THIRD 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 Glenn Stevens as Governor of the Reserve Bank.

This statement records the common understanding of the Governor, as Chairman of the Reserve Bank Board and the Government on key aspects of Australia's monetary policy framework. It builds on the 1996 and 2003 Statements between the Treasurer and the former Governor on the respective roles and responsibilities in the operation of monetary policy in Australia.

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 and the Treasurer on behalf of the Government to affirm their mutual understanding of the operation of monetary policy in Australia.

This statement should continue to foster a clear 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 1959* (the 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 Act nominates the Governor as Chairman of the Board.

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

Section 11 of the Act prescribes procedures for the resolution of policy differences between the Reserve Bank Board 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 in the conduct of monetary policy. Safeguards like this ensure that monetary policy is subject to the checks and balances inherent and necessary in a democratic system.

The Act also 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 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.

Objectives of Monetary Policy

The goals of monetary policy are set out in the Act which requires the Board to conduct monetary policy in a way that, in the Board's opinion, will best contribute to:

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 Board 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, both the Bank and the Government agree on the objective of 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 business cycle while preserving a clearly identifiable performance benchmark over time.

Since the first Statement on the Conduct of Monetary Policy in 1996 inflation has averaged around the midpoint of the inflation target band. The Governor expresses his commitment to the inflation objective, consistent with his duties under the Act. For its part the Government indicates again that it endorses the inflation 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. A forward looking focus is essential as 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 continues to 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.

The Reserve Bank takes a number of steps to ensure that the conduct of monetary policy is transparent. Changes in monetary policy and related reasons are clearly announced and explained. The Bank's public commentary on the economic outlook and issues bearing on monetary policy settings, through public addresses, its quarterly statements on monetary policy and monthly statistical bulletins, promote increased understanding of the conduct of monetary policy. The Bank will continue to promote public understanding in this way.

The Governor has also indicated that he plans to continue the practice of being available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Economics, Finance and Public Administration.

The Treasurer expresses continuing support for these arrangements, which ensure the continued transparency and accountability of the Reserve Bank's conduct of monetary policy – and therefore the credibility of policy itself.

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

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