MACROECONOMICS IN ACTION

Learning to Control Inflation in New Zealand: Inflation Targeting

Before reductions in the inflation rate occurred in New Zealand in the late 1970s, this country experienced inflation that was relatively high among developed countries. The average inflation rate in New Zealand between 1977 and 1986 was 13% per year—much higher than in the United States, for example (see Figure 17.7). However, the inflation rate was reduced in New Zealand to 3.3% per year in the 1990–92 period and to 2.3% in the 1993–96 period. In part, this reduction in inflation was brought about through changes in the legal structure within which the Reserve Bank of New Zealand (RBNZ)—the central bank of New Zealand—was constrained to operate, as discussed in a working paper by Michael Hutchison and Carl Walsh.[1]

The changes in the rules governing the operation of the RBNZ were enacted in the RBNZ Act in December 1989, which went into effect in February 1990. Under the Act, "the primary function of the Bank [the RBNZ] is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices." This

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statement of the goals of the central bank is quite restrictive, because left out are any Keynesian-type objectives, such as "full employment" or "sustained growth," which are goals that often find their way into the language of central bankers. Given that the objective of the RBNZ as defined by the RBNZ Act is to achieve price stability, how should this be done? The Act also specifies that the finance minister (a cabinet member in the government of New Zealand) negotiate a Policy Target Agreement (PTA) with the governor of the RBNZ (the counterpart of the chairman of the Fed) at the beginning of the governor's term of office. This PTA specifies explicitly what price stability means, in terms of numerical objectives, for the governor's term. These objectives are then publicly announced. Should the governor be judged by the prime minister of New Zealand to have failed to meet the goals set out in the PTA, he or she can be removed from office.

In practice, the PTAs that have been negotiated consist of explicit inflation targets. For example, the first PTA agreed to under the RBNZ Act specified a target range for the inflation rate of 0–2% per annum to be achieved by December 1992. As mentioned above, the RBNZ Act appears to have been very successful in meeting its intended goal of reducing inflation in New Zealand. Inflation targeting in this instance seems to have been much more successful than was the targeting of monetary aggregates in some countries in the 1970s and 1980s.

The rules in the RBNZ Act governing the operation of New Zealand's central bank put an unusual amount of structure on monetary policy relative to what governs most central banks in the world. For example, in the United States, the Federal Reserve Act is quite vague about the policy objectives of the Federal Reserve System, and the chairman of the Fed can certainly not be fired by the President during his or her term of office because of monetary policy errors. New Zealand was highly innovative in central banking by setting up explicit objectives and penalties for its central bank. Other central banks, including the Bank of Canada and the Bank of England, have since introduced inflation targeting, though in a less restrictive structure than in New Zealand.

[1]See M. Hutchison and C. Walsh, 1998. "Disinflation in New Zealand," working paper, University of California, Santa Cruz.