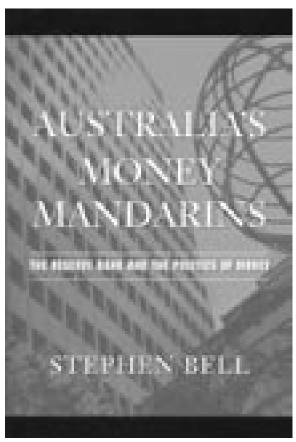
The Mandarins of Martin Place

The RBA prefers to maximise policy discretion while avoiding increased accountability



Australia's Money Mandarins: The Reserve Bank and the Politics of Money
Stephen Bell

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Reviewed by Stephen Kirchner

Money Mandarins is a thorough examination of the evolution of monetary policy governance in Australia. Bell's main focus is the process by which the Reserve Bank (RBA) has become increasingly independent of government and its implications for macroeconomic policy. Bell comes down in support of the RBA's distinctive governance framework, arguing that its success serves to discredit the rational choice literature that inspired the revolution in central banking institutions in the rest of the world during the 1990s.

Bell brings together a wide range of primary and secondary source material. The most interesting aspect of the book is the many interviews with current and former RBA officials and economic policymakers, from which Bell quotes extensively. Although these interviews necessarily contain a great deal of *ex post* rationalisation and self-justification, they are nonetheless quite candid in their discussion of the history and current framework for Australian monetary policy. The interviews mostly serve to confirm what has become a well understood story about the role of monetary policy in Australia's recent economic history, but one that has not benefited from systematic exposition. Bell has made a significant contribution in bringing this material together and making it accessible to a general audience.

The RBA is exceptional among the world's central banks in the path it has taken towards greater

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independence, in its approach to inflation targeting and key aspects of its governance framework. As Bell documents, the current governance framework for Australian monetary policy has a long history, some of it pre-dating the 1959 *Reserve Bank of Australia Act*, and there have been only minimal changes to its statutory framework in the period since. This is in sharp contrast to the global revolution in central banking institutions and governance, starting with New Zealand in the late 1980s, and spreading to most of the industrialised world's central banks during the 1990s.

Australia's failure to fully participate in this revolution in central bank governance is partly the result of the politicisation of monetary policy in the late 1980s and early 1990s. Bell documents the intellectual chaos and incoherence that afflicted Australian monetary policy in the 1980s, as the RBA struggled to define its role in the newly deregulated financial environment. The Bank's catch-all statutory mandate gave it little guidance as to how policy should be conducted or to what end, with some disastrous macroeconomic outcomes, most notably the early 1990s recession. The fact that the RBA presided over some of the world's highest interest rates is offered by Bell as evidence of its independence (p. 119), as opposed to its lack of credibility. It was this experience that prompted a large number of critics to argue in favour of Reserve Bank reform, which then became a key part of the federal Coalition's 1993 election platform. According to Bell, 'within the Bank there was understandable alarm; its institutional foundations were under attack and the fate of senior staff was uncertain' (p. 60).

The Coalition's 1993 election defeat was a major set back for this reform agenda, yet 1993 is also the year in which Governor Bernie Fraser began to articulate an inflation target as the basis for Australian monetary policy. The RBA was moving in step with international practice, through the adoption of interest rate targeting as its operating instrument and inflation targeting as the goal of policy. The RBA differed, however, in that these changes in monetary policy practice were not accompanied by reforms to the governance, accountability and transparency framework for the Bank. By the time the Coalition came to office in 1996, it was thought sufficient to merely codify existing practice through an exchange of letters between the Treasurer and Reserve Bank Governor. Bell quotes Governor Macfarlane as saying that this was 'the minimum fuss way of doing it' (p. 161).

Bell is correct in identifying the distinctiveness of the RBA's approach. Although the RBA is an inflation targeter, its target is only loosely defined, the Bank retains a conflicted statutory mandate and lacks the rigorous accountability and transparency regime that accompanied statutory reform of central banking institutions in other countries, most notably the Bank of England and Reserve Bank of New Zealand (RBNZ). Bell quotes Governor Macfarlane as saying 'ours was definitely regarded—of the dozen models available—as being the softest of the spectrum' (p. 83). Bell sees the RBA's failure to embrace key elements of central bank reform and its apparent success in the discretionary conduct of policy as a challenge to the theoretical rational choice literature that underpins the arguments of reformists and even suggests that the RBA now serves as a model worthy of international emulation.

The problem with this view is that there is no evidence that Australia's fortunate macroeconomic experience in the 1990s is due to Australia's distinctive approach to monetary policy governance, as opposed to what the RBA *does* share in common with other central banks, which is an increased commitment to price stability relative to previous decades. Australia has shared in what has become known as The Great Moderation, the decline in the volatility of inflation and output across the industrialised world in the 1990s. There is considerable debate in the economics profession about the role that changes in monetary policy practice might have played in the Great Moderation, but unfortunately no consensus.

The RBNZ is a natural point of comparison for the RBA and Bell subscribes to the now well-established conventional wisdom that the RBNZ's more rigorous approach to inflation targeting, now partly abandoned in favour of the Australian approach, has been a negative for its economy (p. 102). A superficial review of the data does not remotely support this view. Even including New Zealand's 1998 recession, average GDP growth and the output gap in New Zealand have been little different from Australia, while the unemployment rate has been significantly lower. Disentangling the specific contribution of institutional arrangements to macroeconomic outcomes is an extremely difficult task, one that even economists find daunting. The literature suggests that the RBA has, if anything, been more zealous in its response to inflation, while the RBNZ has been more responsive to deviations in growth from trend. This is most likely a function of structural differences between the two economies rather than different preferences over inflation and output on the part of the two central banks.

Bell's argument is consistent with the view that institutions matter, but he wants us to believe that they matter in a way that is different to the alleged 'neo-liberal orthodoxy' on the subject. Bell sees in Australian monetary policy a rich set of institutional dynamics that sparks his interest as a political scientist and which he claims are not amenable to a rational choice interpretation. Bell's public interest conception of institutional behaviour blinds him to the obvious self-interest at work behind Australia's failure to embrace central bank reform and a more rigorous framework for monetary policy transparency and accountability.

The RBA's preference for its peculiar governance framework (p. 174) is readily explicable in terms of its desire to retain as much discretion over the conduct of policy as possible, while avoiding the increased public scrutiny and accountability that would come with a more rigorous transparency framework. At the same time, the government has little interest in a strongly independent Bank that might constrain its own freedom of action: Max Walsh is quoted saying 'an independent central bank. . . would be an Australian Treasurer's nightmare' (p. 104).

The RBA's broad statutory mandate and 'flexible' approach to inflation targeting allows it to shirk responsibility for specific macroeconomic outcomes. The RBA and Treasury often talk about the inflation outlook as though inflation were still an exogenous variable. The persistence of this rhetoric arguably confuses the public and undermines the credibility of the inflation target. The RBA's recent statements on house price inflation and private sector credit growth have created the widespread impression that these too are now targets for policy. When the RBA says, as it did in its November 2003 Statement on Monetary Policy, that household debt is 'a separate, but no less important issue' than the inflation target (p. 195), it is not difficult to see how the public could become confused on this issue. The RBA's interest in these issues is partly a function of its paternalistic culture and mistrust of market outcomes. Yet the RBA shows no sign of actually taking responsibility for policy outcomes in relation to these matters. Its submission to the Productivity Commission inquiry into housing affordability sought to finger negative gearing as the culprit in house price inflation, with a view to getting the RBA off the hook should the house price boom end badly. Like any other institution, the RBA is a self-interested actor that needs a well-defined governance framework to ensure that its actions are consistent with the public interest.

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The RBA's practice of selectively leaking its policy bias to journalists (p. 155), apart from showing disregard for procedural fairness in handling sensitive information, also suggests than it has a problem with transparency. Bell euphemistically calls this using the media 'strategically'. He lets Macfarlane get away with statements such as 'we already put out the most detailed account of any central bank when we do make a change' in policy (p. 158), yet the RBA's explanations of its policy actions are little more than check-lists of factors influencing policy and its Statements on Monetary Policy are bland and descriptive compared to the more forward-looking and informative statements produced by the Bank of England and the RBNZ. *The Australian Financial Review* is quoted saying 'the RBA rightly argues that it is already among the most transparent of the world's central banks' (p. 153). Journalist Paul Cleary is also quoted saying that these Statements are a 'little-known triumph of transparency' (p. 157). These are laughable propositions for anyone with actual experience of other central banks. Even the Bank of Japan could make a good case for being more transparent than the RBA. Far from being authoritative, these comments only serve to highlight the low standards of the federal parliamentary press gallery.

The other respect in which the RBA's governance framework is deficient is in the composition of its Board, yet Bell takes an overly benign view of these arrangements. The RBA is exceptional in having a part-time amateur policy board, with a representative of the government in the form of the Treasury Secretary having voting rights. Governor Macfarlane is quoted by Bell as saying 'no one has ever understood whether the Treasury Secretary speaks for the Treasury or the Treasurer, and I still don't know the answer to that' (p. 177). This is a perhaps a more powerful statement in favour of removing the Treasury Secretary from his *ex officio* role on the Board than the more conventional one that this position serves as a back channel for political influence.

The role of some of the other, part-time board members, particularly those with business backgrounds, is no less questionable. Think of Bill Gates sitting on the US Federal Open Market Committee or Sir Richard Branson sitting on the Bank of England's Monetary Policy Committee and the absurdity of the RBA's governance arrangements becomes readily apparent. Bell is even sympathetic to the idea of allowing financial sector representation on the Board (p. 179), showing little concern for the risk of regulatory capture. The RBA's preference for an amateur policy Board arguably reflects the desire of its senior officers to monopolise decision-making and limit scrutiny by outside experts. At the very least, monetary policy decision-making should be delegated to a full-time expert committee that is kept separate from the Bank's other governance functions and has substantial external representation to ensure a genuine diversity of policy views.

Bell concludes that 'the system does not need much fixing' (p. 165), which would be music to the ears of the RBA's deeply conservative senior officers. Yet the impetus for reform has not been entirely lost. Bell documents the attempts of Labor members of the House Economics Committee to get central bank reform back on the table (p. 161). In particular, Labor members have argued in favour of writing the Joint Statement on the Conduct of Monetary Policy into the Reserve Bank Act, requiring the RBA to make detailed statements at every policy announcement window (like the RBNZ) and for removing the Treasury Secretary from the RBA Board. Whether this enthusiasm for reform can be sustained into government is questionable, and the ALP has already backed away from the idea of removing the Treasury Secretary from the Board. But the ALP's interest in these issues demonstrates that central bank reform is not just some fixation of the 'neo-liberal right', as Bell would have us believe. The ALP's interest in reform constitutes recognition that these are matters of considerable procedural importance in promoting public accountability in the conduct of monetary policy.

While Bell and many others have given the RBA a good press in recent years, this only proves that nothing succeeds like success. Good luck and good management have arguably made up for what the RBA lacks in terms of a sound governance framework. The RBA is certainly distinctive by international standards, but this distinctiveness is little more than a by-product of its history, institutional inertia and political laziness. There is no strong evidence for or against the peculiarities of the RBA's governance framework, although plenty of evidence in favour of what it *does* now share in common with other central banks.

The most compelling arguments for further reform are largely procedural rather than economic. Processes matter to economic outcomes, even if we cannot always identify their specific contribution. Bell understands the importance of institutions, but his critical edge is blunted by his public interest conception of institutional behaviour. Bell characterises the literature on central bank independence as 'a lifeless form of institutional analysis. It misses the most important thing, human agency and the actual motives and behaviour of key actors' (p. 106). Yet Bell is guilty of precisely this in his naïve public interest assumptions about institutional behaviour. Much of Bell's narrative can be given a straightforward rational choice interpretation. Perhaps the most revealing comment in the book comes in the introduction, when Bell says 'decisions and operations in the upper reaches of the Bank and at the level of the Reserve Bank Board *still* occur in secret, and it is part of the purpose of this book to peer into this closed world' (p. 3 emphasis added). Reform advocates would argue that it should not take a political science professor to make sense of Australian monetary policy.