

Statement on the Conduct of Monetary Policy

This statement was released by the Treasurer the Hon. P. Costello in conjunction with the appointment of Mr I.J. Macfarlane as Governor of the Reserve Bank.

This statement records the common understanding of the Governor (designate) of the Reserve Bank and the Government on key aspects of Australia's monetary policy framework. It is designed to clarify respective roles and responsibilities.

Monetary policy is a key element of macroeconomic policy and its effective conduct is critical to Australia's economic performance and prospects. For this reason, and given the appointment of a new Governor of the Reserve Bank, it is appropriate and timely for the Governor (designate) and the Government to set out clearly their mutual understanding of the operation of monetary policy in Australia.

It is expected that this statement will contribute to a better understanding both in Australia and overseas of the nature of the relationship between the Reserve Bank and the Government, the objectives of monetary policy, the mechanisms for ensuring transparency and accountability in the way policy is conducted, and the independence of the Bank.

Relationship Between the Reserve Bank and the Government

The *Reserve Bank Act* gives the Reserve Bank Board the power to determine the Bank's monetary policy and take the necessary action to implement policy changes.

The Government recognises the independence of the Bank and its responsibility for monetary policy matters and intends to respect the Bank's independence as provided by statute.

Section 11 of the *Reserve Bank Act* prescribes procedures for the resolution of policy differences between the Bank and the Government. The procedures, in effect, allow the Government to determine policy in the event of a material difference; but the procedures are politically demanding and their nature reinforces the Bank's independence. Safeguards like this ensure that monetary policy is subject to the checks and balances inherent and necessary in a democratic system.

In addressing the Bank's responsibility for monetary policy the Act provides that the Board shall, from time to time, inform the Government of the Bank's policy. Such arrangements are a common and valuable feature of institutional systems in other industrial countries with independent central

banks and recognise the importance of macroeconomic policy co-ordination.

Consistent with its responsibilities for economic policy as a whole the Government reserves the right to comment on monetary policy from time to time. However, the Government will no longer make parallel announcements of monetary policy adjustments, when the Reserve Bank changes the overnight cash rate. This will enhance both the perception, as well as the reality, of the independence of Reserve Bank decision making.

Objectives of Monetary Policy

The framework for the operation of monetary policy is set out in the *Reserve Bank Act 1959* which requires the Board to conduct monetary policy in a way that, in the Board's opinion, will best contribute to the objectives of:

- (a) the stability of the currency of Australia;
- (b) the maintenance of full employment in Australia; and
- (c) the economic prosperity and welfare of the people of Australia.

The first two objectives lead to the third, and ultimate, objective of monetary policy and indeed economic policy as a whole. These objectives allow the Reserve Bank to focus on price (currency) stability while taking account of the implications of monetary policy for activity and, therefore, employment in the short term. Price stability is a crucial precondition for sustained growth in economic activity and employment.

Both the Bank and the Government agree on the importance of low inflation and low inflation expectations. These assist businesses in making sound investment decisions, underpin the creation of new and secure jobs, protect the savings of Australians and preserve the value of the currency.

In pursuing the goal of medium-term price stability the Reserve Bank has adopted the

objective of keeping underlying inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short-run variation in underlying inflation over the cycle while preserving a clearly identifiable benchmark performance over time.

The Governor (designate) takes this opportunity to express his commitment to the Reserve Bank's inflation objective, consistent with his duties under the Act. For its part the Government indicates again that it endorses the Bank's objective and emphasises the role that disciplined fiscal policy must play in achieving such an outcome.

Transparency and Accountability

Monetary policy needs to be conducted in an open and forward looking way because policy adjustments affect activity and inflation with a lag and because of the crucial role of inflation expectations in shaping actual inflation outcomes. In addition, with a clearly defined inflation objective, it is important that the Bank report on how it sees developments in the economy, currently and in prospect, affecting expected inflation outcomes. These considerations point to the need for effective transparency and accountability arrangements.

In recent years the Reserve Bank has taken steps to make the conduct of policy more transparent. Changes in policy and related reasons are now clearly announced and explained. In addition, the Bank has upgraded its public commentary on the economic outlook and issues bearing on monetary policy settings, through public addresses and its regular quarterly report on the economy. In furthering the arrangements already in place the Governor (designate) will support the release by the Bank of specific statements on monetary policy and the role it is playing in achieving the Bank's objectives. It is intended that these statements will include information on the outlook for inflation and will be

released at roughly six monthly intervals.

The Governor (designate) has also indicated that he plans to be available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Financial Institutions and Public Administration.

The Treasurer expressed support for these arrangements, seeing them as a valuable step

forward in enhancing transparency and accountability in the Reserve Bank's conduct of monetary policy – and therefore the credibility of policy itself.

The Government and Bank recognise that outcomes, and not the arrangements underpinning them, will ultimately measure the quality of the conduct of monetary policy.

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