy challenges which face all central banks.

Tonight I want to sketch very briefly the course of inflation in New Zealand through the seventies and early eighties but focus most of my attention on the factors which led New Zealand to becoming the first country to formally adopt inflation targeting as we now understand it, on the reasons why that approach to monetary policy seems to have worked very well in New Zealand, and finally on some of the unresolved issues facing us all.¹

Before 1984

Prior to 1984, New Zealand had inflation which was not only high in an absolute sense but had inflation which was markedly higher than the average in other OECD countries, as the graph makes clear. Indeed, with one or two very minor exceptions, our inflation record during the period from 1970 to 1984 was the worst in the OECD.



¹ For a slightly fuller discussion of these issues, see “Inflation targeting 14 years on”, by DT Brash, a speech delivered to the American Economics Association conference in January 2002, on the Reserve Bank of New Zealand’s website (www.rbnz.govt.nz). For a much fuller discussion, see *Innovation in Central Banking: A History of the Reserve Bank of New Zealand*, by John Singleton, Arthur Grimes, Gary Hawke and Frank Holmes, Auckland University Press, 2006.

That inflation was driven at least in part by the rapid escalation in international oil prices, as of course it was in all other countries also. But we added to that exogenous factor weak macroeconomic policy – large fiscal deficits and weak monetary policy. The central bank had no independence from government at all, and monetary policy was repeatedly used for cynical political purposes.

The best known example was 1981: we now know that the central bank repeatedly warned the Minister of Finance throughout that year, confidentially, that inflationary pressures were building, and urged him to authorise a tightening of monetary policy. But the Minister of Finance, who was also the Prime Minister, was facing an election late in the year, and didn't want to do anything which might jeopardize his chances of winning that election.

In the event, he and his party did win the election by a very narrow margin and, faced with the reality of rapidly increasing inflation, in 1982 imposed sweeping controls on prices, wages, dividends and rent which would have made even Richard Nixon blush. Price increases were suppressed for a time but, as so many others who have tried such controls have found, inflationary pressures continued to build.

The arrival of the Lange/Douglas Labour Government

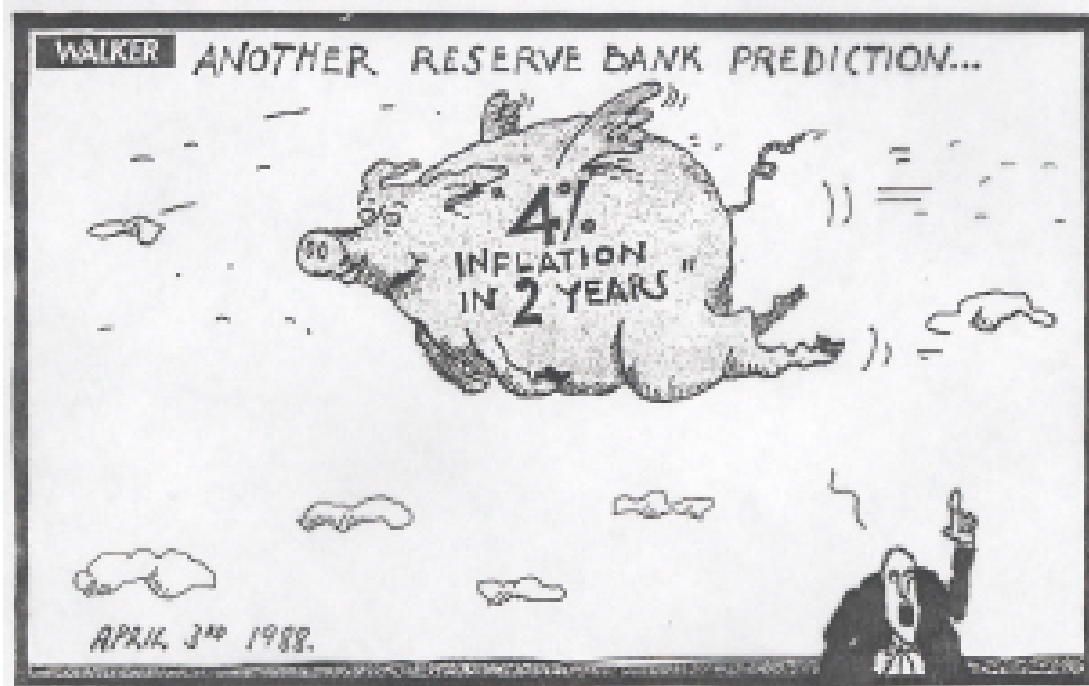
The election of the Lange/Douglas Labour Government in July 1984 radically changed New Zealand's economic policy framework. This is not the place to describe the extent of the changes wrought. They covered a huge range of policies: import controls were phased out and tariffs drastically reduced; export subsidies were abolished; all price, wage, dividend and rent controls were removed; the company tax rate was reduced from 48% to 33%, the top personal tax rate was cut from 66% to 33%, and a Value Added Tax was introduced; many government trading enterprises were privatized; the banking sector was substantially liberalized.

Most relevant for the present discussion, the incoming government floated the New Zealand dollar, and made it clear that the Reserve Bank was to focus on getting inflation under control. It was also made clear that the Minister of Finance would not be involved in the day to day decisions about how best to achieve that. The Reserve Bank was granted de facto independence to operate monetary policy with the specific objective of getting inflation down.

Initially, this was a tough challenge. The extensive deregulation of the economy and reform of the tax system induced an extended period of euphoria in much of the business community. The end of the freeze on prices and wages led to a sharp increase in both, and this was compounded in late 1986 when the Value Added Tax was introduced at a rate of 10% on all goods and services (except financial services). Indeed, for the 12 months to 30 June 1987 – a period which included the introduction of the Value Added Tax – inflation as measured by the CPI rose to 18.9%. Despite monetary policy being tightened substantially following the clear instruction to the Reserve Bank to get inflation under control, with 90 day bank bills briefly peaking above 25%, many in the media and

in the general public saw the anti-inflationary fight as a failure, and high inflationary expectations were well entrenched.

Typical of the general scepticism about the prospect for getting inflation under control was the following cartoon which appeared in early April 1988. It followed a prediction from the Reserve Bank that inflation would be reduced to below 4% within two years.



This was the apparently inauspicious environment in which I was appointed Governor and told to get the inflation rate as measured by the CPI to between zero and 2%. But although inflationary expectations were certainly high, and the challenge of reducing inflation therefore looked substantial, there were a number of extremely helpful factors working towards a constructive outcome.

First, there was the political situation. The Labour Government was strongly committed to getting inflation down to a very low level, and New Zealand's unicameral Westminster-style Parliament meant that Cabinet decisions could be rammed through Parliament with little risk of being slowed or diluted. The Leader of the Opposition National Party – the man who had been both Prime Minister and Minister of Finance between 1975 and 1984 – had been toppled, and a slim majority of the National Party caucus was willing to support focusing the Reserve Bank on getting inflation under control.

Second, there was a substantial degree of unanimity between the Reserve Bank and the Treasury about the importance of getting inflation under control, and no opposition on the

part of the Treasury to the Reserve Bank's making the essential decisions about monetary policy implementation.

Third, we were lucky in coming to the fight against inflation after major countries – particularly this country – had proved that firm monetary policy could achieve a huge reduction in inflation. It wasn't an impossibility: it could be done; Paul Volcker had proved it.

And finally an intangible factor: perhaps because Bill Phillips was a New Zealander, the idea that tolerating a bit more inflation would deliver a bit more economic growth and a bit less unemployment was deeply engrained in the New Zealand psyche. Yet we had seen with our own eyes that tolerating more inflation than almost every other developed country had not brought us faster economic growth in the seventies and early eighties. Our growth had in fact been *slower* than that in other developed countries. Perhaps those who argued that there's no trade-off between growth and inflation in the long run were right after all.

The advent of inflation targeting and the 1989 Reserve Bank Act

It's not entirely clear when inflation targeting in New Zealand was "born". But it is known that then-Minister of Finance Roger Douglas was very concerned in March 1988 that, with inflation moving into single figures for almost the first time in 15 years (with the exception of the brief period of the freeze in the early eighties), the public would expect the Reserve Bank to ease monetary policy, and settle for inflation in the 5% to 7% range. It was in that context that the Minister announced, during the course of a television interview on 1 April 1988, that he was thinking of genuine price stability, "around 0, or 0 to 1%".

Certainly by the time I actually became Governor on 1 September that year it was clearly understood that my task was to get inflation above zero and below 2%. We believed that would reflect genuine price stability – a 1% annual increase in the Consumer Price Index, corresponding to genuine price stability after an assumed measurement bias of 1% was allowed for, plus or minus 1% to allow for the inevitable imprecision of monetary policy.

In preparing the Reserve Bank's annual report for the year to March 1989 in the middle of 1989, I wrote that I was confident that inflation could be reduced below 2 per cent by the year to March 1993. I discussed this with the Minister of Finance, and he asked whether it might be feasible to achieve that by the end of calendar 1992 – he liked the sound of "0 to 2 by '92"! And so it was that "0 to 2 by '92" became the mantra, repeatedly endlessly by my colleagues and me.

When I became Governor in September 1988, the Reserve Bank still had only de facto independence. The legislation governing the Bank still left all power over monetary policy in the hands of the Minister of Finance, and required the Bank to use monetary policy to achieve a wide range of economic and social objectives. Like the legislation under which many central banks still labour to this day, New Zealand's central bank

legislation had been passed into law when the conventional wisdom was that monetary policy *could* in fact deliver full employment, faster growth, and the secret of eternal life as well. The great advantage of having completely new legislation drafted in the late eighties was that thinking had moved on considerably since those days. My predecessor as Governor had formed a working party to design a new institutional structure, and this process included two senior staff members (Peter Nicholl and Arthur Grimes) talking to central bankers and academic economists around the world. The results formed the basis of the new central bank legislation which was passed into law in late 1989.

That law was then – and still is in my opinion – as good as any central bank legislation in the world. Its essential features were six:

- First, the law made it clear that the function of monetary policy was to “achieve and maintain stability in the general level of prices”. No reference to growth, or employment, or the balance of payments, or anything else.
- Second, the law required that, on the appointment or re-appointment of a Governor, there must be a written, public, agreement between the Governor and the Minister of Finance defining what “stability in the general level of prices” means for the five-year term of the Governor’s appointment.
- Third, the law gave the Minister of Finance the power to “override” the agreement between Governor and Minister in case of need, provided that – and it was a crucially important proviso – the “override” was made public.
- Fourth, the Governor was to have completely unfettered independence to operate monetary policy as he (or she) thought appropriate to deliver the agreed definition of “stability in the general level of prices”.
- Fifth, the Governor was required to publish at least once every six months (and in practice, once every three months) a full explanation of how he saw the inflation outlook, and what he was proposing to do about it.
- Sixth, having been given independence to deliver the agreed target, the Governor was to be held accountable for any failure to reach that target.

Why do I believe that the legislation was as good as any in the world? Because it was honest and realistic about what monetary policy can actually deliver, namely an inflation rate. Because it was explicit about allowing for a political input into the goal-setting process – thus dealing with what Charles Goodhart has termed the “democratic deficit” problem. Because it constrained that political input both by making it clear that the overriding objective of monetary policy is to maintain stability in the general level of prices and by obliging the political input to be open and transparent for the public and financial markets to see. Because it obliged the Governor too to explain his actions to the public and financial markets. And because it held the Governor to account for any failure to reach the agreed objective, with the law making it explicit that failure could result in dismissal.²

² I well recall discussing the wording of the legislation with the Minister in early 1989. I expressed surprise that the legislation envisaged an agreement between the Minister and the Governor, not between the Minister and the Reserve Bank. “Ah yes,” I was told, “but we can’t fire the whole Bank. We can’t even realistically fire the whole Board. But we sure as hell can fire the Governor!”

Did it work?

But did the framework established by the 1989 Act work? I have no doubt at all that it did.

Most obviously, the inflation rate came down, and came down even faster than originally planned. The original goal had been to get the inflation rate below 2% by the end of 1992. Following the election of late 1990, and a widespread belief that the exchange rate needed to come down to ease a substantial balance of payments deficit, the goal was changed so that my task was to get the inflation below 2% by the end of 1993. In the event, it was below 2% by the end of 1991, to the considerable surprise of many people both inside and outside the Reserve Bank! To be sure, the inflation rate briefly exceeded the top of the 0 to 2% range in the mid-nineties, and is well outside the now 1 to 3% range at the present time, driven in large part by the rapid increase in the price of oil and other commodities. But taking the last 17 or 18 years as a whole, the framework has kept New Zealand inflation at a very moderate level, certainly no higher on average than that in major developed countries.

Yes, there was a cost in reducing inflation from the high level of the seventies and early eighties – I know of no case where inflation has been reduced *without* cost. But the cost is always to some extent a function of how entrenched inflationary expectations have become. And although I can't prove it, I believe that the framework established by the 1989 Act, with its mandatory transparency and clear accountability for the Governor, did help to reduce inflationary expectations in New Zealand in the very late eighties and early nineties.

I well recall that, in late 1990, not many months after the Minister of Finance and I had formally agreed on the 0 to 2% target after the 1989 Act became law, the head of the New Zealand Council of Trade Unions, Ken Douglas, wrote an article which appeared in one of New Zealand's major newspapers.³ The article argued strongly that the Reserve Bank was focused on an undesirably narrow objective (namely, low inflation), but that, as long as that was the case, unions would need to moderate their wage demands to avoid increases in unemployment. In the weeks that followed, he actively, and with very considerable personal courage, campaigned for moderate wage settlements as a way of reducing unemployment.

I have little doubt that the inflation target played a part in encouraging employers and unions to adjust their wage settlements to levels which were quite quickly consistent with the inflation target, thus reducing the social cost of achieving that target. My colleagues and I certainly devoted a huge amount of effort to making it clear to everybody who would listen – and some who were reluctant to listen! – that we were deadly serious about our commitment to getting inflation below 2% within the agreed timeframe. This involved not simply formal monetary policy statements every three months but many

³ *The Dominion*, 31 October 1990.

hundreds of informal speeches to Rotary Clubs, Chambers of Commerce, farmers' groups, church groups, women's groups, and schools.

The framework also had an effect on fiscal policy. We saw this most dramatically in mid-1990 when the Minister of Finance announced an expansionary Budget just months before the general election scheduled for late that year. Markets were concerned about the loosening in fiscal policy, and became uneasy about the future direction of policy. This was reflected in a rise in long-term interest rates and a fall in the exchange rate, to which we responded by tightening monetary policy. Immediately, an editorial in New Zealand's largest daily paper noted that the Budget had "rekindled inflationary expectations. The (Reserve Bank) was bound to lift interest rates... Electors are frequently bribed to their ultimate cost. This time the independence of responsible monetary control quickly exposes a fiscal fraud."⁴ The main Opposition party campaigned in the election on a commitment to get interest rates reduced, not by leaning on the central bank but by "giving monetary policy some mates" through tighter fiscal policy and deregulation of the labour market.

Five years later, with the party which had been in Opposition now in government, and with several years of fiscal surplus behind it, the Government undertook to reduce income taxes subject to several conditions being met, one of which was that the Reserve Bank was satisfied that such tax cuts would not require a significant tightening of monetary policy.

The framework established by the 1989 Act has also been a very effective way of protecting the central bank from political criticism, at least by the governing party. In my 14 years as Governor, I can not recall a single instance where a Minister, or a Member of Parliament in the governing party, criticised the Bank for having monetary policy too tight. Because the inflation target was agreed in writing between the Minister of Finance and me, it would have been difficult for the Minister, or any member of his political party, to attack me for having policy too tight unless inflation fell below the bottom of the 0 to 2% target range (later the 0 to 3% target range), or appeared likely to do so. And the same situation has continued for my successor: yes, I got plenty of brickbats for having policy too tight from members of the public, and the same has been true of my successor, but to have a supportive government is hugely helpful.

The framework not only encourages *government* to be fiscally responsible, and to refrain from attacking the central bank, it also encourages the *Governor* to behave responsibly. I recall reflecting on that in 1996. At that time, monetary policy was very tight, as it needed to be, with inflation slightly over the top of the agreed 0 to 2% target. The National Party Government was facing an election at the end of the year. I had myself been a candidate for that party in 1981, and although I had not been a member of that party, or of any other party, since the mid-eighties, some people might have suspected that I would be tempted to ease monetary policy to help the National Party's chances of re-election. I was certainly never tempted to do that, but had I been so tempted, the framework established by the 1989 Act would have effectively constrained me. I could

⁴ *New Zealand Herald*, 3 August 1990.

only have eased policy if I could have shown, in the Bank's quarterly monetary policy statement, that a policy easing was justified by the inflation outlook. And any attempt to show that a policy easing was justified would have required me to convince not only the Bank's own economics staff but also the scores of economists and other analysts in the financial market. If they even suspected that I was playing fast and loose with the facts for political ends, interest rates would have been more likely to rise sharply than to fall, as capital fled the country.

There is no doubt in my mind that the framework established by the 1989 Act has worked extremely well.

Why did inflation fall?

But what were the factors that led inflation to fall so steadily in the late eighties and early nineties – certainly more steadily than most of us expected? Many of my central bank colleagues thought that it would be relatively easy to reduce inflation to about 5%, but that we would have huge difficulty in getting it any lower than that, and getting it below 2% would be well nigh impossible.

We were helped by the fact that international inflation had also fallen markedly since the early eighties. We didn't have any huge increases in the price of oil to deal with, though of course there was a brief spike in oil prices associated with the Gulf War. The clean float of the New Zealand dollar after March 1985 meant that the Reserve Bank had effective control over primary liquidity in the banking system. The government was running fiscal deficits, but these were gradually reducing and in any event were being fully funded by the sale of bonds on the domestic market.

And of course monetary policy was tight, with the result that both interest rates and the exchange rate were putting downwards pressure on the economy.

One of the fascinating things about the disinflation experience in New Zealand is that monetary conditions tended to adjust almost automatically to the market's understanding of what was needed. The Reserve Bank did not determine a single interest rate and did not intervene in the foreign exchange market to influence the currency. We sought to influence monetary conditions by varying the amount of primary liquidity in the banking system.

Initially, we were very much focused on the direct price effects of exchange rate movements on the inflation rate, and if the exchange rate fell "too far", or conversely rose "too far" – in other words, if the direct price effects of movements in the exchange rate seemed likely to push the inflation rate outside the target range – we would in principle adjust primary liquidity so that the exchange rate moved back to a place where it seemed consistent with the inflation target. But years went by without our actually having to change primary liquidity. Occasionally we would need to "clear our throat", or engage in "open mouth operations", to indicate that the exchange rate was moving in a way which seemed inconsistent with the inflation target, but we rarely had to actually change

primary liquidity to achieve the desired change in monetary conditions. It seemed to be sufficient that financial markets knew that we *could* inflict pain on financial markets if we had to. And while it is always best when a deterrent doesn't have to be used, we were frankly astonished at how much impact our relatively small deterrent seemed to have!

By the mid-nineties, we had moved away from a focus on the direct price effects of movements in the exchange rate and instead were more focused on the effect which interest rates and the real exchange rate had on the output gap, and so on inflation. We still made no attempt to control any interest rate or any exchange rate but in mid-1997 adopted the Monetary Conditions Index from the Bank of Canada as a way of signaling to the market whether we wanted overall monetary conditions to be tighter or easier, and by how much. This seemed to be a helpful way of making it clear to the financial market that we had no target exchange rate. But for reasons which I won't debate here, this MCI experiment was not a success, and the Bank moved to a conventional approach to the implementation of monetary policy in March 1999, setting an overnight interest rate at which it is willing to lend money to, and receive money from, the banking system. Prior to that time, however, we may well have been the only central bank which set neither an interest rate nor an exchange rate.

Is it the end of history?

Is inflation targeting “the end of history” from a monetary policy point of view?⁵ Certainly, I believe it has a huge amount to commend it, and the arguments advanced against it recently, by people like Joseph Stiglitz, seem completely unfounded.⁶

But there remain a number of important unresolved issues, in inflation targeting as in other approaches to monetary policy. How best should central banks communicate the conditionality of their inflation forecasts, while still conveying useful information? To what extent can central banks make sufficiently reliable estimates of the output gap, and to what extent do changes in the output gap now affect the inflation rate?

And is there more to achieving monetary stability than keeping the prices of goods and services purchased by the household sector stable? During the last decade or so, consumer price inflation has been exceptionally well behaved in most major economies. But at the same time, as I don't need to remind anybody in this conference, we have experienced severe episodes of monetary instability in other guises, including asset price instability and financial system instability. These experiences leave us with plenty of unanswered questions.

⁵ The suggestion that monetary policy might have reached the “end of history” in the sense that Francis Fukuyama had in mind was first raised, and rejected, by Stephen Grenville, then Deputy Governor of the Reserve Bank of Australia, in an address to the 30th Anniversary Conference hosted by Monetary Authority of Singapore on 20 July 2001.

⁶ In one recent article by Stiglitz which appeared in *The Independent Financial Review*, New Zealand, on 21 May 2008 he asserted that “today, inflation targeting is being put to the test and it will almost certainly fail”. He extended his sympathies “to the unfortunate citizens” of the 23 countries he listed as having adopted inflation targeting. But his description of inflation targeting was a caricature, totally misrepresenting inflation targeting as practised by all the central banks that I know.

For a small open economy like New Zealand, one of the big policy issues is whether anything can be done to moderate the big swings in the real exchange rate which appear to be inherent in the current policy framework. New Zealand is seen by financial markets as a stable, English-speaking democracy, so when we raise the policy interest rate to restrain inflation we often see a pronounced increase in the exchange rate, with most of the monetary policy pressure being exerted on tradable sectors and too little being exerted on non-tradable sectors. The consequence is that the current account deficit increases – recently to some 9% of GDP.

We know, because Milton Friedman told us so, that ultimately current account deficits don't matter where the public sector is in surplus and the exchange rate is floating, as is true in New Zealand. But we also know that running a very large current account deficit for decades on end inevitably builds up a very substantial amount of net foreign liabilities, and makes a country vulnerable to any interruption in its ability to access world capital markets. I have more than a passing suspicion that we will eventually come to recognise that the central bank needs an additional policy instrument, one which affects the level of spending in the economy without having any direct effect on the exchange rate.