

Central Banking – A Parting View

*Address by the Deputy Governor, M. J. Phillips,
to the Economic Society of Australia
(NSW Branch), Sydney, 25 March 1992.*

As I prepare to depart the central banking scene, I would like to share with you some thoughts about the role of the central bank, its priorities and its relationship with the parliament and the government.

These are already topics of discussion at two levels in the community. I am not seeking to join the polemic at party political level; my objective is rather to contribute, out of my own experience, to the intellectual debate that has been developing and that I hope might continue on an objective plane.

I'll be chatting about three issues – the proper role of monetary policy, inflation targets, and the accountability of the central bank. This final issue is very much concerned with the degree of autonomy or independence accorded to the central bank and with the need for checks and balances. Of necessity, the coverage will be brief.

For economy of language some commentators have tended to lump these issues together under the omnibus heading “central bank independence”. That can be confusing. While there may be some overlaps, the issues are not inseparable and should be debated separately.

The Role of Monetary Policy

One needs to be modest about the role that monetary policy can sensibly play. It is, as we know, a blunt instrument which cannot be narrowly or selectively focussed. For instance, it would have defects as an agent for income redistribution. Which is not to say that monetary policy has no effect on income distribution – but the effect cannot be accurately foreseen. It tends to discriminate in an indiscriminate fashion.

Equally, monetary policy is not suited to dealing with what we used to call fundamental problems in the balance of payments. Again, that is not to say that monetary policy has no effect on the balance of payments. Obviously it does, through many doors. By raising or lowering interest rates, it affects the propensity of investors to shift capital into or out of Australia. By influencing the level of domestic demand, it affects the demand for imports and the availability of goods for export. By influencing the exchange rate, it can affect both the current and the capital account of the balance of payments (and, in the process, the returns received by exporters and the level of overseas debt measured in domestic currency).

These various effects can pull in different directions.

Over the longer haul, and I apologise for repeating what I have said on previous occasions, **structural** problems in the balance of payments have to do with the community's attitudes towards savings, consumption, investment and debt. They are not problems that can be directly targeted by monetary policy. Other areas of policy are more relevant. The best contribution monetary policy can make to them is to help keep inflation under control.

The anti-cyclical role of monetary policy – to help smooth out the effects of the business cycle – is a matter of some dispute among economists. Clearly there is a role, but it should not be overstated. And, if one looks back over post-war cycles, the role has not always been performed at optimum effectiveness. Given the problems of forecasting, that should not be too surprising.

In any event the anti-cyclical role should be seen as secondary. While the monetary authorities need to be conscious of, and to take account of, the stage of the cycle, i.e. of the existing and projected level of activity and employment, they must not take their eye off the medium-term strategic objective of low and stable inflation.

The Governor of the Bank of Canada, in recent evidence to the Canadian Parliament, put his view of monetary policy's role in words that I am happy to recycle – “there are more economic goals than price stability that people... can and should care about. However, that is not itself a good reason for believing that monetary policy can best achieve them by aiming at all of them directly.... There is no basis for believing that such a multiple approach, implying that monetary policy can focus on a number of different targets at the same time, is effective.... There is good reason to believe that the best way for monetary

policy to contribute in a sustained way to good general economic performance – probably quite well captured in the goals of high employment and rising living standards – is by focussing on price stability.”¹

The Objectives of the Central Bank

Not everyone accepts that view, of course, though I believe the great majority of economists and central bankers do. There is a small minority who see no role for monetary policy at all. Some others see price stability and full employment as alternative objectives and talk about trade-offs between them. Such trade-offs exist only in the short term. In the medium term, they certainly do not. Full employment is a pipe-dream if inflation is not kept under control.

I am pleased to see that there now appears to be a political consensus on the need to keep inflation down. Let me offer you three quotes. One is from the Prime Minister's “One Nation” statement of 26 February; one is from the Coalition's “Fight Back” document; and one is from the 1975 Budget Speech of the then Treasurer, and now Governor-General, Bill Hayden. I wonder if you will recognise immediately which is which.

- “We are no longer operating in that simple Keynesian world in which some reduction in unemployment could apparently always be purchased at the cost of some more inflation. Today it is inflation itself which is the central problem. More inflation simply leads to more unemployment.”²
- “Inflation is a form of financial fraud that discourages saving and investment and distorts production and investment decisions.”³

1. Opening Statement before House Committee on Finance, Ottawa 16 January 1992.
 2. 1975-76 Budget Speech delivered by Hon. W.G. Hayden MP, 19 August 1975.
 3. “Fight Back” – Federal Coalition Policy Document – 21 November 1991.

- “Inflation... encourages speculation rather than production, it erodes the value of savings. It is a totally corrupting influence on the fabric of society.”⁴

But, if we agree that monetary policy should be directed primarily to price stability, it still leaves the question – how should the central bank’s objectives be set out in its charter – in our case in the Reserve Bank Act.

I have been comfortable with the present charter which requires the Bank to use its powers so as best to contribute to stability of the currency, full employment and the economic prosperity and welfare of the people of Australia – or, to be more precise, I have been comfortable with my interpretation of that charter.

Three things can be said about its aims. **First**, they go well beyond the ambit of monetary policy on its own, and there is a need to judge what contribution monetary policy can best make. **Second**, they are medium-term, on-going aims – not something to be sought this year and forgotten again next year, but something to be consistently striven for. That means establishing a good basic structure within which the prospect of their achievement is maximised. **And third**, without price stability as a part of that basic structure, the aims of full employment and economic prosperity are not sustainable in the medium term.

Ergo, combatting inflation deserves top billing among the Bank’s objectives; but to be pursued in ways which contribute best in the medium term to employment and general economic welfare.

I would still argue that that is the only rational interpretation of the Act. If everyone agreed, there would be no need to amend it. If not, and there appears to be some dissension, then a case can be made for amendment, not to insert price stability as the sole objective with no other guidance, but to give clear primacy to price stability and to

provide some added guidance along the lines of my interpretation of the present charter.

If one looks around the world, central bank charters cover a very wide range. There is the UK where legislation makes no reference to the Bank of England’s monetary policy role or objectives; there is the New Zealand experiment which has price stability as the sole objective of the Reserve Bank though subject to the government’s right to override. And there is the German example, which in many ways is more interesting and closer to my own views on charters.

The German Federal and State Governments are required by law, in all their activities, to “act in a way which, within the framework of a market economy, simultaneously fosters price stability, a higher level of employment, external equilibrium and adequate economic growth”⁵ – not all that much different from our Act.

However, that requirement does not apply to the Bundesbank. It is directed to take note of, and support, the government’s general economic policy but without prejudice to the performance of its own function “which is described as regulating the volume of money in circulation and of credit supplied to the economy with the aim of safeguarding the currency”.⁶

Not surprisingly, the Bundesbank arrangements have had a major influence in planning for the proposed European Central Bank.

In recent years, a supplementary question has arisen. Should there be an explicit, quantitative inflation target? New Zealand has adopted such a target and Canada is heading down that road.

It is too early to draw conclusions from either of those experiments. But, more generally, I don’t favour an inflation target. I recognise the argument that it can help with perceptions. But the other side of the coin is that it can tend to limit operating flexibility.

4. “One Nation” – Prime Minister’s Address to Parliament – 26 February 1992.

5. H. Bockelmann – “Objectives and Credibility of Monetary Policy” – Paper to Pacific Region Central Bank Conference, Sydney 1990.

6. *ibid.*

Too much flexibility might be open to criticism, and can be abused, but a country as exposed as Australia to the outrageous fortunes of external events needs a degree of flexibility in policy administration.

I would add that explicit targets are not necessary if a central bank has clearly and credibly demonstrated its commitment to the preservation of price stability. The Bundesbank, for instance, has not so far felt a need for an inflation target.

My preference is for an objective in qualitative rather than quantitative terms. If, for some reason, the lawmakers were ever to decide otherwise, I would hope at least that the objective was clearly defined as an on-going, medium-term one, and that the need for short-term flexibility, to deal with external shocks and the like, was adequately covered.

Central Bank Accountability

Which brings me to the vexed and, I fear, politically charged question of central banking independence – or autonomy – or separateness – depending on your sensitivity to the language.

It is a topic which has had a fair bit of media coverage in recent years, particularly since gaining an added, multinational dimension with the move towards European monetary integration.

Again, there are various examples around the developed world. At one extreme, I guess, is the statutory independence of the Federal Reserve System and, close behind it, the Bundesbank. At the other, is the British view that the government sets monetary policy and the Bank of England gives effect to it.

In the middle of last year, in an editorial headed “The Bank makes mischief”, the London Times thundered that the Bank of England “can offer its advice forthrightly in private, but its duty is to carry out the Treasury’s orders”.

There are some, of course, who believe, or at least assert, that that applies to Australia also. Neither the law nor the historical record is on their side.

A decade or more ago, they might have been on firmer ground. However, developments over the intervening period have given the Bank greater capacity for independent action than in any previous period post-war.

Until the beginning of the 1980s, the major instruments of monetary policy were interest rates and variations in the Statutory Reserve Deposit ratio, with resort also to lending controls:

- So far as interest rates were concerned, government security yields were set in advance by the Treasurer. The Bank was empowered to regulate bank interest rates but only with the prior approval of the Treasurer.
- While variations in the Statutory Reserve Deposit ratio were within the Bank’s prerogative, in practice they were referred to the Treasurer for approval before being made; and adjustments to exchange controls, which were sometimes used for monetary policy as well as balance of payment purposes, also required the Treasurer’s approval.

During the period when Australia had a monetary “target”, or something that approximated one, it was the Treasurer’s rather than the Bank’s target and it was announced in the Budget Speech.

The exchange rate was fixed by the Government under the Bretton Woods arrangements and the Reserve Bank cleared the market each day at the rate fixed.

Not a lot of autonomy in all of that, I’m afraid, and it must have influenced the views of senior central bankers and officials of that time about the proper relationship between the Bank and the Government.

Over the past decade, lending controls have gone; Statutory Reserve Deposits have gone; exchange controls have gone; bank interest rate controls have gone; government security issue yields are determined at open tender; and the exchange rate is floating. Short-term

interest rates are the only remaining monetary policy instrument. They are determined through the interplay of market forces and the Reserve Bank's market operations.

It is a very different ball game with a very different level of autonomy. Those who keep dredging up international league tables of central bank independence, constructed ten years or more ago and virtually unchanged since, really need to go back to square one.

There is room for legitimate debate, of course, about whether the autonomy available is adequate or is properly exercised, and whether there is sufficient accountability.

Those who favour greater central banking autonomy call on a range of conceptual and practical arguments. However, the essence of the case is this – the prime objective of the central bank is to pursue price stability; to do its job dispassionately and consistently, it needs to be apart from the hurly burly of day-to-day politics. Similarly, if monetary policy is to have the desired medium-term focus, it needs to be exempted from the pressures of the political (as distinct from the business) cycle.

Understandably, that line of argument has its critics who take the position that the very idea of a central bank independent of the **government of the day** is undemocratic, and that monetary policy should be set by government as just another piece of the overall economic policy jigsaw.

The claim that central banking independence is undemocratic needs to be treated with care. In Australia, as in most countries, the body elected by the people is the Parliament. If the Parliament were to decide, in its wisdom, that there were certain functions better allocated to a separate statutory body rather than to the government of the day, that would not be inconsistent with parliamentary democracy. It should be assumed, of course, that the body would be given a clear set of objectives and would be accountable for its decisions.

The US Federal Reserve Board meets these tests. In its case, the separation of powers in

the USA makes the accountability of the Board to the Congress easier to understand, and allowed a previous Chairman to speak of the Board being independent **within** government rather than independent **of** government.

While, **in concept**, the position is not much different in Australia, the distinction between government and parliament tends to be less clear in our polarised version of the Westminster system.

Nonetheless, when the Australian Parliament enacted central banking legislation in 1945 and again in 1959, it put the task of forming monetary and banking policy into the hands of the Reserve Bank Board. It gave the Board the set of objectives I discussed a few minutes ago; it established some important checks and balances, including special arrangements to resolve differences of view with government; and it required the Board to give an annual account of its operations to the Parliament.

Coombs, writing of the inter-departmental arguments leading to the 1945 legislation, described his anxiety “to protect the Bank from arbitrary or narrowly political interference” ...He saw Parliament as the potential source of that protection and argued that “not merely should any directive [from government] be derived from a formal decision of Cabinet but that ...Parliament should be informed so that the Bank's views would become known and the issues debated”.⁷

In essence, that was how it turned out, though one might question whether an annual report, on its own, provides a sufficient degree of accountability to the Parliament.

Clearly, accountability must go with autonomy. The greater the autonomy, the greater in turn should be the accountability, to the Parliament and to the public.

The Federal Reserve Board, which on paper is possibly the most independent of central banks, cannot be oblivious to the policy aims of the US Administration. But it needs to give priority to the objectives entrusted to it by

7. Trial Balance, Macmillan 1981.

Congress. It is not free of political pressure any more than other central banks, including the Reserve Bank; its Chairman and the other governors come under quite severe pressure at times, both overtly and covertly, from the Administration. But the President cannot alter any of the Board's decisions; that can only be done by an Act of the Congress.

The Chairman of the Board is required to appear regularly before the Committees of Congress to explain and justify, in public, the Board's decisions and their consequences.

The German situation is only different in degree. I've already mentioned that the Bundesbank is required to take notice of the government's policy aims but not to the detriment of its own price stability objective. The Federal Government may request that a Bundesbank decision be deferred for up to two weeks and it may try to put public pressure on the Bundesbank but it cannot countermand the decision.

It needs to be remembered, of course, that the Bundesbank's pre-eminence is only in the area of domestic monetary and credit policies. If it seeks to press a view in other areas – as happened in the negotiations leading to the re-integration of East and West Germany – the government may ignore the advice and even rebuke the Bundesbank.

There is another factor that is important in determining how independent a central bank really is, quite apart from the constitutional and legal position. It is the "personal equation", in other words the way in which the members of the central bank board, particularly the chairman, conduct their relationships with the government.

One can look back at the United States over the post-war period and see clear differences in those relationships, usually reflecting the views and the strength of purpose of the chairman of the time. A similar diversity can be seen in most other countries.

Maintaining an effective relationship with Government while preserving the central bank's capacity to form its views and

determine its policies free of party political influence can be a difficult balancing act at times. But the "independence" of the bank depends as much on the skill with which that act is performed as on the specific wording of a piece of legislation. I have worked with a series of Governors with well-developed senses of balance.

In Summary

Let me now try to draw the various threads together. I have focussed only on the central bank's monetary policy responsibilities. Its other roles in banking supervision, protection of the payments system, the note issue and government banking will have to wait for other occasions and, perhaps, other speakers.

The central bank which emerges from this talk, or should emerge if I have managed to convey my thoughts at all lucidly, is one:

- (a) that takes a broad view of its responsibility to support sustainable economic growth but gives clear primacy to achieving and maintaining price stability;
- (b) that has sufficient autonomy and protection from political intervention to enable it to consider issues and reach policy judgments professionally and dispassionately;
- (c) that exercises that autonomy responsibly;
- (d) that maintains a continuing and effective exchange of information and views with government;
- (e) that is accountable for its actions to the parliament and, through the information and explanation it provides, to the broader community.

In the on-going debate about the role and accountability of the Reserve Bank, I would hope that these criteria might at least form an acceptable philosophical starting point.