
Reserve Bank Independence

Talk by the Governor, Mr B.W. Fraser, to the National Press Club, Canberra, 15 August 1996.

In my first talk as Governor I discussed the Reserve Bank's independence. I would like to return to that topic today.

It is a topic which has provided a good deal of copy for journalists over the years. Perhaps it is all the conflict and intrigue which has given it such instinctive media appeal. Conflicts have been perceived, for example, within the Bank, and between the Bank and practically every conceivable body from the Treasury, the Treasurer, the Government and the Opposition, through to the financial markets. All have been spotted and reported at one time or another.

To be fair, journalists are not the only ones who have perceived such conflicts, or tried to make something of them. And, although far less frequent than their reported sightings, occasional tensions have arisen, inevitably so, I think. Sometimes these have been sustained by the odd colourful utterance from one or more of the protagonists.

'Independence' as an issue might have been expected to go off the boil following the March election and the new Government's clear commitment to recognise and respect the Reserve Bank's independence. This seemed to ensure the continuation of what, in reality, was an independent Reserve Bank under the previous Government. But the very time when everyone is publicly declaring the Bank to be

independent is the very time when the media should be showing more – not less – curiosity in the issue. That now seems to be emerging.

Against that prospect, I want to offer some comments on what I think Reserve Bank independence means in practice, and on the checks and balances necessary to appropriately protect and temper the exercise of that independence. I will obviously draw on my years at the Bank, but I will try also to be forward looking.

Independence from Politicians

Talk of 'independence' occurs mainly in the context of the freedom which central banks have to conduct monetary policy without political interference. It is not the only form of independence which is relevant to central banks, but it is the best place to start.

The usual argument for an independent central bank is that governments and politicians cannot be trusted to do the right thing with interest rates. They are assumed to be driven by the electoral cycle, and prone to manipulate monetary policy for short-term political gains. It is an argument which might find wide acceptance in this audience, but I think it is a bit simplistic, and perhaps a touch cynical. A lingering temptation to engineer interest rate changes for short-term political

reasons no doubt persists, but it is countered somewhat these days by the knowledge that any such manipulation will be caught out – that the financial markets, in particular, will see through the ruse, and punish the perpetrators. Today's politicians appreciate that extended front page reportage of a plunging exchange rate, for example, could easily outweigh any positive effects of a politically inspired cut in interest rates.

The corollary of this argument is that an independent, expert body not bound up in the electoral cycle would do a better job than politicians in conducting monetary policy. This seems to me to be the strongest reason for entrusting responsibility for monetary policy to an independent central bank, although I would want to add a very important caveat – namely, that the bank's independence should be exercised within an appropriate framework. Monetary policy is, in a number of respects, more 'technical' and less 'political' than fiscal policy. Having said all that, I must also add, of course, that central bankers have no monopoly of wisdom or judgment, and are certainly not infallible. Their performance over time – their track record – will afford the best test of the validity of this corollary.

It has always seemed sensible to me that the Reserve Bank should exercise its independence in a consultative way with the Treasurer of the day. There are several reasons for this. To begin with, the Bank is required by law to consult with the Treasurer, as well as with the Secretary to the Treasury. This helps to avoid surprises, and the transmission of conflicting signals to the markets and others: it is obviously sensible, after a change in interest rates, for both the Bank and the Government to tell much the same story. Secondly, central bankers occupy only part of the economic playing field, but they are affected by what is happening elsewhere. Regular consultations provide opportunities for the Bank to keep abreast of what is developing, for example, on the fiscal front, and – in earlier times – on wages policy.

It has puzzled me that this brand of 'consultative independence' sometimes has been interpreted as reflecting weakness – and

a lack of independence – on the part of the Reserve Bank.

Critics have peddled the line over the years that the Bank was 'political', but no hard evidence has ever been advanced. There is none. Three federal elections have been held in the past seven years and only in one of those instances were interest rates reduced shortly ahead of election day. This was the March 1990 election. On that occasion, rates were reduced in the preceding January and February; these reductions were criticised widely as being both 'political' and inflationary – but so were several of the following 13 reductions which were made between April 1990 and July 1993. In retrospect, no objective observer could reasonably challenge the economic soundness of any of that long series of reductions.

Much of the wind beneath the view that the Bank was 'political' flowed from Paul Keating's comment at a press conference in February 1989 that 'they do what I say', and from a more celebrated but harder to document comment at a supposedly private dinner in December 1990 that he had the Reserve Bank (among others) 'in his pocket'. I believe Mr Keating regretted being associated with those throwaway lines and, to my knowledge, he never repeated them. On more than one occasion, he complained that the Bank had acted in ways which were contrary to his own preferences – clear enough evidence, I would have thought, that the Bank was not in his pocket.

I also have denied that the alleged 'in the pocket' jibe was ever an accurate description of the relationship between the Treasurer and the Reserve Bank, as did my predecessor, Bob Johnston. The original quip was unfortunate enough, but its repetition *ad nauseam*, in the face of all the denials, was even worse in my view; it certainly did nothing to enhance the Bank's standing in financial centres around the world.

To concoct evidence where none existed, critics even impugned sinister overtones to my 'mateship' with Paul Keating. Some went so far as to suggest that Mr Keating only had to get on the phone to me and I would do his

bidding. As well as being malevolently ignorant, such stories were extremely offensive to the other Bank staff and Board members involved in all the Bank's decisions on monetary policy.

For the record, I always have been pleased to be counted a 'mate' of Paul Keating, in the proper sense of that term. I had hardly spoken to Mr Keating before he appointed me to the Treasury job in September 1984, but I naturally saw a good deal of him over the ensuing dozen years, both in that position and as Governor of the Reserve Bank. I admired his resolute commitment to change things, and shared many of the broad value judgments which lie at the root of that commitment (several of which, incidentally, are encapsulated in the Reserve Bank's 'charter'). I will always be enormously grateful that he had sufficient confidence in me to appoint me to two of this country's top policy positions – without his confidence, I do not believe I would ever have had the opportunity to serve in either position.

But none of this provided any basis for glib assertions of cronyism and worse. Commentators should not be surprised, nor should they suspect intrigue, if a Treasurer and a Governor happen to see eye to eye on particular economic policies or strategies; and the Governor should not have to engage in public slanging matches with the Treasurer to demonstrate the Bank's political independence.

In a similar vein, while they sit somewhat uneasily with their declarations of central bank independence, I think it is understandable that Prime Ministers and Treasurers will make public comments on monetary policy from time to time. Intrepid questioning by members of the media alone is guaranteed to elicit an occasional comment from even the most guarded Treasurer! This happens everywhere, including in countries like the United States, Germany and France which boast independent central banks. In Australia, both the Prime Minister and the Treasurer have commented on possible interest rate movements in recent weeks, and similar kinds of comments were made by their counterparts

in the previous Government: then, as now, these should be seen as views which Ministers are entitled to express, and not as evidence of political interference in monetary policy making.

During the recent election campaign, the Coalition parties stated in very clear terms that they would 'protect the integrity and independence of the Reserve Bank', and this has been reaffirmed several times subsequently by the Treasurer. On a number of occasions also, the incoming Government has endorsed the Bank's 2-3 per cent inflation objective, and the multiple goals of the *Reserve Bank Act*, which require the Bank to have regard for economic growth and employment, as well as for inflation.

Overseas, there has been quite a push also to give more independence to central banks. In Europe, in particular, several countries have passed legislation to this effect, and it is a condition of entry into the European Monetary Union that members' central banks be independent. What, to me, is noteworthy about this push is that it has been conducted largely in terms of inflation objectives and targets. Even in Australia, where the incoming Government has endorsed the multiple objectives in the *Reserve Bank Act*, there has been a tendency to emphasise low inflation. That accords with good central banking orthodoxy but, to my taste, equating independence with inflation targets alone is a form of Clayton's independence.

Behind these subtle differences in taste are deep debates about trade-offs between inflation and unemployment. Without going into detail, it is generally agreed that no such trade-off exists in the long term; the policy implication which flows from this is that the best contribution monetary policy can make to sustained economic growth is to hold down inflation. The problem with this argument, however, is that the long term can be quite long indeed – five years or more. In the short term – that is, in the year or two ahead, which is clearly a highly relevant period for most people – trade-offs do arise.

As everyone knows, monetary policy affects both output and inflation (and both are

affected by other policies as well). In fact, the impact of monetary policy on inflation comes about largely through its impact on output and employment – that is, by creating slack in the goods and labour markets. Central banks have a duty to try to minimise economic fluctuations, but they can tackle this task in different ways. When inflation, for example, threatens to go off the rails, judgments have to be made about how quickly it should be brought back on track; these judgments involve real trade-offs between inflation and unemployment.

In the second half of 1994, when it appeared likely that future inflation would exceed the Bank's 2-3 per cent objective, monetary policy was tightened quite decisively to limit the extent and the period of the expected rise above 3 per cent. Monetary policy could have been tightened in a more draconian way, with a view to minimising the period with inflation above 3 per cent. By not following that course, the Board was saying implicitly that the possible benefits of such action fell short of its potential costs in terms of lost output and jobs. Similarly, the reduction in interest rates announced two weeks ago could have been held over until inflation was firmly back within the 2-3 per cent band, but again a judgment was made that the benefits of a little insurance against the economy faltering outweighed any risk that inflation might kick up unexpectedly.

Monetary policy decisions frequently raise questions of trade-offs of this kind, although they are not always explicit. The multiple objectives of the *Reserve Bank Act* help to make the trade-offs explicit in Australia, which is one reason why I have always championed our approach over the more fashionable, inflation-only objective of many other central banks. This is not a theoretical issue. There is no doubt in my mind that had the Reserve Bank been charged with fighting inflation only through the 1990s, monetary policy would have made much less of a contribution to economic recovery than it actually did; interest rates would have gone down more grudgingly in the early 1990s, and up more enthusiastically in the mid 1990s.

With the independence which the Reserve Bank has enjoyed over the years has come extra responsibilities. One of these is greater accountability. The Bank has worked hard to explain clearly to the public, the Parliament and the markets where it has been coming from, what it has done, and why. I think the Bank has come a long way in this regard, and much further than most other central banks – which is not to say that we should become so transparent as to expose all the intricacies of the Board's decision making processes, or to permit financial markets to anticipate the Bank's every move. Accountability also requires credible performances by the Bank in relation to all its objectives, not just inflation.

I should emphasise at this point that, in seeking to keep output and employment considerations to the fore in monetary policy deliberations, I am not seeking to downplay or backtrack on the inflation objective. I have made too big a commitment to lowering inflation over the years to start backtracking now. The issue, instead, is that both inflation and employment are important, and both can be progressed simultaneously, as we have seen in Australia and the United States, for example, over recent years. It is the job of central banks to worry about inflation, and they are innately inclined to do that. But they should not be fixated solely with inflation, and we should not be loading the dice even more in that direction.

I think we are fortunate in Australia in having evolved a 'framework' which helps to protect the Bank's independence and encourages it to be exercised in a balanced way. The four pillars of this framework are as follows.

- (i) *Multiple objectives*. As I have said, I see the Bank's explicit multiple objectives as a counter to the (understandable) pre-occupation of central banks with low inflation. I therefore welcome the Government's decision not to seek to change the Bank's charter. I would not be surprised if, over time, some central banks with a single inflation objective

were to come under pressure to give more weight to employment considerations, to help revive their sluggish economies and reduce unemployment.

- (ii) *A flexible inflation target.* Targets can be helpful in providing an anchor for inflation expectations, and a discipline on monetary policy. But they should be flexible enough to serve those purposes, and to avoid any proclivity to press the alarm button every time inflation threatens to go above the target. The Reserve Bank's target is flexible; it is expressed in terms of keeping underlying inflation in the 2-3 per cent range over the business cycle. It is consistent with the multiple objectives approach in recognising that inflation has a cyclical element, which policy should allow for, and it also recognises that if inflation goes outside the target range the speed of its return should be determined by weighing up the risks on both employment and inflation. I am pleased that the present Government, like its predecessor, has expressed its support for this target.
- (iii) *Consultations between the Bank and the Treasurer.* These have developed over the years, and have become more structured in recent times under Mr Willis and Mr Costello. As well as being required by law, these serve several useful purposes, as I noted earlier. They also constitute an important check on errant egos. The Act provides that, in the event of a disagreement between the Board and the Treasurer over the direction of monetary policy, the Treasurer's view shall prevail but, in that situation, the Treasurer is required to table both the Board's advice, together with his reasons for over-riding that advice, in both Houses of Parliament. So far, and for reasons which are not hard to fathom, that situation has not arisen.
- (iv) *A good Board.* The Board is the formal decision making body of the Bank and is involved in all changes in interest rates. It is an important part of the present framework: it helps to keep the Bank team honest; it brings a 'real world' dimension

to policy discussions, consistent with the charter's emphasis on employment as well as inflation; and it adds to the authority of the eventual decisions. Members generally have stuck to their self-imposed rule that only the Chairman should speak for the Board, but I can tell you that they take their responsibilities very seriously, and work hard at them – notwithstanding the occasional cheap shot in the media that they merely rubber stamp the Bank's (or the Government's) views. During my 12 years on the Board, I have had the opportunity to work with many competent, decent people committed to ensuring that the Bank did all it could to promote, not sectional interests, but, in the words of the Act, 'the economic prosperity and welfare of the people of Australia'. I hope that future appointees to the Board will keep this aspect of the Board's role in mind.

My thoughts for today's talk were assembled before I became aware of yesterday's accord between the Treasurer and the new Governor. The words and the emphasis are different, but much of the thrust of the framework I have been describing is reflected in the agreed statement on the conduct of monetary policy. Considerable effort also appears to have been directed towards ensuring that the statement was consistent with the *Reserve Bank Act*. It is a neat match – some might say suspiciously neat. It is no longer my business, but so long as that basic consistency with what is in the Act is maintained, the statement would not cause me any particular difficulties. In fact, because it essentially formalises current practices, it has a rather sweet ring to it for me. It suggests that we are all marching to the same tune now, something that seemed impossible only a few years ago when the present Government was in Opposition.

Whatever the framework, there is always scope for different people to emphasise different aspects. This is where personalities can be important. I have made clear my preference not to see the present balance of objectives biased any more towards lowering inflation – not, I repeat, because inflation is

unimportant, but because growth and employment are also important. While I see no particular need to be further emphasising the inflation objective, that will, no doubt, be welcomed by many in the central banking fraternity, the financial markets and at least some parts of the media. At the end of the day, however, what will matter most is not nuances contained in joint statements or in legislation, but the community's assessment of the Bank's performance in helping to deliver sustained non-inflationary growth and lower unemployment.

Independence from Markets

So much for keeping the Reserve Bank independent of political pressures. To do the job it is required to do, the Bank also needs to be free of financial market pressures. It would be ironic if one form of influence were to be substituted for another: if the short-termism of politicians were to be replaced by the short-termism of the financial markets.

The issues which arise with the markets are not dissimilar from those associated with politicians. It is not a matter of never trusting the markets, or of assuming they are always wrong, or of 'taking them on'. Perceived conflicts of the latter kind might help to enliven the reportage of market developments, but that is not the way the Reserve Bank normally interacts with the financial markets. My oft-stated view is that markets – including financial markets – are not perfect, but they tend to do a better job than the alternatives. We should listen to them, but we should also be aware of their shortcomings.

Financial markets summarise the views and judgments of large numbers of participants. This has led to claims that the collective wisdom embodied in market prices is superior to that available to even well-staffed central banks or Treasuries. Be that as it may – and more often than not central banks will view the same data in much the same way as the markets – it is not the real issue. Markets are

not infallible; they are often quick to change their collective minds; and they have their own frameworks, which can be quite different from that of the Reserve Bank.

The last point is the real issue. Most financial market participants rate low inflation ahead of the Reserve Bank's other objectives. This reflects a number of factors, but the financial harm that is done to holders of bonds when inflation and interest rates rise is the main one. We see their (understandable) priorities in market reactions to different economic indicators: weak economic activity and employment numbers, for example, are generally welcomed because they imply lower inflation and higher bond prices, while strong numbers are generally frowned upon because of concerns that they will be followed by higher inflation and interest rates down the track.

A lot of what is written about the Reserve Bank's 'credibility' is in the narrow context of the Bank's credibility with the financial markets for delivering low inflation. This is important, but to actually deliver low inflation the central bank needs credibility in labour and other markets more than it does in the financial markets. To build this broad community support for its anti-inflation objective, the Bank also needs to build credibility in relation to its other objectives. Community support for low inflation is likely to dissipate unless the Bank can help to deliver some gains in employment and living standards.

I think there is an important point here, and one which commentators might ponder next time they are rushing off to seek reactions to a change in monetary policy. Not only do financial markets participants have an understandable pre-occupation with low inflation, they also have more ready access to the media than people in other sectors of the economy with a probable greater focus on output and employment. The most notable feature of the survey of 32 economists conducted ahead of the recent interest rate cut was not that practically no-one picked the reduction, but that virtually everyone polled was from the financial sector.

The Reserve Bank obviously needs to work closely with the financial markets, and they will often be useful allies in maintaining discipline in macroeconomic policies. But their often different priorities should not be overlooked. In my view, the Bank's best protection against being swayed unduly by the

financial markets is close adherence to the same framework which I outlined earlier to help avoid political interference. Of special significance in this connection are the multiple objectives of the Bank, and the appointment of competent Board members with a national perspective.