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Transition to Inflation Targeting: is the New Zealand Experience Useful?

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Abstract: The article examines the New Zealand experience of the transition to inflation targeting. In particular, the necessity and reasons for New Zealand's transition to this regime were analyzed. When adjusting inflation expectations, the Reserve Bank's activities in cooperation with the government were taken into account. The influence of the official cash rate on market rates was also studied. In addition, the exchange rate of the "Comfort zone" and the "Trade Weighted Index" were studied as part of the monetary policy. As part of open market operations, the Reserve Bank's "Quantitative easing" instruments were analyzed.

Key words: monetary policy, inflation targeting, inflation expectations, official cash rate, "Trade Weighted Index", "Large-scale asset purchases", "Urgent lending practice".

Introduction

When it comes to the inflation targeting regime, the first thing that comes to mind is the experience of New Zealand, which realized the priority of this regime earlier than others and switched to it. So!, which of the necessary things did New Zealand choose to switch to an inflation targeting regime, and what were the stages and processes of transition to this regime? It was in this article that the New Zealand experience of the transition to inflation targeting was studied, which is considered a relevant and interesting object of research for researchers.

It should be noted that the Reserve Bank's determination of the inflation rate at low rates as the only medium-term goal of monetary policy is explained by the instability of macroeconomic indicators, such as high inflation, low average annual economic growth and the emergence of imbalances between nominal incomes and real goals.

"In the 1970s and 1980s, prices in New Zealand rose sharply. During this period, the annual consumer price index was 10-15 percent, which was much higher than inflation in the country's main trading partners"[1]. At this stage, let's focus on the main factor that is considered to be the cause of inflation. Until 1970, the Reserve Bank pursued a tight monetary policy. However, no matter how much the Reserve Bank wanted to, in the 1970s and 1980s it could not get out from under the influence of the government. That is, the emergence of macroeconomic problems, such as rising unemployment against the background of a reduction in production as a result of restrictive policies, increased the government's pressure to pursue a soft monetary policy. As a result, the Reserve Bank's expansionary policy encouraging government spending has led to an increase in production costs and increased inflationary processes. This, in turn, led to a further expansion of the scale of macroeconomic problems.

To date, it is worth noting that every country that has chosen an inflation targeting regime is switching to this regime with its own characteristics. In this case, the main aspect is explained by the scale of macroeconomic problems in the country and the directions of their solution. It is thanks to different approaches to solving similar problems that some countries have managed to achieve the set inflation target at the first stage, and others at the second or third. In this regard, the study of the experience of New Zealand as a country that has successfully passed inflation targeting and the practical use of priority aspects in it are of great practical importance for countries that are currently transitioning to inflation targeting, and determine the need and relevance of conducting research on this issue.

Literature review. A number of studies have been conducted on New Zealand's transition to inflation targeting, as well as the Reserve Bank's use of monetary policy instruments, some of which have been discussed in this article.

D. Archer, an expert at the Reserve Bank of New Zealand[2] notes the following four key features associated with the country's transition to an inflation targeting regime: "Firstly, a nominal variable (for example, price levels or inflation) was recognized as the only achievable medium-term goal of monetary policy; secondly, monetary policy It was aimed directly at achieving a medium-term goal with a clearly defined inflation target, and not at achieving an indirect intermediate goal; Thirdly, an institutional structure was formed that clearly defined the respective roles and obligations of the main participants (the Central Bank and the government); fourthly, special attention was paid to ensuring transparency to support the agreement and compensate for "weaknesses" in the institutional structure".

A.Bollard[3] puts forward the following theses: "at the initial stage of the inflation targeting regime, the Reserve Bank of New Zealand was characterized as a strict inflation regulator, but as inflation expectations approached the target, it became a "flexible" inflation regulator". In addition, A. Ballard in his research explored the New Zealand style of inflation targeting, emphasizing the role and importance of price stability in macroeconomic policy. In addition, he investigated the effectiveness of a flexible inflation targeting policy in the face of internal and external shocks.

The exchange rate is one of the indicators that play an important role in New Zealand's monetary policy. After all, the reforms in this area are all the more significant because they have been successful for many years. In particular, R.Sullivan[4] notes that "over the past 40 years, almost all forms of currency regime have been used in New Zealand. Although there have been dramatic changes in macroeconomic indicators over this period, the long-term dynamics of the real exchange rate have undergone surprisingly little change. That is, the introduction of an inflation targeting regime did not have a serious negative impact on the dynamics of changes in the real exchange rate".

In our opinion, it is necessary for any central bank to clearly define its obligations to determine and achieve the inflation target, in particular, the intermediate and strategic objectives of monetary policy. In this case, it is important that the communication channel regarding inflationary expectations of the population and business entities regularly ensures efficiency.

Methodology. The scientific and theoretical aspects of the article are based on the study of the approach and views of a number of foreign economists on this topic and the presentation of the author's attitude towards them, as well as the macroeconomic conditions for the implementation of monetary policy in the context of New Zealand's transition to inflation targeting, as well as the fact that currently there are many approaches and points of view in New Zealand for inflation. analysis of the monetary policy pursued by the Reserve Bank, In carrying out this study, methods of comparative assessment and scientific abstraction, system analysis were used.

Analysis and results. It is worth noting that after 1980, the Reserve Bank was more confident than the Ministry of Finance in bringing the country out of difficult macroeconomic conditions to sustainable development in the future. It follows from this that at the initial stage of the transition to inflation targeting, incentive measures were implemented aimed at strengthening the Reserve Bank's independence status and ensuring its exclusive powers in the monetary sphere in order to prevent it from falling under the influence of political decisions and pressure. In particular, in 1989, a new version of the law "On the Reserve Bank of New Zealand" was adopted, which laid the foundation for the Reserve Bank's transition to an inflation control regime, which was assessed as a turning point that opened new horizons for the monetary policy of central banks in the future. politics at the international level.

It is known from international experience that there are such types of inflation targeting as single-point, corridor, range, and the type of inflation targeting corridor is chosen by the Reserve Bank. "The Reserve Bank's monetary policy report for the first quarter of 1990 provides the following data: the following transitional target levels for reducing inflation: according to it, by December 1990 – a range of 3-5 percent; by December 1991 – 1.5-3.5 percentage range; by December 1992, the range was 0-2 percent"[5].

At the same time, it is worth noting that even in the period after 1992, the achievement of maintaining the inflation rate in the range of 0-2 percent was warmly supported by the country's political elite. Because the governor of the country, whose term of office was set until the end of 1993, tried to ensure price stability in society during his term of office, and this also reflected in the real figures of 1 percent in 1992 and 1.3 percent in 1993. The level of the target inflation corridor of 0-2 percent remained until December 1996, and from that period the upper limit was increased to a 1 percent range, as a result of which the width of the corridor was 0-3 percent. However, at the end of the third quarter of 2002, the Reserve Bank decided to ease monetary policy and changed the target range by 1-3 percent, increasing the lower limit by 1 percent (Figure 1).

At the same time, the Reserve Bank presented its new approach in September 2012. According to him, it was announced that in the next period there will be a transition from the target type of corridor to the target type with a range of 2 ± 1 percent. Economist R. Kendal noted that "this approach was proposed in order to maintain inflation expectations at 2 percent and to be able to respond to inflation as it approaches the upper or lower boundary of the corridor"[6].

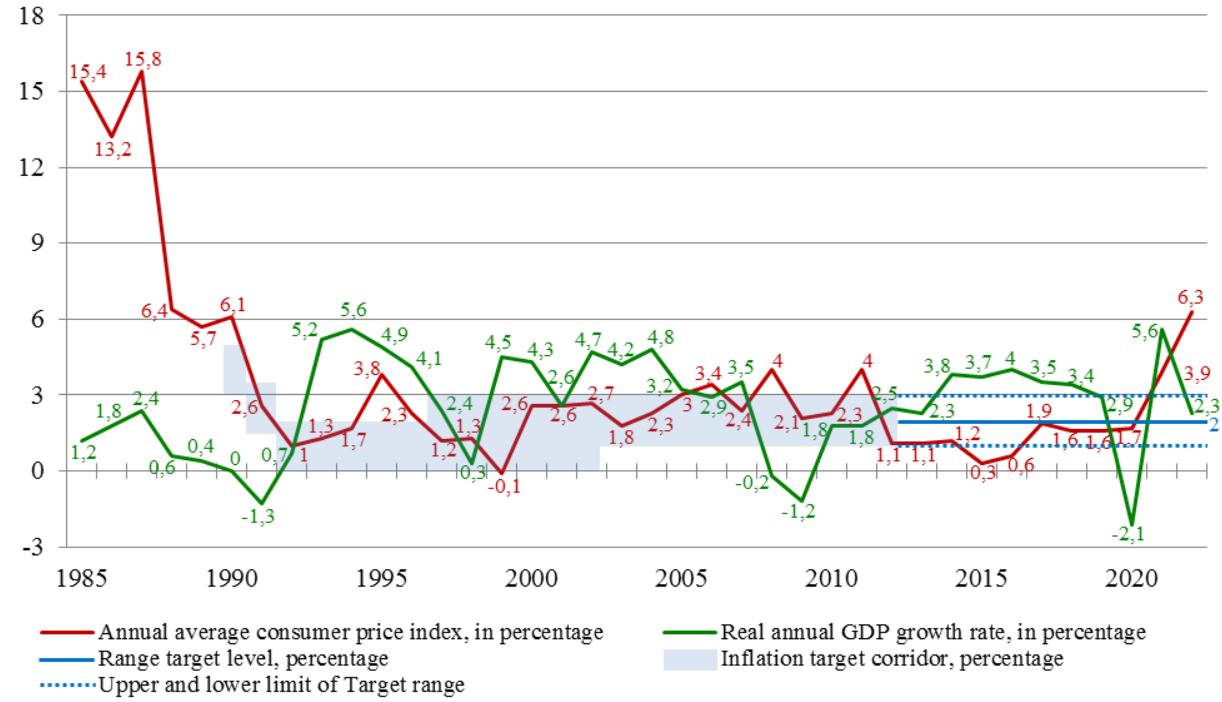

Figure 1. Annual dynamics of GDP and CPI growth in New Zealand in 1985-2022[1].

From the data in Figure 1, it can be seen that the real inflation rate after the transition to inflation targeting was largely formed within the established target corridor. In particular, only in 7 of the last 30 years has the actual inflation rate exceeded the upper limit of the target corridor. Of these, it is worth noting that inflation in 3 years was formed under the influence of external shocks, such as the global crisis, COVID-19 and the Russian-Ukrainian conflict. In particular, the annual

[1] Developed by the author based on data from the International Monetary Fund (https://www.imf.org/en/Countries/NZL) and the Reserve Bank of New Zealand(https://www.rbnz.govt.nz/).

growth rate of the CPI increased sharply - to 4% in 2008 and 2011 and to 6,3% in 2022. It is worth noting separately that the average CPI growth rate in 2000-2022 was 2,37%. For comparison, this figure was 2,74% in Australia, 2,49% in the United States and 2,15% in Canada (Figure 2).

It can also be seen that the annual growth rate of production in New Zealand during this period was also higher than inflation. In particular, only during 8 of the last 30 years, GDP growth rates have been formed at a level below the annual CPI. In this regard, over the past 6 years, the above-mentioned external shocks have led to a reduction in production volumes. In particular, the annual GDP growth rate dropped sharply to -1,2% in 2009 and -2,1% in 2020. The average GDP growth rate for 2000-2022 was 2,79%. For comparison, this figure was 2,79% in Australia, 1,99% in the United States and 1,98% in Canada (Figure 2).

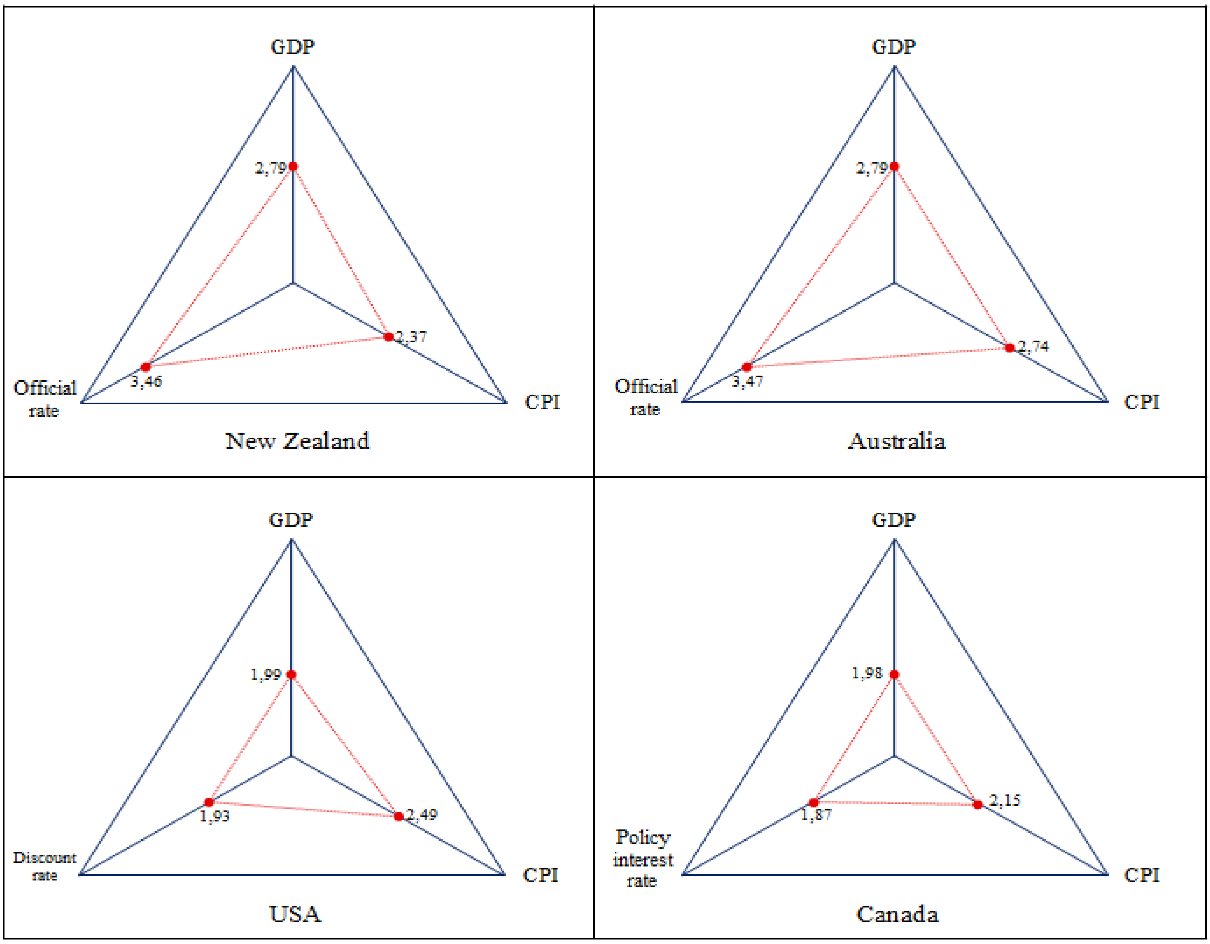

Figure 2. Average growth dynamics of CPI, GDP and central bank rates in countries in 2000-2022[2]

Figure 2 shows that the dynamics of the three main indicators averaged over 23 years is formed very close to each other in New Zealand and Australia, as well as in the United States and Canada. This was largely due to efforts to preserve the difference between real indicators due to the territorial proximity of the countries.

The above aspects demonstrate the need to reform the country's monetary policy in connection with the macroeconomic problems that arose in New Zealand in the 1980s, as well as the Reserve Bank's choice of an inflation targeting regime. The following is an analysis of the Reserve Bank's experience in using monetary policy instruments in the inflation targeting regime.

In accordance with the Reserve Bank of New Zealand Act[7], achieving and maintaining overall price stability in the medium term and supporting sustainable employment are identified as the

[2] Developed by the author.

main tasks of the Reserve Bank. Therefore, the Reserve Bank applies monetary policy instruments based on these goals.

Exchange rate policy (Comfort zone, Trade Weighted Index, TWI). The exchange rate is one of the indicators that play an important role in New Zealand's monetary policy. After all, the reforms in this area are all the more significant because they have been successful for many years. In particular, “in New Zealand, almost all forms of currency regime have been used over the past 40 years. Although there have been dramatic changes in macroeconomic indicators over this period, the long-term dynamics of the real exchange rate have undergone surprisingly little change. That is, the introduction of an inflation targeting regime did not have a serious negative impact on the dynamics of changes in the real currency ratio”[4].

At this stage, it is acceptable to focus on the specifics of the New Zealand foreign exchange market. In particular, A. Besuen[9] defines the country’s foreign exchange market as an unusual and active market. “According to the Bank for International Settlements (BIS), in 2019, the daily turnover of the New Zealand foreign exchange market is 55% of the country’s gross domestic product. For comparison, in Switzerland, where an open economy is calculated and intensive foreign exchange trading is conducted, this figure is 35 percent. For this reason, the effect of interventions in New Zealand differs from the effect of interventions in other countries, and this is due to the fact that there is a lot of liquidity in the New Zealand dollar”.

It is worth noting that the Reserve Bank tries to stay at the level of the exchange rate (Comfort zone). The “comfort zone” of the currency exchange rate means that at the same time, it will be advisable to form inflation within the target range of 2 ± 1 percent, as well as stimulate production.

As we know, it is necessary that the exchange rate of each country serves the effectiveness of foreign trade relations. It follows that the Reserve Bank has introduced the “Trade Weighted Index” (TWI), which represents the value of the New Zealand dollar compared to 17 currencies of the main trading partners, whose share in the total foreign trade balance of the country exceeds 1%, in order to ensure the real effectiveness of the exchange rate. In 2021, 86% of New Zealand’s total foreign trade will be carried out in the above-mentioned 17 currencies. Currency values in accordance with the “Trade Weight Index” are reviewed and published annually (Table 1).

Table 1 The private weights of New Zealand dollars in 2017-2022 against 17 currencies in the basket “Trade Weight Index”[3]

Private weights	2017	2018	2019	2020	2021	2022
Australian dollar	20,7325	20,6866	19,8373	19,1853	18,7106	17,2918
US dollar	13,9802	14,0116	13,3803	13,2674	13,6429	13,5653
Japanese Yen	6,3548	6,8036	6,5150	6,3890	6,0667	5,6817
UK pound	4,5625	4,3248	4,3446	4,1046	4,0925	3,2215
Euro	11,3486	10,7823	10,9482	10,5337	10,4174	10,0541
South Korean won	3,7820	3,4464	3,6518	3,5391	3,7389	3,5350
Chinese yuan	19,6604	20,3902	21,1142	22,8948	23,4762	27,0396
Malaysian ringgit	2,3753	2,3508	2,6124	2,5652	2,2379	2,0527
Hong Kong dollar	1,3493	1,3550	1,5853	1,5118	1,3512	1,2190
Indonesian rupee	1,6042	1,5667	1,5768	1,6638	1,7075	1,8483
Thai Baht	2,9442	3,1383	3,0586	3,0028	2,6956	2,8420
Singapore dollar	3,7989	3,5221	3,7571	3,8690	4,3094	4,4700
Canadian dollar	1,5874	1,5026	1,4810	1,5575	1,4910	1,2660
Taiwan dollar	1,7505	1,7395	1,6840	1,7198	1,7666	1,8096
Indian rupee	2,1735	2,1719	2,1412	1,8698	1,8449	1,7408

[3] Developed by the author based on data from the official website of the Reserve Bank of New Zealand – https://www.rbnz.govt.nz/

Fillipin peso	0,9060	0,9384	0,9662	0,9734	0,9883	0,7256
Vietnamese dongi	1,0897	1,2692	1,3460	1,3530	1,4624	1,6370
Total weight	**100**	**100**	**100**	**100**	**100**	**100**

The regular formation of exchange rates in accordance with the "trade weight index" serves to balance relations in mutual trade. The index also demonstrates the country's international competitiveness, allowing it to adapt various changes in the currencies of mutual trading partners to the general trend.

The "Trade Weight index" can also be used to ensure stable dynamics of the nominal exchange rate of the partner countries during the period without sharp fluctuations. This is also evident from the trend in the formation of the nominal exchange rate in recent years (Figure 4).

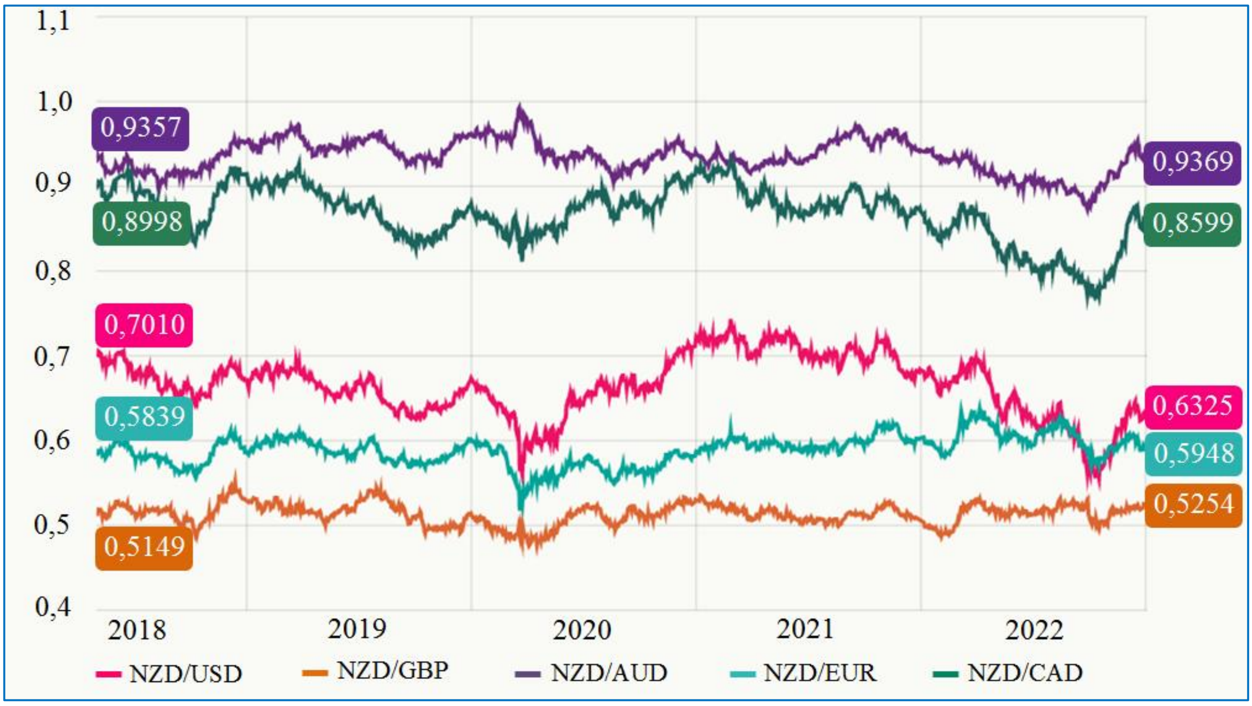

Figure 4.1. Dynamics of the nominal exchange rate of the New Zealand dollar against the currencies of the main partner countries[4]

Figure 4 shows that at the end of 2022, the nominal exchange rate of the New Zealand dollar against the world's highly liquid currencies remained virtually unchanged compared to the level as of May 1, 2018. That is, over the past period, the New Zealand dollar has stabilized at 10,83% against the US dollar, depreciated by 4,64% compared to the Canadian dollar, by 2,03% compared to the British pound, by 1,86% compared to the euro and by 0,12% compared to the Australian dollar. This indicates that the Reserve Bank is pursuing an effective monetary policy aimed at ensuring the international competitiveness of the country's currency.

Conclusion

The following aspects are important in the New Zealand experience:

First of all, the Central Bank of New Zealand, when switching to inflation targeting, clearly noted how well the interim monetary policy goals correspond to the strategic goals of ensuring price stability. Because most central banks focus their main attention on ensuring price stability, not on inflation itself, but on the factors that shape it, in particular, the amount of money in circulation and the level of credit expansion. After all, these factors serve only as a channel of communication in making monetary policy decisions.

[4] Developed by the author based on data from the official website of the Reserve Bank of New Zealand – https://www.rbnz.govt.nz/

Secondly, the Central Bank of New Zealand is not too committed to the goals of the government's macroeconomic policy. That is, in the event of macroeconomic problems, such as a reduction in production, an increase in unemployment, the government used a two-pronged approach aimed at protecting interests from pressure. At the same time, the inflation targeting regime gave priority to monetary policy and took the initiative to lead the country out of difficult macroeconomic conditions to sustainable development in the future. It follows from this that in order not to be influenced by political decisions and pressure at the initial stage of the transition to inflation targeting, it is important to introduce incentive measures aimed at strengthening the independence status of the Central Bank and ensuring its exclusive powers in the monetary sphere.

Thirdly, the Reserve Bank welcomed the transition from the target corridor to the target range. Because the target range allowed the Reserve Bank to pursue a flexible policy. This made it possible to mitigate the impact of fluctuations in the global economic environment on inflation, in particular on domestic economic indicators. After all, in recent years, the economies of countries have suffered more from external shocks than from internal ones. It is in this situation that the Reserve Bank is trying to reduce its responsibility. It is worth noting that there are also problems with the target range. That is, in some situations, due to the narrowness of the range, the real inflation rate may increase the probability of going beyond the range.

Fourth, when it comes to the New Zealand economy, it would be appropriate to pay attention first of all to the high liquidity of the New Zealand dollar. Because, due to the fact that changes in the exchange rate in the country actively affect production and the well-being of the population, the Reserve Bank directs large-scale resources to ensure the stability of the exchange rate, if necessary. At the moment, most central banks always have difficulty ensuring sharp fluctuations in their national currencies. While in some countries there is an imbalance of supply and demand for currency in the domestic market, in others there are serious differences in the real exchange rate with foreign partner countries. The following New Zealand experience is of particular importance in this regard: according to it, the Reserve Bank introduced a "trade weight index" representing the value of the New Zealand dollar compared to 17 currencies of the main trading partners, whose share in the country's total foreign trade balance is more than 1% in order to ensure the effectiveness of the real exchange rate. The regular formation of exchange rates in accordance with the "trade weight index" serves to balance mutual trade relations. The index also demonstrates the country's international competitiveness, allowing it to adapt various changes in the currencies of mutual trading partners to the general trend. The "Trade Weight index" can also be used to ensure stable dynamics of the nominal exchange rate of the partner countries during the period without sharp fluctuations.

The process of the Reserve Bank's transition to an inflation targeting regime was generally successful, but in some aspects. Over the past 30 years, stable production has been achieved while maintaining low prices. This increases the relevance and importance of studying New Zealand practice as a foreign experience.

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