Submission to the Senate Standing Committee on Economics

Inquiry into the Reserve Bank Amendment (Enhanced Independence) Bill 2008

by

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Foreword

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The importance of central bank independence

At least since the late 1960s and early 1970s, it has been widely agreed among economists that *expectations* play an important role in influencing the rate of inflation which a country experiences over any given period of time.

That is, if people (in their various capacities as consumers, employees or business managers) *expect* the general level of prices to continue rising at a rapid pace, they will tend to behave in ways that *ensure* that it does – for example, by 'buying now rather than later' in order to 'beat' anticipated price rises (and thus adding to demand pressures); by pursuing wage claims that incorporate an element of 'compensation' for anticipated price rise (and thus, to the extent that such claims are successful, adding to labour cost pressures); and by raising selling prices to recoup anticipated cost increases (and thus adding directly to inflation).

Conversely, if prices are expected to remain generally stable – or, at least, to rise at a pace sufficiently modest to escape general attention – then their behaviour is more likely to be consistent with inflation remaining low and stable.

Thus, keeping people's expectations regarding the future rate of inflation (or *inflation expectations*) low and stable (or '*well anchored*', as economists sometimes say) contributes to keeping inflation itself low and stable.

Well-anchored inflation expectations can materially assist an economy to cope with an impulse or shock which causes a jump in the price of a particular good or service, or the prices of a range of goods and services - such as the introduction of a new indirect tax, or an increase in oil prices. If people expect that such an impulse will trigger subsequent rounds of price increases, they will be inclined to behave in ways (such as those described above) that make such subsequent rounds of price increases more likely. Conversely, if people's inflation expectations are well-anchored, then the initial inflationary impulse is less likely to lead to a sustained increase in inflation.

People's expectations regarding the future rate of inflation are obviously conditioned by their recent experience of inflation – which is one reason why, the longer inflation has persisted at an elevated rate, the harder (and the more costly in terms of economic growth foregone and jobs lost) it is to bring it down.

Inflation expectations will also be affected by people's perceptions of the competitive structure of the economy. If they believe that strong domestic or international competition (or, in the case of sectors where strong competitive pressures are absent, effective regulatory action) will prevent cost increases from being passed on in the form of price increases, inflation expectations will be more stable. Similarly, if people understand that wage increases in excess of productivity growth are likely to lead to job losses, inflation expectations will be more stable.

However, inflation expectations are also informed by people's understanding of how economic policy will react to a rise in inflation. If it is widely believed that those responsible for economic policy are unwilling to take firm action in response to an acceleration in inflation, or that they will be unable to sustain that action in the face of an adverse public reaction to slowing economic growth and rising unemployment, or that they will postpone a response because of an imminent election, then people will expect inflation to accelerate and hence will seek to take actions to protect themselves against it – actions which will make a further rise in inflation more likely.

The orthodox economic policy response to rising inflation is tighter monetary policy – that is, higher interest rates. Higher interest rates are almost never popular (other than, perhaps, with people whose primary source of income is interest; but they represent a very small proportion of the population). Higher interest rates are particularly unpopular with people servicing mortgages, who in turn tend to be concentrated in marginal electorates. Thus, politicians are reluctant to accept responsibility for increasing interest rates, and quick to oppose increases in interest rates when they are not (and cannot be held) directly responsible for them.

When, as was the case in Australia until the 1990s, the setting of interest rates is understood to be ultimately in the hands of elected politicians, it is harder to convince the public that monetary policy will respond as required to any inflationary impulse, or that any such response will be sustained until inflation has been brought down to an acceptable level. And such scepticism is well-founded. There are numerous examples, from Australia and elsewhere during the 1970s and 1980s, of political considerations being given greater weight than economic ones in the formulation of decisions regarding interest rates. When Treasurer, Paul Keating once famously boasted that 'monetary policy was simply a matter of picking up the telephone to the Governor of the Reserve Bank' who, on another occasion, he had described as being 'in his pocket'; such comments, even if they gave an exaggerated depiction of the extent of political interference in the conduct of monetary policy, were hardly conducive to building widespread confidence that the exigencies of the electoral cycle would not occasionally transcend the requirements of sound economic policy.

As the significance of inflation expectations to the inflationary process became more widely recognized and understood among economists, the importance of *policy credibility* to influencing inflation expectations gained more recognition. 'Policy credibility' means the belief that those responsible for formulating and implementing economic policy have both the intention and the ability to achieve their stated policy objectives, even if it entails some political or other costs. In the context of monetary policy, 'policy credibility' has come to be associated with *central bank independence* – that is, the ability of central banks to set monetary policy without any requirement to seek approval or permission from elected officials for their proposed course of action. This was particularly the case in countries such as New Zealand, Australia, the United Kingdom and Sweden, where high inflation rates had persisted for longer than in (for example) the United States, Germany and Switzerland where, significantly, the independence from political intervention in the setting of interest rates had been long-established.

New Zealand was the first of these countries formally to establish the independence of its central bank, with the coming in to force of a new Reserve Bank Act in February 1990. Nordic countries were the next to follow.

The Reserve Bank of Australia began to assert a form of *de facto* independence during the early 1990s, which was tacitly accepted by the then Government – even as that independence was vigorously demonstrated when the Bank raised its cash rate target by 2.75 percentage points in the space of three months, between August and November 1994. Significantly, this was the first occasion (at least since the mid-1970s) when a rise in actual inflation was *not* accompanied by a noticeable rise in inflation expectations. This episode underscores the contribution that central bank independence makes to policy credibility.

The Reserve Bank's independence was formally recognized in the Joint Statement on the Conduct of Monetary Policy issued in August 1996 by then Treasurer Peter Costello and then Governor-designate Ian Macfarlane.

Similar statements were issued at the time of Ian Macfarlane's re-appointment as Governor in July 2003, Glenn Stevens' appointment as Governor in September 2006, and most recently in December 2007 after the election of the present Government. These statements have also set out the mechanisms by which consultations occur between the Government and the Reserve Bank, and by which the Reserve Bank is accountable to the Parliament and to the public for its conduct of monetary policy.

Can the independence of the Reserve Bank be further enhanced?

Australia has been well-served by these arrangements. Australia's inflation rate has averaged 2.6% per annum since the September quarter 2006, almost exactly in the mid-point of the target range. Abstracting from the impact of the introduction of the GST in 2000, the 'underlying' inflation rate has been outside the target range (in either direction) for only 14 of 47 quarters, and outside of it by more than 0.5 percentage points for only 4 quarters (including the most recent two).

Moreover, this achievement has not been at the expense of the other objectives laid out in the *Reserve Bank Act*, in particular, 'the maintenance of full employment in Australia': the proportion of Australia's civilian working-age population in employment has exceeded 60% since 2004, for the first time since the 1974 recession.

Although many global and domestic factors have contributed to these outcomes, the enhanced credibility of Australia's monetary policy framework has surely been prominent among them.

Despite that, the conduct of monetary policy in Australia is especially notable, by comparison with other countries with similar arrangements, for the amount of controversy it generates. That there is debate about monetary policy is, in a democratic society, unexceptional. The fact that most Australian mortgages are at floating interest rates, unlike most other Western economies (with the exception of the United Kingdom, so that changes in monetary policy are more quickly and directly transmitted to a large proportion of the population than in most other comparable countries, may explain the much greater public attention devoted to monetary policy in Australia than in, say, the United States or Europe.

What has been particularly unusual in Australia is the extent to which the government of the day has participated in such debates. The previous Government explicitly 'reserved the right to comment on monetary policy from time to time', and members of that Government exercised that right frequently.

In no other Western country with an independent central bank have decisions to raise interest rates been the object of so much commentary by members of the government itself (including Ministers with responsibilities for economic policy) as has been the case in Australia. Much of this commentary took the form of suggesting, in advance of RBA Board meetings, that interest rates should not be lifted; or, after Board meetings, that interest rates should not have been lifted.

There was never (to my knowledge) any suggestion that criticism by members of the previous Government of monetary policy decisions carried any threat, explicit or implied, to the security of tenure of Reserve Bank officials, including the Governor or the Deputy Governor. Nevertheless, the fact that these two officials are appointed by, and can have their appointments terminated by, the Treasurer without reference to Parliament, leaves open the possibility that a Government which felt sufficiently aggrieved by the decisions of the Reserve Bank could use its powers of appointment and dismissal to influence the conduct of monetary policy. A Government could, for example, conceivably interpret decisions by a Governor and Deputy Governor to raise interest rates which it found especially politically inexpedient to constitute such a departure from 'good behaviour' as would, in the terms of section 24 (1) of the *Reserve Bank Act*, provide grounds for termination of their appointments.

That possibility may well be very remote. It might even be said that it exists only in theory. Nonetheless, removing that possibility, even if it is only theoretical, would serve to enhance perceptions of the Reserve Bank's independence.

It seems eminently reasonable that the Governor and Deputy Governor of the Bank should have the same statutory independence as the Commissioner and Second Commissioner of Taxation, or the Australian Statistician, positions which also demand a high degree of visible independence from political interference in order to discharge their responsibilities effectively.

That said, it does seems odd that the precise form of words envisaged by the Bill provide for the termination of a Governor's or Deputy Governor's appointment by the Governor-General solely on the grounds of becoming 'permanently incapable of performing his or her duties', engaging in 'paid employment outside the duties of his or her office' or becoming bankrupt, and does not allow for his removal on the grounds of 'proven misbehaviour' upheld by resolutions of both Houses of Parliament, as is the case with Commissioner and Second Commissioner of Taxation and the Australian Statistician (or, for that matter, Judges of the High Court).

That may also appear to be a very slight possibility. However the Shadow Treasurer, Malcolm Turnbull, has provided (in his Second Reading Speech on the Bill in the House of Representatives) as an example of the circumstances in which such a provision would be well justified, the behaviour of the then Governor of the Bank of Italy in 2005.

It would seem prudent, therefore, that if the tenure of the Governor and Deputy Governor of the Reserve Bank is to be enhanced in the way envisaged by the Bill, that it the Bill should also include provision for 'proven misbehaviour' to be a ground for removal upon a resolution to that effect by both Houses. Desirably, 'proven misbehaviour' might be specifically defined to exclude decisions with regard to the cash rate target *per se* as constituting 'proven misbehaviour' simply because the Government of the day disagreed with them, or even if they turned out (with the benefit of hindsight) to have been ill-advised.

Is there a need to enhance further the accountability of the Reserve Bank?

The Reserve Bank's accountability to the Parliament and to the Australian public in respect of its conduct of monetary policy has been significantly enhanced over the years since it was formally granted independence in 1996. In particular:

- the *Statements on Monetary Policy*, originally envisaged as being issued semi-annually, have been published quarterly since February 1997, have expanded in length from 23 pages to 63 pages, and have provided progressively greater disclosure about the economic forecasts on which the Bank's monetary policy decisions have been based (indeed, the Bank's forecasts are updated twice as often as Treasury's, and in the case of forecasts for GDP and inflation are provided in more detail than Treasury's);
- since December 2007, the Reserve Bank Board has issued a statement after every Board meeting, rather than only after meetings which resulted in a change in the cash rate target;
- also since December 2007, minutes of Board meetings have been publicly released two weeks after each meeting; and
- the Governor, his Deputy and other senior officials appear twice a year before the House of Representatives Standing Committee on Economics to give evidence and answer questions on their conduct of monetary policy.

All told, these arrangements require the Reserve Bank to issue at least 28 public statements about monetary policy each year, or more than once a fortnight on average, not counting speeches by the Governor and other officials which from time to time touch on aspects of monetary policy or the Bank's Annual Report.

It is difficult to envisage how the accountability of the Reserve Bank could be meaningfully further enhanced.

Some might argue that accountability might be further enhanced by disclosing the votes of Board members, as is the case at the US Federal Reserve, the Bank of England, and the Bank of Japan.

However, while there might be considerable public interest in the votes cast by individual Board members, it is not clear that disclosure of individual votes would enhance the independence of the Reserve Bank. It could prejudice the tenure of Board members who voted more frequently in favour of interest rate increases (since the appointment of Board members would continue to be at the Treasurer's discretion, subject now only to the requirement that they be selected from a list provided by the Governor and the Treasury Secretary). It could expose Board members who are CEOs or directors of other businesses to accusations of conflicts of interest between their responsibilities as RBA Board members and their business activities; or indeed make it harder for such Board members to vote in ways which may indirectly harm their business interests (by exposing them to criticism from shareholders in or other directors of their companies for voting for interest rate increases).

Moreover, the main value in publishing details of the votes of those who participate in the making of monetary policy decisions in those countries where that occurs is to enable market participants to evaluate the significance of their public comments. Thus, for example, if a member of the US Federal Open Markets Committee who has a track record of dissenting from decisions to raise interest rates makes a speech in which he or she expresses particular concern about upside risks to inflation, that carries far more weight than a similar speech by an official who has never dissented from a decision to lift interest rates.

However in Australia, members of the Reserve Bank Board (other than the Governor and the Deputy Governor) are specifically precluded from making public comments about the Board's deliberations. As a result, knowledge of how they voted on particular proposals is of far less value in assessing the outlook for monetary policy than is the case with members of the US Federal Open Market Committee, or the Bank of England's Monetary Policy Committee.

Revelation of the votes of individual Board members would only be of value in the event of a major restructure of the Board itself, with a view to it being comprised of individuals with a specialized knowledge of monetary and banking policy (as is the case in the US, Britain and Japan, for example), rather than the more general skills and experience represented on the Reserve Bank Board (including, in the case of its members from a business background, decision-making under conditions of uncertainty). It is not clear that a compelling case for a change of this nature has ever been mounted, let alone made, in the Australian context.

An amendment to the present Bill has been proposed which would require the Governor to appear before the House of Representatives Standing Committee on Economics 'not less than four times per year if requested by the Committee', instead of twice a year as required at present.

While it is an important point of democratic principle that the Reserve Bank be answerable to the Parliament for its stewardship of the authority which the Parliament, via the Government, has delegated it, the extent to which this objective has been fulfilled by the current arrangements is open to question.

The Governor's opening statements to the Committee have typically (and not unreasonably) followed very closely the text of the immediately preceding quarterly *Statement on Monetary Policy*, and thus typically not added to what was already on the record about the Bank's most recent thinking on the factors affecting monetary policy settings. And although the Committee's hearings do, in principle, provide an opportunity for more detailed questioning and scrutiny of the Bank's thinking, all too commonly members of the Committee have instead seen them as providing opportunities to attempt to ensnare the Governor or other officials into supporting a particular line of political argument (attempts which successive Governors have thus far managed to avoid), or for individual Committee members to demonstrate how 'in touch' they are with, or sensitive they are to, the consequences of higher interest rates or rising bank fees for their constituents.

It is not readily apparent how doubling the number of opportunities for grandstanding of this nature this would enhance the accountability of the Reserve Bank.

Nor is there any relevant precedent in other jurisdictions for requiring such a high frequency of appearances by central bank officials before the legislature. The Chairman of the US Federal Reserve Board appears before committees of each House of Congress twice a year: but while that implies that he makes four such appearances annually, in practice the appearances before the Senate and House Committees are scheduled on successive days in February and July, the Chairman's testimony to each is identical, and the questions typically cover similar subject matter. The Governor of the Bank of England appears before the Treasury Committee of the House of Commons three times a year, in March, June and November. There are no specific requirements for the Governor of the Reserve Bank of New Zealand before that country's Parliament at all.

In short, there would appear to be no useful purpose served by this amendment.