



MONETARY POLICY AND THE POLICY TARGETS AGREEMENT

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Summary

- Monetary policy is the process by which the Reserve Bank of New Zealand (the Reserve Bank) controls the money supply to ensure price stability in goods and services and confidence in the currency.
- In New Zealand, the functions of the Reserve Bank are set out in the Reserve Bank of New Zealand Act 1989. The Act requires the Reserve Bank Governor to sign a Policy Targets Agreement (PTA) with the authorised Minister (usually the Minister of Finance).
- A new PTA will be signed between the authorised Minister and the next appointed Reserve Bank Governor. The current Governor's term ends on 26 September 2017. Deputy Governor Grant Spencer has been appointed Acting Governor for a period of six months, given the proximity of the 2017 general election, to enable the recruitment of a new Governor to assume office in March 2018.
- New Zealand has had 11 PTAs to date, with the latest signed in June 2017. The June 2017 PTA renewed the September 2012 PTA, and requires the incoming Acting Governor to keep future annual inflation between 1–3 percent on average, over the medium-term, with a focus on keeping future average inflation near the 2 percent target midpoint.
- The Reserve Bank conducts monetary policy in New Zealand through the tightening or loosening of the Official Cash Rate (OCR). This rate, currently at 1.75 percent, is at its lowest level since it was introduced in March 1999.

What is monetary policy and how does it work?

Monetary policy is the tool by which a central bank ensures price stability. It involves using interest rates to target a specified inflation rate (or inflation target band) to provide a stable environment for business investment and economic growth. In New Zealand, the primary function of the Reserve Bank is defined in the Reserve Bank of New Zealand Act 1989 (the Act), and is "...to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices".¹

According to the Reserve Bank:

"Low and stable inflation is the best contribution monetary policy can make to the New Zealand economy. High and variable inflation imposes several significant costs on the public. A well-functioning inflation-targeting central bank helps avoid these costs, while avoiding the damaging effects of deflation".²

In a 2012 report, the Treasury said that in the short-term monetary policy seeks to smooth demand fluctuations, and in the long-run monetary policy is effective in achieving "...clarity of real price signals by seeking generalised price stability".³ This activity is known as inflation targeting, where the Reserve Bank tightens or loosens monetary policy depending on economic conditions within the economy in order to keep annual inflation

¹ Reserve Bank of New Zealand Act 1989, s 8.

² Michelle Lewis, John McDermott and Adam Richardson "[Inflation expectations and the conduct of monetary policy in New Zealand](#)" (2016) 79 (4) Reserve Bank Bulletin at 3.

³ The Treasury [Treasury Report: Reserve Bank Policy Targets Agreement](#) T2012/886 (May 2012) at [3].

close to a target point or within a target range. The Reserve Bank pioneered inflation targeting in the late 1980s, and was the first central bank to adopt a formal inflation target.⁴

The monetary policy mechanism

A tightening of monetary policy works its way through an economy as follows.

- As interest rates rise (including deposit rates), households receive greater incentives to save, thus reducing household consumption and demand for goods and services. This places downwards pressure on prices and therefore reduces inflation.
- The cost of borrowing rises, reducing households' disposable incomes for those with mortgages and loans. Lending costs for firms increase, reducing the attractiveness of investment and expansion plans as they become unviable, reducing growth within an economy.
- The exchange rate tends to appreciate as higher interest rates attract foreign depositors. This makes imports cheaper (placing downward pressure on tradables inflation), while also making New Zealand's exports of goods and services more expensive.⁵ This dampens demand for locally made goods and services, which eases production constraints within New Zealand, placing downward pressure on inflation.

The opposite occurs when interest rates decline. The opportunity cost of spending reduces, the exchange rate tends to depreciate (making New Zealand's goods and services more competitive), borrowing becomes cheaper, and expansion and investment plans look more profitable. All this places upward pressure on annual inflation.

There is normally a lag of a year or more before the full effect of a change in monetary policy works its way through an economy, and has the desired impact on inflation. For this reason the Reserve Bank has a medium term inflation target.

The Official Cash Rate

Since 1999, monetary policy in New Zealand has involved the setting of short-term interest rates through adjusting the Official Cash Rate. The OCR influences the wholesale price for borrowing or lending for New Zealand's registered banks. The banks pay interest on any funds borrowed from the Reserve Bank (at a rate 50 basis points above the OCR) and receive interest on any overnight funds deposited with the Reserve Bank (at the OCR up to a certain value, and then at an interest rate 100 basis points below the OCR). This creates the upper and lower bounds of the overnight rates banks are willing to pay/accept from other domestic banks. The resulting interest rate is called the Overnight Interbank Cash Rate, which normally tends to be slightly lower than the OCR.⁶ Through adjusting the OCR, the Reserve Bank influences short and long-term interest rates in New Zealand, and thus the cost of borrowing money from banks and the return on deposits. Other factors, such as international interest rates also influence interest rates in New Zealand (especially long-term interest rates).

Reviewing the Official Cash Rate

The OCR is reviewed seven times a year by the Reserve Bank's Governing Committee, which was established in 2013 by the Governor, Graeme Wheeler, and is similar in form and function to the Bank of Canada's Governing Council.⁷ The committee is composed of the Governor of the Reserve Bank, the two Deputy Governors and the Assistant Governor. While the committee takes a consensus approach to deciding monetary policy, the Reserve Bank Governor has statutory responsibility for all monetary policy decisions and retains the right of veto on committee decisions.^{8,9,10} In most other developed economies, it is a committee or board that

⁴ Dr Don Brash, Reserve Bank Governor "[Inflation targeting 14 years on](#)" (Speech delivered at the American Economics Association Conference in Atlanta, 5 January 2002).

⁵ Tradables inflation measures the change in price of those goods and services that are imported or in competition with foreign goods, either in domestic or foreign markets.

⁶ Reserve Bank of New Zealand [The Official Cash Rate in action](#).

⁷ John Murray, Deputy Governor, "[Monetary Policy Decision making in Canada](#)", Bank of Canada Review, (Autumn 2013) at 4.

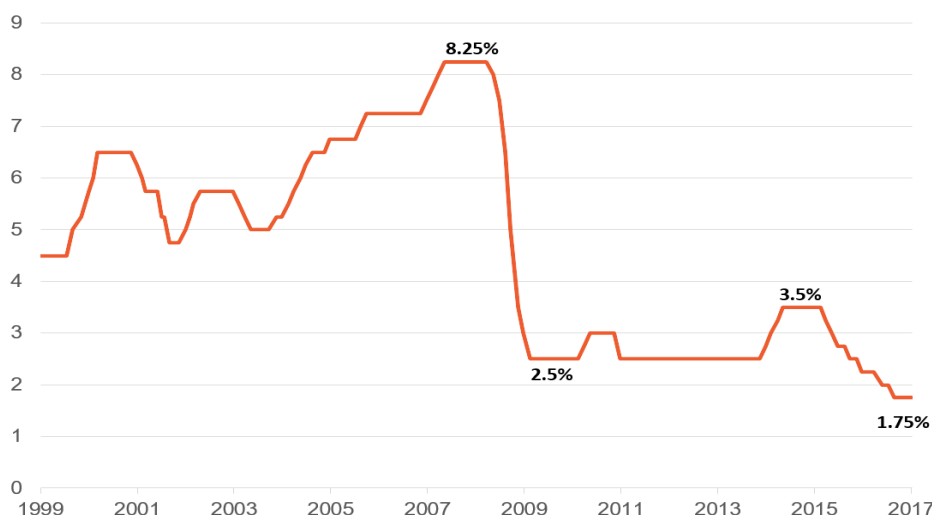
⁸ Reserve Bank of New Zealand Act 1989, s 11.

has the statutory authority to make monetary policy decisions (see Appendix 1). In April 2017, former State Services Commissioner Iain Rennie was appointed by the Treasury to investigate the Reserve Bank's process for determining policy decisions.¹¹ In responding to unforeseen events the Reserve Bank can also adjust monetary policy in an unscheduled move. For example, it reduced the OCR by 50 basis points to 5.25 percent on 19 September 2001 following the September 11 attacks in the United States.¹²

Trends in the Official Cash Rate

Chart 1 shows the OCR since it was introduced in 1999 at a rate of 4.5 percent. The OCR peaked at 8.25 percent from July 2007 to July 2008, before dropping to 2.5 percent from April 2009 through to June 2010 in response to the Global Financial Crisis. The Reserve Bank then gradually increased the OCR to 3.5 percent in July 2014, before commencing a further easing of monetary policy from June 2015. Currently the OCR, at 1.75 percent, is at its lowest recorded level.¹³

Chart 1. The Official Cash Rate 1999 - 2017



Source: Reserve Bank [Official Cash Rate \(OCR\) decisions and current rate](#).

New Zealand's Policy Targets Agreement

Under s9 of the Act, the authorised Minister (usually the Minister of Finance) must sign a PTA with the Reserve Bank Governor before any appointment or reappointment of a Governor. The policy targets can also be reviewed or altered at any time. In a 2002 speech reflecting on 14 years of inflation targeting in New Zealand, the then Reserve Bank Governor Dr Don Brash said that the Act and accompanying PTA provides the Governor with "...instrument independence but not full goal independence".¹⁴ Dr Brash went on to state:¹⁵

"The legislation was drafted in such a way that the PTA *could* have been based around exchange rate targeting, nominal income targeting, or conceivably even money aggregate targeting, but in the context of the time everybody understood that the PTA would be based around the inflation target..."

⁹ Dr John McDermott, Assistant Governor "[How the Bank formulates and assesses its monetary policy decisions](#)" (Speech delivered to the Manawatu Chamber of Commerce in Palmerston North, 13 July 2016).

¹⁰ Graeme Wheeler, Reserve Bank Governor "[Decision making in the Reserve Bank of New Zealand](#)" (Speech delivered to the University of Auckland Business School in Auckland, 7 March 2013) at 5.

¹¹ Hamish Rutherford "[Reserve Bank governor's unique power over interest rates to come under review](#)" Stuff (8 April 2017).

¹² Reserve Bank of New Zealand [Monetary Policy Statement](#) (November 2001) at 2.

¹³ Reserve Bank of New Zealand [Official Cash Rate \(OCR\) decisions and current rate](#).

¹⁴ Brash, above n 4, at 3.

¹⁵ Brash, above n 4, at 3.

The current Reserve Bank Governor's five year term ends on 26 September 2017, three days after the 2017 general election. The Government has announced that Deputy Reserve Bank Governor Grant Spencer will be Acting Governor for a period of six months from 26 September 2017. This will allow the elected government to appoint the next Reserve Bank Governor and the Minister of Finance (or authorised Minister) to sign a new PTA. A PTA was signed between the Minister of Finance Steven Joyce and incoming Acting Reserve Bank Governor Grant Spencer in June 2017. The PTA renewed that signed by the Minister of Finance Hon Bill English and Reserve Bank Governor Graeme Wheeler on 20 September 2012, and includes four sections:¹⁶

1. Price stability – The goal of monetary policy is to maintain a stable general level of prices, which supports the Government's economic objective of delivering permanently higher incomes and living standards through the promotion of a growing, open and competitive economy.
2. Policy target – In pursuing the objective of a stable general level of prices, the Reserve Bank is to monitor prices via a range of price indices (including asset prices). The policy target is defined as keeping "...future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term, with a focus on keeping future average inflation near the 2 per cent target midpoint".¹⁷
3. Inflation variations around target – The PTA provides the Reserve Bank with the ability to look through temporary inflation shocks, which do not affect the medium-term inflation target, or over which monetary policy has no influence (e.g. the Reserve Bank may decide to look through events that have a short-term impact on prices, such as an increase in the excise duty on tobacco products). If the Reserve Bank were to respond to temporary shocks by adjusting the OCR, it could create unnecessary instability in output and employment.
4. Communication, implementation and accountability – When the annual inflation rate is outside (or projected to be outside) the medium-term target range, the Bank will explain in its Monetary Policy Statements the reasons why and the measures taken or proposed to ensure that inflation outcomes remain consistent with their medium-term target range. The implementation of monetary policy is to occur "...in a sustainable, consistent and transparent manner, have regard to the efficiency and soundness of the financial system, and seek to avoid unnecessary instability in output, interest rates and the exchange rate".¹⁸

Eleven Policy Targets Agreements to date

The first PTA was signed in March 1990 between the Minister of Finance Hon David Caygill and the Reserve Bank Governor Dr Don Brash. It set a policy target of achieving an annual inflation rate of 0–2 percent by the year ended December 1992. This deadline was subsequently pushed back a year in the December 1990 PTA signed between the Governor and Finance Minister Ruth Richardson.

In December 1996, the inflation target band was widened to 0–3 percent in the PTA signed between Rt Hon Bill Birch and Reserve Bank Governor Dr Don Brash. The widening of the inflation target band was the result of coalition negotiations between the National Party and the New Zealand First Party following the first Mixed Member Proportional (MMP) election.¹⁹ A new PTA was signed between Reserve Bank Governor Dr Don Brash and Treasurer Hon Winston Peters in December 1997 prior to the Governor commencing his third term as Reserve Bank Governor.

With the change in government in the 1999 general election, the new Treasurer Hon Dr Michael Cullen signed a new PTA with Reserve Bank Governor Dr Don Brash in December 1999. While retaining the 0–3 percent annual inflation target band, the new PTA instructed the Bank to "...seek to avoid unnecessary instability in output, interest rates and the exchange rate" when implementing monetary policy.²⁰

¹⁶ Reserve Bank of New Zealand [Policy Targets Agreement](#) (20 September 2012).

¹⁷ The price stability target is defined in terms of Statistics New Zealand's All Groups Consumers Price Index.

¹⁸ Reserve Bank of New Zealand [Policy Targets Agreement](#) (20 September 2012).

¹⁹ Reserve Bank of New Zealand [The evolution of Policy Targets Agreements](#) (2000) at 6.

²⁰ Reserve Bank of New Zealand [Policy Targets Agreement for 1999](#) (16 December 1999).

The annual inflation target band was amended in September 2002 in a PTA signed between Finance Minister Hon Dr Michael Cullen and the new Reserve Bank Governor Dr Alan Bollard. The bottom of the target band was increased to 1 percent (resulting in a target band of 1–3 percent) and the Bank was instructed to take a “forward-looking, medium-term approach to achieving price stability”, with annual inflation to remain within the target band “on average over the medium term”.²¹ Further PTAs were signed in May 2007 and December 2008 without any changes to the inflation target band.

The PTA signed in September 2012 retained the 1–3 percent medium-term target band for inflation, but also included the requirement for the Governor to focus on “...keeping future average inflation near the 2 per cent target midpoint”.²² The incoming Reserve Bank Governor Graeme Wheeler said that the two percent midpoint target would “help better anchor inflation expectations”.²³ The PTA also included a stronger focus on financial stability, with the Reserve Bank also required to monitor asset prices within the economy.²⁴ In commenting on the September 2012 PTA, Westpac Chief Economist Dominick Stephens said that the requirement to monitor asset prices provided the Reserve Bank with “...a mandate to increase interest rates in response to a house price boom, even if consumer price inflation was low”.²⁵

Table 1 shows the PTAs signed to date, the signatories, and the inflation policy target within each.

Table 1. Policy Targets Agreements 1990 - 2017

Policy Agreement date	Targets	Reserve Bank Governor	Minister of Finance / Treasurer	Annual inflation policy target
2 March 1990		Dr Don Brash	Hon David Caygill	0 – 2 percent by the year ended December 1992
19 December 1990		Dr Don Brash	Hon Ruth Richardson	0 – 2 percent by the year ended December 1993
16 December 1992		Dr Don Brash	Hon Ruth Richardson	0 – 2 percent
10 December 1996		Dr Don Brash	Rt Hon Bill Birch	0 – 3 percent
15 December 1997		Dr Don Brash	Hon Winston Peters	0 – 3 percent
16 December 1999		Dr Don Brash	Hon Dr Michael Cullen	0 – 3 percent
17 September 2002		Dr Alan Bollard	Hon Dr Michael Cullen	1 – 3 percent on average over the medium-term
24 May 2007		Dr Alan Bollard	Hon Dr Michael Cullen	1 – 3 percent on average over the medium-term
18 December 2008		Dr Alan Bollard	Hon Bill English	1 – 3 percent on average over the medium-term
20 September 2012		Graeme Wheeler	Hon Bill English	1 – 3 percent on average over the medium-term, with a focus on keeping future average inflation near the 2 percent target midpoint
6 June 2017		Grant Spencer (Acting)*	Hon Steven Joyce	Same as above

Note: * Grant Spencer will be Acting Reserve Bank Governor from 27 September to 26 March 2018.

Source: Reserve Bank [Policy Targets Agreements](#).

²¹ Reserve Bank of New Zealand [Policy Targets Agreement for 2002](#) (17 September 2002).

²² Reserve Bank of New Zealand [Policy Targets Agreement for 2012](#) (20 September 2012).

²³ Reserve Bank of New Zealand [New Policy Targets Agreement signed today](#) (20 September 2012).

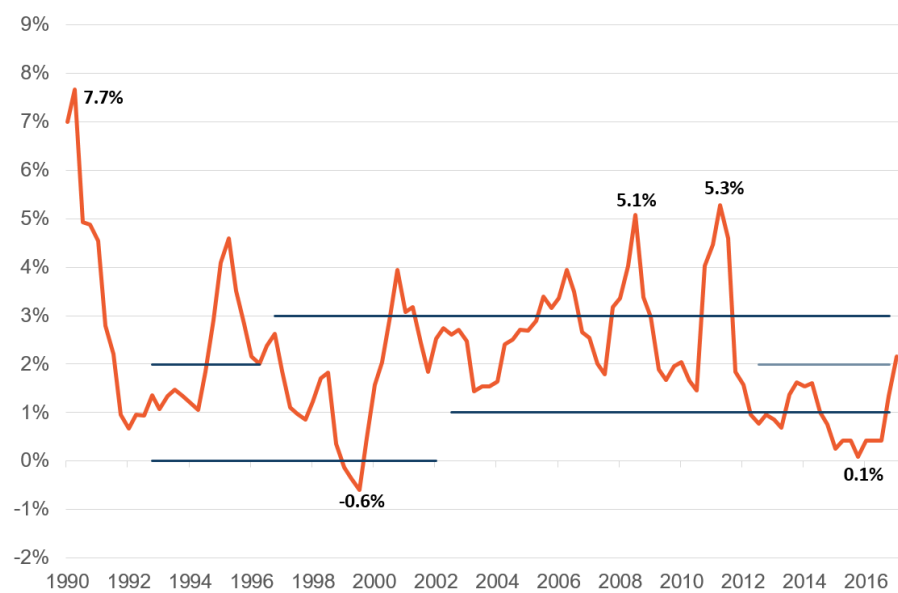
²⁴ Reserve Bank of New Zealand, above n 18.

²⁵ Westpac Bank, Something old, something new. RBNZ Policy Targets Agreement Review (20 September 2012).

Annual inflation

New Zealand's annual inflation rate has recently returned within the Reserve Bank's medium-term inflation target band. Annual inflation was 1.3 percent in the year ended in the December 2016 quarter, rising to 2.2 percent in the year ended in the March 2017 quarter, thus ending a period of two years where it sat below the bottom of the band. Annual tradables inflation was negative from the June 2012 quarter through to the December 2016 quarter (apart from the year ended in the June 2014 quarter when it was 0.1 percent).²⁶ The higher New Zealand dollar and low international commodity prices (especially oil prices which resulted in lower petrol prices) has been a factor behind lower tradables inflation. The Reserve Bank noted in its November 2016 *Monetary Policy Statement* that "...the prolonged period of negative tradables inflation is unusual historically".²⁷ As a result, it has flowed through to lower inflation expectations which have presented "...an ongoing challenge for monetary policy".²⁸ Chart 2 shows the annual inflation rate and the PTA target band since 1990.

Chart 2. Annual inflation in New Zealand and the PTA target band 1990 - 2017



Sources: Statistics New Zealand [Consumer Price Index](#).
Reserve Bank [Policy Targets Agreements](#).

In the last decade, annual inflation peaked above 5 percent in mid-2008 and mid-2011. The increase in the rate of GST from 12.5 percent to 15 percent on 1 October 2010 caused the annual inflation rate to peak at 5.3 percent in the year ended June 2011.²⁹ As a result of a build-up of inflationary expectations in mid-2011, the Reserve Bank expressed concern in the September 2011 *Monetary Policy Statement* that inflation expectations had increased.³⁰ Under the PTA the Reserve Bank is able to look through such one-off events unless there is an increase in inflationary expectations and outlook.

The previous peak in annual inflation in the September 2008 quarter was driven by high levels of external inflation, with strong rises in international food and oil prices (leading to higher petrol prices). Annual inflation in New Zealand peaked at 5.1 percent, while annual inflation within the OECD area rose to 4.9 percent in July of that year.

In recent years low annual inflation has not just been a New Zealand phenomenon. Excess resource capacity and sluggish growth in developed economies since the Global Financial Crisis has resulted in low rates of

²⁶ Tradables inflation measures the change in price of goods and services that are either imported or compete against imports.

²⁷ Reserve Bank of New Zealand [Monetary Policy Statement](#) (November 2016) at 5.

²⁸ Reserve Bank of New Zealand, above n 23, at 5.

²⁹ Statistics New Zealand has stated the annual inflation rate would have been 3.3 percent, had the GST rate remained at 12.5 percent.

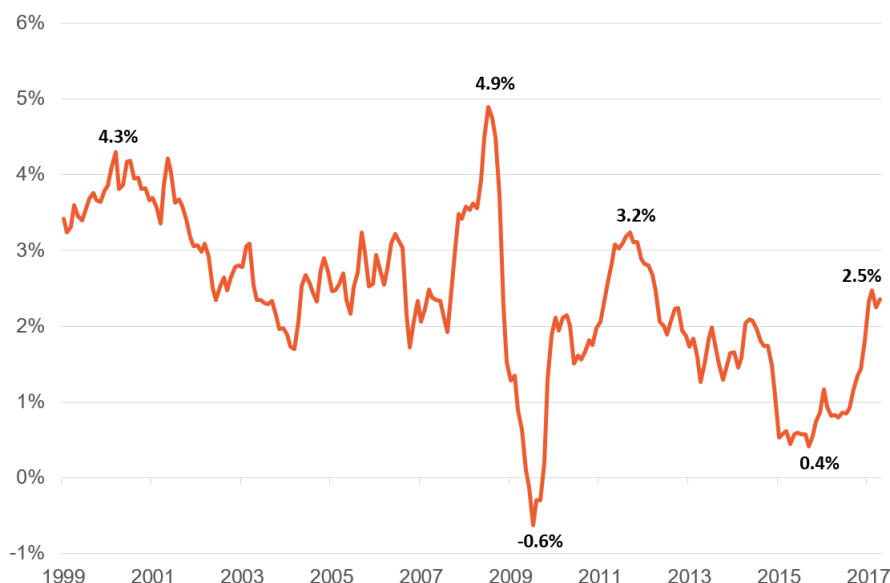
³⁰ Reserve Bank of New Zealand [Monetary Policy Statement](#) (September 2011) at 4.

inflation in a number of countries. As a result of low annual inflation, central banks loosened monetary policy interest rates to record low levels. Only recently has the U.S. Federal Reserve commenced tightening monetary policy, while other central banks continue their policy of quantitative easing. Quantitative easing takes place when the central bank buys government and private bonds, and in doing so, increases the money supply within an economy (the bank often pays for the purchases through creating more electronic cash). Previous holders of these bonds then have cash to invest elsewhere in the economy. This has the effect of lowering interest rates and raising asset prices (such as listed company share prices). Rising asset prices increases households' sense of wealth, and promotes spending.

It should be noted that unlike a number of other central banks, whose monetary policy interest rates have fallen close to zero (or below) and which cannot reduce interest rates further to ease monetary policy, the Reserve Bank's official cash rate remains at a level (1.75 percent) which allows for a further easing in monetary policy if conditions require it. In a speech in early March 2017, the Reserve Bank Governor said that "the risks around future OCR movements are considered to be equally weighted".³¹

Annual global inflation started to rise during the second half of 2016. The OECD reported that annual inflation was 2.4 percent in the year ended April 2017 within the OECD area (down slightly from annual inflation of 2.5 percent in February 2017) (Chart 3). Higher international energy prices, which rose by 8.2 percent in the year ended April 2017, have placed upward pressure on prices.

Chart 3. Annual inflation within the OECD 1999 - 2017



Source: OECD [Consumer Prices](#).

Alternative monetary policy frameworks

Gross Domestic Product (GDP) targeting and price-level targeting have been suggested as other monetary policy frameworks. In a recent article John C. Williams, President and Chief Executive Officer of the Federal Reserve Bank of San Francisco, said that it was opportune to reassess monetary policy frameworks in an environment where the natural real interest rate had declined.³² The natural interest rate is the short-term interest rate at which monetary policy is neither accommodative nor contractionary. A lower natural rate of interest provides less room to stimulate the economy during times of economic downturn, as central banks are

³¹ Graeme Wheeler, Reserve Bank Governor "[Some thoughts on the balance of risks around the Reserve Bank's monetary policy setting](#)" (Speech delivered to Craigs Investment Partners' Investor Day in Auckland, 2 March 2017).

³² John C. Williams "[Monetary Policy in a Low R-star World](#)" (August 2016) 23 Federal Reserve Bank of San Francisco Economic Letter.

reluctant to reduce interest rates below zero.³³ In the article, Williams said the following policies were worth considering:³⁴

- targeting a higher rate of inflation: or,
- replacing inflation targeting by a flexible price-level or nominal GDP targeting framework.

A long-run inflation target of 4 percent?

The International Monetary Fund published a Working Paper in 2014 presenting the case for raising the long-run inflation target for central banks to 4 percent. According to the author, “A higher inflation target raises the long-run levels of nominal rates, allowing larger decreases in rates before the zero bound becomes binding. The flexibility makes it easier for a central bank to restore full employment when an economic slump occurs”.³⁵

“A four percent target would ease the constraints on monetary policy arising from the zero bound on interest rates, with the result that economic downturns would be less severe. This benefit would come at minimal cost, because four percent inflation does not harm an economy significantly”.³⁶

In a 2012 speech, Governor of the Bank of Canada Mark Carney, (now Governor of the Bank of England) said that any increase in the inflation target would risk “unmooring inflation expectations and destroying the hard-won gains that have come from the entrenchment of price stability”.³⁷ As a result, risk-premiums may increase due to rising inflation expectations, leading to higher real interest rates (interest rates after accounting for inflation), which would have a negative effect on the real cost of borrowing.

The Bank of Canada has recently completed a formal review of its inflation targeting framework. It investigated whether a higher inflation target would be appropriate. It concluded that the low inflation problem arises relatively infrequently in economic history, whereas the cost of higher inflation is ongoing, while it may be more difficult to stabilise inflation at higher rates.³⁸

Nominal Gross Domestic Product (GDP) targeting

Nominal GDP targeting involves the central bank targeting a specified annual nominal GDP rate (e.g. 5 percent). The nominal GDP rate includes two components:

- the volume of goods and services produced within an economy (i.e. real GDP)
- the annual change in prices of those goods and services.

It is possible to have the same nominal GDP growth rate with a low level of annual inflation along with a high real GDP growth rate, as it is with a high annual inflation rate and a low level of real GDP growth. Under nominal GDP targeting, the monetary policy settings are likely to be similar under each of the different scenarios shown in Table 2 below as the overall nominal GDP rate is the same (i.e. 5 percent).

³³ Some central banks have moved to negative interest rates in order to ease monetary policy and place downward pressure on their exchange rate. The Swiss National Bank implemented a negative interest rate on 17 December 2014, with the Swiss three month Libor rate currently operating in a range of -0.25 to -1.25 percent.

³⁴ John C Williams, above n 28.

³⁵ Laurence Ball “[The Case for a Long-Run Inflation Target of Four Percent](#)” (June 2014) IMF Working Paper at 1.

³⁶ Laurence Ball, above n 31, at abstract.

³⁷ Mark Carney, Governor of the Bank of Canada and Chairman of the Financial Stability Board “[A monetary policy framework for all seasons](#)” (Remarks by Mr Mark Carney at the 2012 US Monetary Policy Forum, sponsored by The Initiative on Global Markets, University of Chicago Booth School of Business, New York City, 24 February 2012) at 3.

³⁸ Bank of Canada, “[Renewal of the inflation-control target – Background information](#)” (October 2016) at 3.

Table 2. Scenarios of nominal GDP targeting

	Annual inflation	Annual Real GDP	Annual Nominal GDP
Scenario A	1%	4%	5%
Scenario B	3%	2%	5%
Scenario C	5%	0%	5%

Supporters of nominal GDP targeting say that it would potentially provide greater monetary policy stimulus during periods of high inflation and low real economic growth. It would also prevent central banks from having to respond to supply-shocks which lead to an increase in inflation over the short-term. Following a period in which the nominal GDP growth rate was lower than targeted, the central bank would ease monetary policy in order to promote economic growth. The opposite would occur when nominal GDP growth comes in above target.

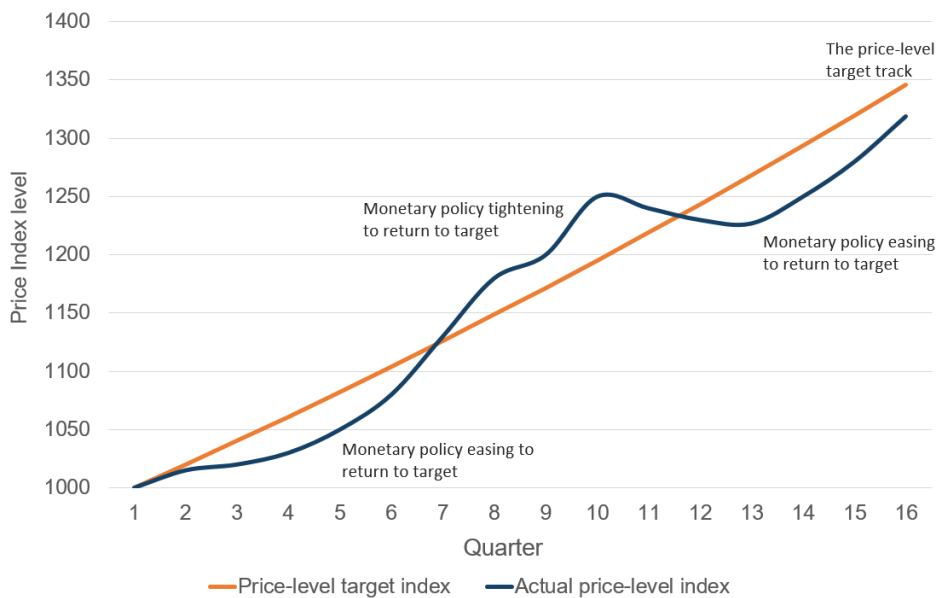
Proponents of inflation targeting monetary policy would argue that central banks often look through such supply-shocks when setting monetary policy. They also take into account the broader impact of any monetary policy tightening or loosening on the economy. It also may be difficult to communicate why the official cash rate is kept at the same level during significant changes in the annual inflation rate. In a 2012 memorandum to the Minister of Finance, the Reserve Bank also questioned how revisions of real GDP growth (as undertaken periodically by Statistics New Zealand) would be handled under a nominal GDP targeting regime.³⁹

Price-level targeting

Another option is targeting a particular change in a price index over time (known as price-level targeting) which results in a price track going forward (e.g. targeting the Consumers Price Index to rise by 2 percent per year). Price-level targeting has only been tried by the Bank of Sweden during the 1930s. Under such a scenario, departures from the specified price-level accumulate over time, which could result in significant tightening or easing of monetary policy in order to bring prices back on track (Chart 4). This is the main difference between price-level targeting and inflation targeting. With price-level targeting, any deviation from the fixed price path is resolved through monetary policy tightening or easing by increasing or decreasing interest rates, resulting in a period of offsetting inflation levels. Inflation targeting on the other hand, does not seek to offset periods where the inflation rate has been outside the target band. It aims to bring the underlying inflation rate back within the target band (i.e. it is forward looking). Price-level targeting (in theory) provides greater certainty of changes in prices over the medium to long-term. The success of such a regime depends on the impact on inflationary expectations, and whether firms and households believe that the central bank will act accordingly when the price-level undershoots or overshoots its price-level target.

³⁹ Reserve Bank of New Zealand "Memorandum to the Minister of Finance. Issues relating to inflation targeting and the PTA" (2 May 2012) at 5.

Chart 4. Price-level targeting example



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APPENDIX 1. Monetary policy inflation targets in other countries

The following table details the inflation target goals of other central banks along with whom within each bank decides on whether to tighten or loosen monetary policy.

Country / Country area	Central Bank	Monetary Policy Inflation Target (Annual inflation)	Monetary policy decision made by
Australia	Reserve Bank of Australia	Between 2–3 percent, on average, over the cycle.	Reserve Bank Board
Canada	Bank of Canada	1 to 3 percent, with the Bank's monetary policy aimed at keeping inflation at the 2 percent target midpoint.	Governing Council
Euro area (<i>includes Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain</i>)	European Central Bank	Below, but close to, 2 percent over the medium-term.	Governing Council
Israel	Bank of Israel	Between 1 and 3 percent.	Monetary Committee
Japan	Bank of Japan	2 percent.	Policy Board
New Zealand	Reserve Bank of New Zealand	Annual inflation of between 1 and 3 percent on average over the medium-term, with a focus on keeping future average inflation near the 2 percent target midpoint.	Governing Committee (Governor retains statutory responsibility for decisions, and the right to veto decisions)
Norway	Norges Bank	Close to 2.5 percent over time.	Executive Board
South Korea	Bank of Korea	2 percent	Monetary Policy Board
Sweden	Sveriges Riksbank	Around 2 percent per year	Executive Board
United Kingdom	Bank of England	Price stability is defined by the Government's inflation target of 2 percent. The Government must specify its definition of price stability at least once in every 12 month period. Any deviation of more than 1 percentage point either side must be explained through an open letter.	Monetary Policy Committee
United States	United States Federal Reserve	2 percent, as measured by the annual change in the price index for personal consumption expenditures.	Federal Open Market Committee

Sources: Central bank websites.

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