A 'NEW ERA' FOR THE RESERVE BANK?

Australia's central bankers should face greater scrutiny and accountability, argues **Stephen Kirchner**

On 6 December 2007, the incoming Labor government announced a 'new era' for the Reserve Bank of Australia (RBA) with revised arrangements for appointing the bank's senior officers and external board members, in conjunction with a new joint 'Statement on the Conduct of Monetary Policy' between the bank and the government.[1] On the previous day, the RBA also announced new arrangements for communicating with the public about monetary policy.[2] The RBA board's press release was careful to indicate that these measures had been under consideration for 'some months.' However, their announcement at the first RBA board meeting after the federal election was hardly coincidental. Reform of the governance arrangements for the RBA had been expected to be a priority for the new government after more than ten years of neglect under the former treasurer, Peter Costello. The RBA had also fallen to the bottom of international rankings of central bank transparency.[3]

While in some respects an improvement, the new arrangements leave the RBA operating under an outdated and internationally anomalous governance structure that is incompatible with modern demands for central bank transparency and accountability. They also leave in place many of the flaws from previous iterations of the joint 'Statement on the Conduct of Monetary Policy' since August 1996.[4] The new arrangements may serve to entrench bureaucratic influence on monetary policy and weaken the RBA's accountability for inflation at a time when it is presiding over the worst underlying inflation outcomes since the current economic expansion began sixteen years ago.[5]

Appointment of senior officers

Under the new statement, the positions of the governor and deputy governor of the RBA will have their level of statutory independence raised to be equal to that of the Commissioner of Taxation and the Australian Statistician. Their appointments will be made by the Governor-General in Council, and can be terminated only with the approval of both houses of Parliament in the same session of Parliament. This measure serves to increase the independence of the RBA's senior officers, in that they can no longer be dismissed by ministerial fiat. In practice, however, this was not a serious threat under the previous arrangements.

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The RBA's senior officers have always enjoyed a high degree of effective independence, owing to the fact that dismissal would be politically costly to the government of the day if the governor and deputy governor enjoyed a strong reputation. International capital markets could also be expected to severely mark down Australian-dollar-denominated assets in response to any attempt to compromise the RBA's independence.

Section 11 of the *Reserve Bank Act 1959* already provides a procedure for resolving policy differences between the RBA board and the government of the day. The treasurer can override a decision of the RBA board, but this would lead to the tabling in Parliament of the board's reasons for differing with the government's decision. As the most recent joint statement notes, 'the procedures are politically demanding and their nature reinforces the Reserve Bank's independence in the conduct of monetary policy.' That no treasurer has invoked these procedures strongly suggests that the existing arrangements already afford the RBA a high degree of effective independence. The RBA's willingness to raise interest rates in the middle of the 2007 federal election campaign does not point to it being politically intimidated.

The new arrangements may instead err in the direction of affording the RBA's senior officers too much protection. Central bank independence needs to be balanced with accountability for performance, especially in relation to inflation outcomes. Under the new arrangements, it will be even more difficult to remove an RBA governor for poor performance, at least in the absence of a bipartisan political consensus. This compounds a more serious problem, which is that the performance of the RBA in relation to monetary policy and inflation outcomes is poorly benchmarked (see below). By contrast, the New Zealand model establishes a clear relationship between inflation performance and the tenure of the governor of the Reserve Bank of New Zealand, including a procedure for dismissing the governor for nonperformance.

The new arrangements in relation to the RBA's senior officers reinforce its independence on paper, but in practice the new government has addressed a nonexistent problem by taking measures that may actually detract from central bank accountability rather than enhancing central bank independence.

Appointment of external board members

Under the new arrangements, the Treasury secretary and the RBA governor will maintain a register of 'eminent' candidates of the 'highest integrity,' from which the treasurer will be required to make new appointments to the RBA board. This provision is designed to remedy the situation by which these appointments have been used for political patronage, most recklessly in the case of former treasurer Peter Costello's appointment of Robert Gerard to the board in 2005. The Gerard affair also exposed weaknesses in the 'Code of Conduct for Reserve Bank Board Members,' mainly the lack of effective sanctions for noncompliance. The larger problem under the former government was not so much the politicisation of board and senior officer appointments, but Treasurer Costello's failure to perform his ministerial responsibilities in a timely fashion. The vacancy created by Bob Gerard's resignation was not filled for more than a year, while the deputy governorship of the RBA was also left unfilled for five months.[6] Warwick McKibbin's first five-year term on the RBA board expired on 30 July 2006, but the then-treasurer did not sign off on his reappointment until at least 27 July, leaving his eligibility to participate in the next RBA board meeting formally in doubt until the last minute.[7]

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The new arrangements serve to protect the appointments process from undue political influence, but create a new problem in that they will effectively limit board appointments to those who meet with bureaucratic approval from the official family of the RBA and Treasury. This is likely to limit the diversity of views represented at board meetings and reduce effective external scrutiny of monetary policy decision-making. The new appointments process for external board members risks entrenching the influence of the RBA's senior officers over the monetary policy decision-making process, at the expense of those who may have previously been critical of the bank's monetary policy. It is not clear whether the register of eminent candidates will be a public document that is itself open to scrutiny. The involvement of the Treasury in this process is also at odds with international trends in central bank reform, which generally seek to increase the degree of separation between monetary policy and the fiscal authority.

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The Treasury secretary's continued ex officio membership of the RBA board is also at odds with these trends. The traditional objection to the Treasury secretary's role on the RBA board is that it might serve as a vector for political influence over monetary policy. But a more basic and powerful objection is that the Treasury secretary's role on the board is not well-understood. Former RBA governor Ian Macfarlane said that 'no one has ever understood whether the Treasury Secretary speaks for Treasury or the Treasurer and I still don't know the answer to that … The only time the question has been put to the test it was clear that the Secretary was representing the views of the Treasury and not the Treasurer.'[8] Such confusion concerning the role of a key member of the RBA board is undesirable in itself, and is best resolved by removing the Treasury secretary from it, in line with international practice. Section 13 of the *Reserve Bank Act 1959* already mandates 'close liaison' between the RBA governor and Treasury secretary, providing for as much input as needed from the Treasury in relation to monetary policy and other issues.

Central bank communication

In its media release, the RBA also announced new procedures for communicating with the public about monetary policy. Governor Glenn Stevens elaborated on the rationale for the RBA's new transparency regime in a speech to the Sydney Institute on 11 December 2007.[9] Stevens was careful to dissociate the new measures from the change in government, saying that the RBA had 'reflected on this for some time this year,' and that he 'was very pleased to learn when I met the new Treasurer a couple of weeks ago that he supported the changes.' While it is likely that the new measures have as much to do with the change at the top of the RBA in 2006 as with the change of government in 2007, the RBA's internal consideration of these matters may have been designed to preempt inevitable demands for increased transparency following a change of government.

The RBA will now release a statement following each monthly board meeting, even when interest rates are not changed. This brings the RBA into line with the practices of central banks in comparable countries, and is a marked improvement on the previous arrangements, whereby the RBA simply noted that interest rates had been left unchanged, without giving reasons. Indeed, it is only in the last few years that the RBA has made an announcement of any kind following board meetings if interest rates were not changed. The first such statement, following the December 2007 board meeting, saw a rally in bond futures and a decline in the Australian dollar despite a steady interest rate outcome, implying that the statement conveyed new information to the market, resulting in more efficient pricing of financial instruments. This outcome contrasts with the RBA's former claims that releasing the minutes would not add useful information.

The RBA board's decision on interest rates will now be announced at 2:30 p.m. on the day of the board meeting, rather than the following day during the RBA's regular morning dealing intentions window. This largely reflects changes in logistical arrangements surrounding interest rate announcements, but even seemingly inconsequential administrative arrangements in relation to policy announcements have important implications for the conduct of monetary policy. It is only comparatively recently that the RBA has committed to any sort of announcement schedule for interest rate changes (which partly explains the former lack of statements after monthly board meetings). In previous years, the RBA announced changes in interest rates at its convenience. For example, in 1997, the RBA twice changed interest rates on days other than that following the monthly board meeting (23 May and 30 July). In December 1996, inappropriate public comments by former governor Bernie Fraser delayed an interest rate announcement. While unscheduled policy announcements are justified in extraordinary circumstances, the discretion that the RBA formerly exercised in relation to the timing of policy announcements generated needless uncertainty and costs for financial markets.

The new arrangements are a welcome improvement, but they still leave the quality and quantity of the RBA's communication with the public below that exhibited by comparable central banks. The qualitative aspects of central bank communication are difficult to measure objectively, but there are some basic metrics for the quantity of central bank communication. RBA governor Glenn Stevens gave only four public speeches and appeared before a parliamentary committee twice in 2007, his first full year as governor. By contrast, US Federal Reserve chairman Ben Bernanke gave twenty-three public speeches and appeared before Congress seven times. It is hard to believe that the chairman of the Federal Reserve is less busy than the RBA governor. Former governor Ian Macfarlane took considerable pride in his nonexistent public profile, not once giving an on-the-record media interview during his decade as governor, but at the same time often complaining that his views were misrepresented in the media.[10] Macfarlane also developed a reputation in financial markets for off-the-record backgrounding of favoured financial journalists as a substitute for more open channels of communication. In comparable countries, such a low public profile for the central bank governor would be unacceptable, but it has become the norm in Australia.

Board minutes

The RBA will now also release minutes of the monetary policy deliberations at its monthly board meetings, with a two-week lag, bringing the RBA more into line with international practice. However, the minutes that have been released to date are largely descriptive and backward-looking in their discussion of economic conditions and the policy outlook, a problem that also afflicts the existing quarterly statements on monetary policy. The section on 'considerations for monetary policy' has the potential to be more informative, but the major weakness of the minutes is that they present only a consensus view, suppressing the views of individual board members (if any). In a speech to the Sydney Institute, Governor Stevens argued that:

> The nature of the Reserve Bank Board—a majority of whom are part-time members, drawn from various parts of the Australian community, but seeking to make decisions in the national interest as opposed to any industry, geographical or sectional interest—needs to be considered when thinking about disclosure practices
>
> Readers will also observe that the pattern of votes of individuals is not recorded [in the new minutes], only the outcome. That is a point of difference with other central banks which publish minutes. But in those cases the decision-makers are full-time appointees, in some cases in systems with expressly individual, as opposed to collective, responsibility for their decisions. That is not the system Australia operates, and our pattern of disclosure reflects the institutional arrangements.[11]

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Stevens said that the Bank of England Monetary Policy Committee's 'culture is expressly, by the intention of its creators, one of individual accountability.' The implication is that the RBA has a different institutional makeup and culture, so that 'it would not make sense to "cherry pick" the high transparency aspects of every other system and assume that they should simply be grafted onto the Australian system.' In fact, this is exactly why more fundamental statutory reform of monetary policy governance is required. The RBA board and its statutory responsibilities date back to 1960, and are little changed from the central banking arrangements of the 1930s. Stevens also cites the fact that the European Central Bank does not publish minutes: 'it is argued, not unreasonably, that publication of minutes and voting might prejudice the capacity of the national governors to take a euro area, rather than national, perspective.' This is just one of many arguments that could be made against European monetary union, rather than a valid defence of a lack of transparency in the conduct of monetary policy.

Stevens' doctrine of collective responsibility is an embellishment of the RBA's traditional argument for board secrecy, which is that the backgrounds of the external board members would subject them to undue external pressure if their behaviour on the board in relation to monetary policy became known. The RBA fought an action against News Limited before the Administrative Appeals Tribunal in 2004 over a Freedom of Information request to release the board minutes, an action that was brought to an end by the use of a conclusive certificate. In an affidavit before the AAT, former board member Dick Warburton argued that releasing the minutes would expose external board members to 'undue criticism and pressure from the sectorial [*sic*] groups they nominally represent.'[12] This was explicit acknowledgement of the contradiction that lies at the heart of the governance arrangements for the RBA. While the external board members are notionally appointed to represent sectional interests, such as business or the union movement, their role as monetary policy decision-makers requires them to put aside such interests in favour of the public interest. The RBA's argument, that increased secrecy can resolve such conflicts of interest, would be considered absurd in any other context, but it is one that has nonetheless been accepted in public discourse about Australian monetary policy.[13]

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The failure of the newly released board minutes to identify the voting behaviour of board members explicitly recognises that some of the external board members are potentially too conflicted to discharge their responsibilities in relation to monetary policy in a transparent fashion. Increased transparency in relation to the behaviour of individual board members would alleviate the burden currently placed on the appointments process in ensuring the integrity of decision-making on monetary policy. If the actions of individual board members were on the public record, the public could more effectively monitor their behaviour, alleviating concerns about the potential for political interference, partisan voting, and conflicts of interest.

The RBA is exceptional in failing to separate monetary policy decision-making from its overall governance and broader statutory responsibilities. In the US, for example, monetary policy is the responsibility of the Federal Open Market Committee (FOMC) rather than the Federal Reserve board of governors. Indeed, there is no formal requirement for the chair of the Federal Reserve board to also chair the FOMC, although in practice both bodies have had the same chair. The Bank of England's Monetary Policy Committee is made up of five senior officers from within the Bank, but also four external, mostly part-time, members without executive responsibilities, who are appointed for their academic or other expertise in monetary policy. The different selection processes and backgrounds for the internal and external committee members ensure they bring a genuine diversity of opinion and expertise to the policy process. Separation of monetary policymaking from the overall governance of the central bank and its broader statutory responsibilities is a fundamental principle of modern monetary policy governance, yet one from which Australian policymakers apparently believe themselves exempt.

The RBA's defence of its outdated and anomalous model of monetary policy governance is only explicable by the determination of the RBA's senior officers to maintain their effective monopoly over monetary policy decision-making. By all accounts, the external members of the RBA board have never seriously challenged the policy recommendation made by the bank's senior officers ahead of the monthly board meeting. This may also partly explain the reluctance to make individual board members' contributions to decision-making public. While this might mitigate concerns about the potential conflicts of interest of external board members, it is still a poor basis for upholding the existing arrangements. Adopting models of central bank governance now used in comparable countries would challenge the RBA's effective monopoly over decision-making on monetary policy by bringing genuine external policy expertise and scrutiny to bear on the matter.

The RBA's inflation target

The new joint statement on the conduct of monetary policy follows previous iterations in defining the objective of monetary policy as 'keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short-run variation in inflation over the cycle while preserving a clearly identifiable performance benchmark over time.' In fact, the inflation objective remains poorly defined, which means that the RBA's performance in relation to inflation outcomes is poorly benchmarked, reducing accountability.

The reference to 'over the cycle' lacks a clear interpretation, especially in the Australian context of a sixteen-year economic expansion. The relevant measure of consumer price inflation is also undefined. The RBA exercises considerable discretion in what definition of inflation it references in explaining monetary policy decisions. The RBA generally refers to 'underlying' inflation as the key variable in explaining monetary policy actions. The RBA has recently begun to characterise 'underlying' inflation in terms of the average of its weighted median and trimmed mean measures of consumer price index (CPI) inflation. While this approach is motivated by the RBA's published research into the inflation process, the RBA has not given an adequate public explanation for this choice of measure, which is not one that has been endorsed by the government in the joint statement. The divergent views of the RBA and the former government on whether the RBA was meeting its inflation target in the run-up to the 2007 federal election might indicate the public confusion this lack of formalisation creates. Similarly, the May 2006 increase in interest rates caught financial markets by surprise because markets were looking at different measures of underlying inflation than the RBA. Indeed, the fact that the RBA was using a different definition had to be inferred from the RBA's public statements. It was only when the RBA characterised 'underlying consumer price inflation' as being 'around 2¾ per cent' in the statement accompanying the May 2006 increase in interest rates that it became apparent what measure the RBA was using, but even this inference was only possible by a process of elimination.[14]

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While definition of the inflation target may seem like a largely technical issue, it is critical to the effective conduct of monetary policy under an inflation-targeting regime, which relies heavily on conditioning the public's inflation expectations. In the absence of an agreed-upon definition of the targeted measure of inflation, such conditioning becomes more difficult, weakening accountability for specific inflation outcomes. According to the January 2008 Melbourne Institute survey of inflation expectations, fewer than 14% of respondents expect inflation to be within the RBA's 2–3% target range over the next twelve months.[15]

A new reform agenda for the RBA

The enhanced transparency measures adopted by the RBA following its December board meeting were likely a preemptive strike against demands for increased transparency on the part of the incoming Labor government, designed to ensure that any changes were made on the RBA's own terms. But it should be the new government that takes the lead in making further changes to the governance arrangements for monetary policy.

Monetary policy decision-making should be placed in the hands of a Monetary Policy Committee, separate from the RBA board, with substantial external representation from professional business and academic economists, supported by a secretariat within the RBA. The committee should release minutes of its deliberations, including a record of any votes taken. With members of the committee subject to such public scrutiny, the treasurer could safely make appointments to it. Committee members should be encouraged to play an active role in public debate over economic policy.

The *Reserve Bank Act* should be amended to give the RBA an unqualified mandate to pursue price stability, with other objectives explicitly made subordinate to this mandate. A new statement on the conduct of monetary policy should then set out a more precisely defined inflation objective, including the relevant inflation measure to be referenced in meeting the objective. This measure could be changed from time to time, subject to continued agreement between the RBA and the treasurer. The non-executive members of the RBA board would then be charged with oversight of the Monetary Policy Committee's performance in meeting the objectives set out in the joint statement, reporting to both the treasurer and Parliament. The non-executive board members should be empowered to recommend to Parliament dismissal of the governor for nonperformance if the inflation objective set out in the statement is not met.

The RBA governor should be required to front a media conference following each board meeting, to take questions on monetary policy. These conferences would be similar to those given by the governor of the Reserve Bank of New Zealand, which are now also the subject of a webcast, making the press conference widely accessible beyond accredited media outlets. This would significantly change the dynamics surrounding the reporting of changes in official interest rates, placing the media focus on the RBA's responsibility for interest rate changes, rather than that of the government of the day. The RBA governor should also be required to hold a press conference after each quarterly release of CPI data, to underscore the RBA's responsibility for inflation outcomes.

A 'new era'?

When Ian Macfarlane retired from the RBA governorship in 2006, he was widely hailed as having presided over a new era in monetary policy. But in relation to reform of RBA governance, he and former treasurer Peter Costello presided over more than a decade of neglect that left the RBA at the bottom of international rankings of central bank transparency and an outlier in terms of its model of monetary policy governance. Ian Macfarlane summed up the prevailing attitude to Australian monetary policy governance when he said 'the minimum fuss way of doing it is just to say [it] somewhere in a speech or something.'[16] This culture of neglect in relation to public sector transparency and accountability remains deeply entrenched in many of Australia's key public institutions. The Future Fund, with responsibility for managing up to $100 billion in public assets, has been found to rank below the sovereign wealth funds of some Third World countries on comparative measures of transparency and accountability.[17] The parochialism of the Australian media has arguably been a significant enabler of these low standards, since it seems largely unaware of the much higher standards now established in other countries. The Rudd government has again hailed a 'new era' in monetary policy governance, reinforcing the independence of the RBA's senior officers and board members, but the new arrangements are likely to entrench the bureaucratisation of monetary policy, and fail to address the fundamental conflicts that lie at the heart of the RBA's antiquated and anomalous model of monetary policy governance. With Australia's underlying inflation performance now the worst it has been since the great disinflation of the early 1990s, it is time to consider more fundamental statutory reform of RBA governance to bring about increased public accountability for inflation outcomes.