The Australian Government's Current Approach to Monetary Policy: An Evaluation

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1. Introduction

The responsibilities of the Reserve Bank of Australia are defined in the *Reserve Bank Act 1959*, which sets out very broad objectives for monetary policy. While this Act remains the defining piece of legislation for the Bank's activities, the weight that the Reserve Bank gives to different objectives has changed with time and circumstance.

Consistent with the conservative approach that characterises the behaviour of central banks worldwide, recent changes in the Reserve Bank's approach to monetary policy have been instituted gradually. A typical change might begin with small changes of wording in statements emanating from the Bank, before being reinforced in informal public utterances and then finally acquiring the mantle of 'Bank Policy' in a major speech by the Governor or one of the Bank's Deputy Governors. As a consequence, it is often difficult to define the precise point in time when a particular change was instituted.

The current emphasis on inflation targeting as the primary role of monetary policy really had its genesis as early as the second half of the 1980s, with the adoption of operating procedures that focused on the cash rate as the primary operating instrument of monetary policy and the adoption of the so-called 'check-list' or 'indicators' approach.

Under the check-list approach, adopted following the abandonment of M3 targeting in January 1995, monetary policy emphasised the attainment of short-run stabilisation objectives. At different times, using this approach, monetary policy was directed towards a range of objectives including achieving reasonable growth in activity, reducing the current account deficit and stabilising the exchange rate. The medium-term objective of reducing inflation was relegated to secondary importance.

By the end of 1989, there had been signals both from the Reserve Bank and the Treasury of a move away from the check-list towards an approach which gave greater emphasis to reduction in inflation (Morgan 1990). In subsequent years, the Reserve Bank emphasised that monetary policy had developed a more medium-term anti-inflationary focus than formerly. Considerable emphasis was still given to output and employment objectives and, on occasions, to reducing the current account deficit.

Monetary policy also became more transparent. Changes in short-term interest rates since January 1990 have been announced the moment that they are made. Interest-rate

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changes are less volatile than was the case in the past. In addition, the Bank upgraded its public commentary on the economic outlook and issues bearing on monetary-policy settings, through speeches by senior Bank officers and through quarterly reports on the economy contained in the Reserve Bank *Bulletin*.

By the mid 1990s, the Reserve Bank's approach to monetary policy aimed to achieve dual objectives. The first objective was to keep underlying inflation to an average of 2 to 3 per cent over the course of the cycle. The second objective gave emphasis to achieving desirable output and employment outcomes (Grenville 1996).

With the appointment of Ian Macfarlane as Governor in August 1996 came the further development of a formal Statement by the Treasurer on the Conduct of Monetary Policy (Treasurer, Costello 1996). This Statement gave greater emphasis to 'the importance of low inflation and low-inflation expectations' and also emphasised 'the need for effective transparency and accountability arrangements'. It also reaffirmed the Reserve Bank's medium-term price stability objective of keeping underlying inflation between 2 and 3 per cent, on average, over the cycle.

The Statement also promised enhanced transparency arrangements. The new Governor made a commitment to release, at six-monthly intervals, statements on monetary policy and the role it is playing in achieving the Bank's objectives; these statements would include specific information on the outlook for inflation. The Governor also indicated plans to be available twice a year to report on the conduct of monetary policy to the House of Representatives Standing Committee on Financial Institutions and Public Administration.

As chronicled above, since 1985 there has been an evolution in the focus of monetary policy. From an emphasis on a range of short-term objectives (including output, the exchange rate and the current account deficit) in the second half of the 1980s, to a greater emphasis on reducing inflation in the early 1990s, to a dual-objective (inflation and output) approach, to the current approach which is tightly focused on achieving an inflation target. Over the course of the past decade, Australian monetary policy has not always moved monotonically towards its current state but has tended to meander through a range of policy regimes. Consistent with past performance, the current inflation objective is sufficiently loosely defined that, if circumstances subsequently dictate, there is nothing to stop reversion in the focus of monetary policy to one giving renewed emphasis to unemployment and output or, even, for that matter, to the exchange rate or current account deficit.

The remainder of this paper proceeds by first detailing five issues that are central to the debate about the appropriate settings for monetary policy. Next, an index of independence and accountability is constructed. This index is used to evaluate the Australian performance on monetary policy over time and also to compare the current performance of the Reserve Bank of Australia with that of the Reserve Bank of New Zealand and the Bank of England. The concluding sections draw together earlier material to provide a series of recommendations for changes to the Australian approach as well as presenting an overall evaluation.

2. Central Issues

In recent years, a selection of central banks has chosen to adopt an explicit target for inflation as a basis for determining monetary policy. King (1996) lists eight countries which have recently adopted an explicit inflation target.[1] Apart from countries with an explicit inflation target, there are other major countries, such as the G3 countries (Germany, the United States and Japan), which have also achieved consistently low inflation rates over the past decade.

This section examines certain central issues that lead to the adoption of an inflation target and describes questions that must be addressed in determining the precise institutional arrangements under which such a target is implemented.

2.1 'Finetuning'

There is now a substantial body of literature demonstrating that it is inappropriate to use monetary policy to 'finetune' the economy. This argument is contained in two strands of argument – the first strand based on the effectiveness of such a policy and the second strand based on credibility arguments.[2]

A cogent argument against the use of monetary policy for finetuning the economy is that the effects of changes in monetary policy are transmitted to the real economy only with long and variable lags. The length of these lags is substantial; Lowe (1992) estimates lags of the order of 12 to 24 months. This, alone, is a powerful argument against intervention. Argument is further enhanced when coupled with evidence that the length of these lags can change significantly over the course of the cycle and under changing expectations scenarios (Oster 1988; Grenville 1995).

A further reason why finetuning is not appropriate is the difficulty of forecasting what the state of the economy is likely to be one to two years ahead. Examination of revisions to National Accounts data provided by the Australian Bureau of Statistics demonstrates that there is even inordinate difficulty in defining history with any degree of certainty. These uncertainties are further highlighted when one observes the deficiencies of past forecasts. Examination of the accuracy of past forecasts shows that turning points are particularly difficult to predict.

In order to achieve efficacious outcomes from monetary intervention, monetary authorities must first predict the timing and amplitude of economic turning points and then adjust monetary policy so that it has the desirable outcome at the appropriate point in time. This is virtually impossible in an environment where it is hard to provide accurate forecasts and where the transmission lags of monetary policy are not constant from one cycle to the next.

The arguments against finetuning are enhanced by recent literature emphasising the role of expectations and the importance of credibility and reputation in achieving

1. These countries are: Australia, Canada, Finland, Israel, New Zealand, Spain, Sweden and the United Kingdom.
2. For an in-depth discussion of these arguments, see Stemp (1996b). A briefer discussion is contained in Stemp (1996a).

desirable monetary-policy outcomes. For example, it will be possible to reduce inflation more easily if private agents believe that the monetary authority is committed to reducing inflation (Stemp and Murphy 1991).

There is also another important incentive facing the monetary authority. A need to maintain credibility and reputation means that the monetary authority will face pressure to justify as appropriate all its past approaches to monetary policy. When a central bank is faced with incentives that make it difficult to acknowledge past failings, this means that all assessments of monetary contributions to past outcomes emanating from the central bank must be viewed with some scepticism. In such an environment, it is important that the central bank's approach to monetary policy is, at all times, transparent, so that private agents can evaluate the success of the central bank in meeting its objectives. This ideal of transparency is unlikely to be present when the adopted regime involves finetuning.

The problems highlighted with regard to finetuning suggest that monetary policy can be asked to deliver too much with consequential undesirable effects. In practice, monetary policy can be most effective when it is confined to achieving at most one objective. It is argued below that an inflation target is an appropriate single objective.

2.2 Why target inflation?

There is a substantial literature on the economic costs of inflation. These costs are largely associated with real resources expended by private agents in responding to inflation and the uncertainty it creates. Wealth and income-redistribution effects are also important, including the expenditure of real resources as agents attempt to rearrange their personal affairs so as to be well placed to benefit financially in an inflationary environment. Costs include so-called 'shoe leather' costs, menu costs, the costs associated with the interaction between the taxation system and inflation, as well as effects on the cost of labour and the level of the capital stock. In a non-inflationary environment, resources would be employed more efficiently, increasing the level of present and future output.

In practice, there is ambiguous evidence as to whether or not the costs associated with an increase of inflation from, say, 0 per cent per annum to 5 per cent per annum, warrant concern. While levels of inflation of 100 per cent per annum are likely to introduce substantial distortions into consumption and investment decisions, there is conflicting evidence as to whether or not inflation levels of 5 per cent per annum introduce significant distortions to economic decision-making. Pagan and Trivedi (1983) argue that the welfare costs associated with an increase in inflation are small. Recent work by Feldstein (1996) provides evidence that such costs can be substantial.

Even if the costs of moderate inflation are relatively insignificant, an alternative argument for keeping inflation low is associated with the costs of disinflation. If inflation has a tendency to slowly creep upward, then at some stage inflation levels will reach a point at which it is necessary for inflation to be reduced. But reducing inflation involves corresponding temporary reductions in output levels as well as temporary increases in unemployment. Empirical estimates for Australia show that a 1 per cent reduction in the three-year average inflation rate can lead, in the short run, to as much as a 2 per cent reduction in real output (Stevens 1992, Table 3, p. 218).

If the costs of disinflation have already been met so that inflation is already low, then, in order to avoid future costs of disinflation, it is desirable to maintain low inflation levels. However, whether or not it is appropriate to set a low inflation target in a high-inflation environment will depend on the relative costs of inflation and disinflation. In setting its inflation target, the Reserve Bank of Australia has avoided this last question. King (1996, p. 54) notes that, of those countries which have in recent years adopted an explicit inflation target, only Australia set an inflation target that had already been achieved.

Another reason for focusing on inflation rather than, say, activity, is the long-run neutrality of money; this is the proposition that monetary policy can have an impact only on prices and not on activity in the long run. This establishes inflation as the most suitable medium-term target for monetary policy.

Long and variable lags in the transmission of monetary policy, coupled with the difficulty of providing accurate forecasts of economic outcomes, make it inappropriate to focus monetary policy on achieving more than one objective. The above arguments suggest that a suitable objective for monetary policy would be one that aimed to achieve an appropriate inflation target.

2.3 Distribution of output and employment

One of the costs of inflation is that it leads to transfers between those who are better placed to take advantage of inflation (such as home-owners) and those who are not so well placed (for example, renters). Over time, inflationary pressures can lead to significant real resources being expended by individuals as they rearrange their affairs so as to benefit from inflation. Elimination or reduction of inflation means that these resources are more likely to be utilised more efficiently.

The long-run neutrality of money means that price stabilisation is an appropriate primary objective for monetary policy. Of course, there are some agents in the economy who receive little benefit from reduced inflation – notably the unemployed. And when reductions in inflation are accompanied by higher levels of unemployment, output is distributed away from any newly unemployed individuals. These issues lead well-meaning commentators to suggest that it is inappropriate to focus monetary policy exclusively on an inflation target, and that some weight should be given to output stabilisation objectives in determining the stance of monetary policy. The problem with such an argument is that it fails to acknowledge the difficulties of achieving multiple objectives using monetary policy.

Arguments against finetuning the economy are also arguments against attempting to achieve multiple monetary-policy objectives. Forecasting difficulties and the long and variable lags in the transmission of monetary policy may mean that the timing of monetary policy is inappropriate. In such a situation, well-intentioned attempts to use monetary policy to stabilise output may actually increase the amplitude of the business cycle – thus, making matters worse rather than better.

Furthermore, unemployment often has strong regional components; and it is impossible to run different monetary policies in different regions of Australia. As a consequence, at least part of the unemployment problem, that is, high unemployment in country areas and

differing unemployment levels across State capitals, cannot be addressed by monetary policy.

Is there anything that can be done to change the distribution of output or, at least, improve the prospects and circumstances of the unemployed? Fiscal policy is an obvious candidate. The Mundell-Fleming model of the open economy suggests that, under perfect capital mobility and a flexible exchange rate, fiscal policy will have no impact on national output and can therefore only be used to redistribute output within the national economy.[3] To the extent that this paradigm provides an accurate representation of the Australian economy, it suggests that redistribution of fiscal expenditure should be used to provide a welfare net and job-creation programs for the truly needy rather than in any attempt to increase overall aggregate demand. In addition, the stance of fiscal policy (in particular, the fiscal deficit and levels of public indebtedness) should be chosen so as not to place any unnecessary upward pressure on prices, which would then have to be offset by monetary policy.

It must be emphasised that, in arguing that monetary policy should be focused on achieving an inflation target, it is not being suggested that unemployment and the effects of the business cycle are not important issues. But the fact that unemployment is undesirable does not mean that monetary policy can be used directly to address this problem. Proponents of inflation targeting typically argue for such an approach on the basis that the most effective way that unemployment can be reduced is by creating a suitable environment for long-term growth; low inflation is an important pre-condition for such an environment.

2.4 Upside and downside risks

In its current approach, the Reserve Bank of Australia does set an inflation target, specifically requiring that underlying inflation should achieve an average of '2-point-something' over the course of the cycle. Unfortunately, the success or failure of such an approach cannot be properly evaluated until a full cycle has passed. As detailed in the first section of this paper, Australian monetary policy has not always moved monotonically towards its current state but has tended to meander through a range of policy regimes. Consistent with past performance, there is nothing to stop a substantial change to the focus of monetary policy. Accordingly, there is no strong guarantee that the current approach to monetary policy will be sustained for a long enough period to allow a proper evaluation of the Reserve Bank's success in achieving its stated objective.

Future uncertainty must be allowed for in any evaluation of current institutional arrangements. Accordingly, in any assessment of the current approach, it is appropriate to specify both upside and downside risks. In particular, short- to medium-term outcomes are likely to be major determining factors in whether inflation targeting is allowed to continue into the long term as the sole monetary-policy objective.

3. As a model of the Australian economy, the Mundell-Fleming model has several deficiencies that should be noted. First, Australian international capital flows do not satisfy perfect capital mobility. Second, expectations are not modelled in this paradigm. Third, the exchange rate is a crucial means of transmission in this model; however, the exchange rate does not always act as predicted.

In the event of a favourable supply shock, inflation is likely to be further reduced, accompanied by strong employment growth. Under this scenario, which encompasses the most likely upside risk, the inflation-targeting approach would almost certainly be seen as highly successful and the likelihood of an inflation-targeting approach being allowed to continue would be greatly enhanced.

The most likely downside risk arises as the business cycle moves into its next trough. Depending on the magnitude of the next recession, there could be considerable pressures on the Reserve Bank to adopt a stance for monetary policy which emphasises employment and output outcomes as well as inflation. This would come at precisely that stage in the cycle, a turning point, when activist monetary intervention is likely to be least effective; indeed, when there is a high probability that attempting to finetune the economy will do more harm than good. This would likely be followed by a substantial change to the focus of monetary policy, most probably associated with a resurgence in inflation. Indeed, if agents in the economy see that such an outcome could easily eventuate, inflationary expectations now will be higher than otherwise, leading also to higher actual inflation.

One way that such an undesirable outcome can be avoided is by enshrining the inflation target in a legislated central bank contract between the government and senior officers of the Reserve Bank.

2.5 Optimal central bank contracts

Following from the seminal work on time inconsistency by Kydland and Prescott (1977), a substantial literature on incentives facing central bankers and desirable properties for associated central bank contracts has recently developed.

Barro and Gordon (1983) demonstrated that an unconstrained central bank may adopt a stance for monetary policy that is biased towards achieving a level of inflation which is too high.[4] Extending Barro and Gordon's framework, Rogoff (1985) showed that society will be better off by appointing a central banker who places too large a weight on inflation-rate stabilisation relative to employment stabilisation. In subsequent work, Lohmann (1992) showed that a better outcome is achieved if the government retains the right to override an otherwise independent central banker in times of extreme supply-side shocks. In normal times, the central banker sets the inflation rate independently at his discretion. In extreme situations, he implements a flexible escape clause: the larger the output shock, the more the central banker accommodates the government's *ex post* demands in order to avoid being overridden.

Rogoff and Lohmann focus on the government's choice of central banker, viewing the government as choosing from a population of potential bankers with differing preferences over inflation and output fluctuations. The government picks the banker whose preferences are such that the resulting conduct of monetary policy maximises the government's

4. This literature assumes that the central bank has a target level of output which exceeds the full-employment level of output. Such an assumption can be justified on two separate grounds. First, distortions (such as those arising through taxation) can mean that the full-employment level of output is socially suboptimal. Second, the true full-employment level of output is not observable and agents in the economy may mistakenly believe that full-employment output is higher than is really the case.

expected utility. In a further development of this approach, Walsh (1995a,b) examines how the behaviour of central bankers can be modified by appropriate incentive structures. In particular, he investigates whether there is an optimal contract the government should offer to the central banker. That is, if central banks respond to the incentives they face, then what form should those incentives take? In Walsh's framework, suitable incentives can take the form of a state-contingent wage contract for the central banker but, in some cases, may also resemble an inflation-targeting rule or even a dismissal rule. The precise structure of any optimal contract depends on the availability and timing of information to government and central banker.

Assuming that the central banker cares about holding office and has the same objective as the government, Walsh (1995a) derives an optimal contract that involves dismissal of the central banker under specific circumstances. This dismissal rule works as follows: the government must establish a critical inflation rate and dismiss the central banker whenever actual inflation exceeds this value. In Walsh's framework, the critical inflation rate would need to be adjusted in the face of significant aggregate-supply shocks, but cannot be adjusted in light of aggregate-demand disturbances. Walsh observes that the structure of this optimal contract looks similar to the approach currently adopted under the *Reserve Bank of New Zealand Act 1989.*

There are certain aspects with respect to this literature on optimal central bank contracts that need to be emphasised. First, even when output and employment outcomes are very important considerations for all agents in the economy, an optimal central bank contract should focus exclusively on achieving an inflation target. Second, the optimal central bank contract should involve the threat of some significant sanction against the person(s) responsible for implementing monetary policy if the designated inflation target is not achieved. Third, there should be an appropriate adjustment to the inflation target if significant supply-side shocks hit the economy.[5]

2.6 Summary

The inherent difficulties associated with finetuning an economy suggest that trying to achieve too much with monetary policy can lead to undesirable outcomes. Because of these difficulties, efficacious outcomes from monetary policy are best achieved by focusing monetary policy on achieving a single objective. The long-run neutrality of money coupled with evidence on the costs of inflation suggest that, if a single objective is to be chosen for monetary policy, then an inflation target is appropriate.

A decision to target inflation does not imply any assessment that unemployment or troughs in the business cycle are unimportant, but, rather, that monetary policy is not the appropriate instrument with which to address these problems in the short run. Adjustments

5. It is important to make the distinction between objective criteria (or loss functions) and operating rules. In the optimal central bank contract literature, the inflation target is a way of evaluating or synthesing the community loss function. It is possible to have an inflation target that focuses solely on achieving an outcome for inflation that lies in a specified range, and yet have an operating rule that responds to both output and inflation. The reason for this is that, as long as all agents in the economy care about both inflation and output outcomes, then by specifying an acceptable range for inflation there is also an implicit acceptable range for output. By broadening the acceptable range for inflation, the corresponding implicit range for output is narrowed.

in fiscal expenditure, so as to provide an appropriate welfare net and job-creation programs, are the best way to achieve appropriate distributional outcomes. In the long run, low inflation is a precondition for output growth and the creation of more jobs.

Also, even in a world where all agents are concerned about outcomes for output as well as inflation, the best result can be achieved by requiring the central bank to focus solely on achieving an inflation target. This is because there can be a temptation to try to achieve an output and employment outcome which is too high and this can lead to undesirable inflationary pressures with no compensating increase in output.[6] Recent literature suggests that an inflation target, subject to an override provision in the case of major supply shocks, and with appropriate sanctions on responsible individuals if the inflation target is not met, provides an appropriate structure for an optimal central bank contract.

The easiest way that undesirable outcomes can be avoided is through enshrining the Reserve Bank's inflation objective in appropriate legislation. Consistent with the literature on optimal central bank contracts, this legislation should clearly set out the inflation objective, the person(s) responsible for achieving the inflation objective, and appropriate sanctions if the inflation objective is not met.

3. Constructing an Index of Independence and Accountability

Having argued above that a legislative approach to the implementation of monetary policy should be adopted, this section sets out certain desirable criteria that can be found in the legislative approaches adopted in other countries. Subsequently, these criteria will be used to calculate indices of independence and accountability at different points in time and for different central banks.

The desirable criteria are as follows:

- *Specification of objectives*: measures the extent to which the ultimate objectives of monetary policy are clearly specified.
- *Inflation target*: measures the extent to which specified objectives for monetary policy are focused on a clear, well-defined inflation target.
- *Operational responsibility*: measures the extent to which the central bank has operational responsibility for achieving its specified objectives without direction or interference from the relevant government.
- *Ultimate responsibility*: measures the extent to which there is a clearly defined and ultimate responsibility for meeting the specified objectives. This ultimate responsibility can rest either with an individual or group of individuals.
- *Transparency*: measures the extent to which information and forecasts used in determining the stance of monetary policy are clearly available.
- *Accountability*: measures the extent to which the consequences, for those ultimately responsible, of not meeting the specified objectives are clearly set out. Accountability may involve the dismissal, reduction in salary, or other form of sanction of those ultimately responsible if specified objectives are not met. Given that it has been shown that an optimal central bank contract would also include an override

6. Misguided pressure for the central bank to achieve output and employment outcomes that are too high may come from politicians concerned about their own re-election rather than from within the central bank.

provision in the case of significant supply shocks, any measure of accountability should also include appropriate override provisions.

3.1 Evaluating the Reserve Bank's current approach

Under current arrangements, the Reserve Bank of Australia has a clearly specified inflation target. As a consequence, it ranks highly on the specified objectives criterion. On the inflation-target criterion, its ranking would improve marginally if a specific range for inflation were specified rather than just an average 'over the course of the cycle'. The Bank also ranks highly against the transparency criterion; its performance in this regard could be improved however, if it were to provide regular minutes of meetings of the Bank Board.

An important consideration that has a bearing on the assessment of the Bank's success in meeting the other criteria is the composition, operation and legislative position of the Reserve Bank Board.

The Board is composed of the Governor, two Deputy Governors, the Secretary to the Treasury, an academic economist, and five business representatives. The Governor and Deputy Governors are appointed for terms of up to seven years, the Secretary to the Treasury is appointed *ex officio*, the academic economist and five business representatives are appointed for five-year terms. During the life of the previous Labor Government, there was also a Trade Union representative on the Bank Board. Presumably to avoid potential conflicts of interest, there is a requirement that Board members cannot be directors, officers or employees of businesses whose main activity is banking – this means that many individuals who might be particularly well-suited for determining the stance of monetary policy are precluded from Board membership. Little is known about the precise method of operation of the Board. There are no minutes of meetings. It is not even known whether votes are taken on specific issues or the Board operates under a consensus arrangement.

Under the Reserve Bank Act, the Board has ultimate responsibility for the setting of monetary policy. But, in the past, Treasurers have been known to claim full responsibility for interest-rate changes. Also, the lack of financial-market and monetary expertise of business representatives on the Board means that the Bank and Treasury arguments may not be viewed sufficiently critically. This lack of technical expertise by some Board members, the close association of other Board members (notably, the Secretary to the Treasury) with the implementation of other aspects of government policy, and the absence of detailed minutes of Board meetings means that, in practice, it is not possible to evaluate the extent of government influence on Board decisions. Also, the definition of the inflation target is sufficiently loose that it is going to be extremely difficult to determine when the inflation target has, or has not, been achieved. There is no override provision in the case of major supply shocks; perhaps because the specification of the inflation target is so loose that an override provision is not considered necessary. The position of the Board, coupled with the possibility for government to intervene surreptitiously in the implementation of monetary policy gives the Bank a mediocre ranking against the operational-responsibility criterion and very low rankings against ultimate-responsibility and accountability criteria.

In the spirit of previous studies, this paper next employs the six criteria to create an index of independence and accountability. While it must be recognised that the compilation of such an index is somewhat subjective, an index does provide a useful way of evaluating a range of issues and providing an overall perspective.

Table 1 compares the current approach of the Reserve Bank of Australia with the approaches adopted in June 1996 (prior to the Treasurer's August Statement on the Conduct of Monetary Policy) and in June 1987 (when the monetary stance was determined using the check-list approach). A ranking of 1 indicates that no attempt has been made to satisfy the relevant criterion. A ranking of 5 means that the Reserve Bank has been highly successful in meeting the criterion.

Table 1: Independence and Accountability of the Reserve Bank of Australia at Different Points in Time

Graded on a scale of 1 to 5

Criteria	June 1987	June 1996	June 1997
Specification of objectives	1	5	5
Inflation target	1	3	4
Operational responsibility	3	3	3
Ultimate responsibility	1	1	1
Transparency	1	3	4
Accountability	1	1	1
Raw mean	**1.33**	**2.67**	**3.00**

Table 1 demonstrates a substantial improvement in independence and accountability from June 1987 until June 1996, coupled with even further improvement between June 1996 and June 1997.[7] Those areas in which significant improvement has been achieved are: in the clear specification of objectives, in the setting of an inflation target, and in improved transparency. For some criteria, no progress has been achieved since June 1987. Throughout the past decade, the measure for operational responsibility has remained in the midrange of success. Virtually nothing has been done over the past decade to improve unsatisfactory levels on the definition of an individual or group of individuals who are ultimately responsible for the implementation of monetary policy and in the accountability criterion which measures the implementation of review procedures in the event that monetary objectives are not met.

7. Different individuals might choose to give different weights to alternative criteria. For that reason the raw mean should be considered as an ordinal measure rather than a cardinal measure of independence and accountability. However, the statement that there has been a substantial improvement between June 1987 and June 1996 can be justified because the change over that period has involved an improvement in so many components of the index.

3.2 Comparison with approaches adopted in New Zealand and the United Kingdom

Two countries that have chosen to adopt a legislated inflation target are New Zealand and the United Kingdom.[8] It is informative to examine how the central banks in these countries perform against the six criteria as well as on the overall index. By constructing a comparable index for these countries, it is possible to provide a benchmark for an overall evaluation of the performance of the Reserve Bank of Australia.

Generally speaking, both the Reserve Bank of New Zealand and the Bank of England show a high average on the overall index, with the New Zealand approach ranking slightly ahead of the approach soon to be adopted in the United Kingdom. By clearly specifying an inflation target, both institutions rank highly on the specified-objectives criterion as well as the inflation-target criterion. Also, both central banks have full operational responsibility. In both cases, while the government determines the objective of monetary policy, the central bank has operational responsibility for achieving the specified objective without direction or interference from the relevant government. Also, for both central banks there is clear ultimate responsibility for inflation outcomes. In the case of the Reserve Bank of New Zealand, the Governor has ultimate responsibility; for the Bank of England, ultimate responsibility lies with the Monetary Policy Committee.

Both central banks have suitably transparent reporting arrangements. The Reserve Bank of New Zealand's Policy Targets Agreement (PTA) is a public document; the New Zealand Bank is required to release a six-monthly Monetary Policy Statement. The monthly meetings of the Bank of England's Monetary Policy Committee will be minuted, and released no later than six weeks after the meeting. There will also be enhanced requirements for reports to the Parliament.

The Reserve Bank of New Zealand seems also to be more accountable with the Governor being subject to possible dismissal if the Minister of Finance or the Bank's Board of Directors believe that his performance in meeting the inflation objective has been inadequate. Appropriate override provisions have also been specified. While the performance of the Monetary Policy Committee of the Bank of England will be monitored at monthly meetings of a reformed Court of the Bank, there is no indication of any override provisions for the inflation target or of what is expected to happen if performance is considered unsatisfactory.[9]

Table 2 compares the current approach by the Reserve Bank of Australia with the current approaches of the Reserve Bank of New Zealand and the Bank of England. This

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8. The approach of the Reserve Bank of New Zealand is defined in the Reserve Bank of New Zealand Act. A changed framework for British monetary policy was announced by the Chancellor following the election of the Labour Government in May 1997 (Chancellor of the Exchequer, Brown 1997). The Reserve Bank of New Zealand and the Bank of England provide detailed information about their current approaches on the World Wide Web.

9. Under the *Bank of England Act 1946*, the Court of Directors of the Bank of England has overall responsibility for all affairs of the Bank. The Chancellor has proposed that the Court be reconstituted to comprise no more than 19 members consisting of the Governor, his two Deputies, and 16 non-Executive Members. The Court will be representative of the whole of the United Kingdom. The non-Executive Members will be appointed for their expertise and will be drawn widely from industry, commerce and finance.

table shows that the Reserve Bank of Australia still has substantial area for improvement particularly in the definition of ultimate responsibility and accountability but also in the delegation of clear operational responsibility to the Bank.

Table 2: Independence and Accountability of the Reserve Bank of Australia Current Approach Compared with other Central Banks

Graded on a scale of 1 to 5

Criteria	Reserve Bank of New Zealand	Bank of England	Reserve Bank of Australia
Specification of objectives	5	5	5
Inflation target	5	5	4
Operational responsibility	5	5	3
Ultimate responsibility	5	5	1
Transparency	5	5	4
Accountability	5	3	1
Raw mean	**5.00**	**4.67**	**3.00**

3.3 Summary

In summary, Tables 1 and 2 demonstrate that, in recent years, the Reserve Bank of Australia has gone a substantial way toward adopting an inflation-targeting approach which ranks highly against some of the six criteria. However, comparison with other central banks shows that further significant improvements can still be made.

4. Recommendations

How can the Reserve Bank of Australia achieve further independence and accountability? The preceding analysis has described the deficiencies in the current approach. This analysis can now be extended to suggest ways in which the current approach can be improved. On the basis of previous arguments, the following proposals would seem appropriate:

- The current focus on an inflation target as the sole objective of monetary policy should be continued.
- A clearer inflation objective should be defined. This should include precise indications of success or failure in meeting the specified objective including an appropriate override clause in the case of significant supply shocks.
- Ultimate responsibility for success or failure in meeting the specified objective should be delegated to a suitably qualified individual or group of individuals. This individual or group of individuals should be clearly independent of government

influence. On face value, at least, it would appear that some members of the current Bank Board may not be suitably qualified for this role. This does not mean that the current Bank Board could not have a supervisory and review role, similar to that of the Board of the Reserve Bank of New Zealand or of the proposed reformed Court at the Bank of England.

- There should be a clearly defined set of review procedures if the specified objective is not met.
- Current transparency arrangements should be continued. These should be extended to provide full minutes of meetings of the Reserve Bank Board. Also, if ultimate responsibility for the stance of monetary policy rests with a group of individuals rather than with a single individual, minutes of meetings of that group should also be publicly available.

5. Conclusion

When considering the introduction of innovative approaches to monetary policy, it is important to remember that a government's approach to the setting of monetary policy is an important factor in determining national welfare outcomes. For this reason it is appropriate that central bankers should adopt a conservative approach to the revision of policy objectives. Even if it is now acknowledged that inflation targeting is appropriate as a monetary-policy objective, this does not necessarily mean that it would have been a good idea for the Reserve Bank of Australia to have been a pacesetter in pioneering new approaches to monetary policy.

However, the legislative experiment conducted by the Reserve Bank of New Zealand has now run since 1990 with a considerable degree of success. Also, a significant number of OECD countries now have an approach to monetary policy which is focused towards the achievement and sustainability of low inflation outcomes. In a world of flexible exchange rates and limited impediments to international capital flows, the decision by other central banks that they should pursue an inflation target actually creates a bandwagon effect, building pressure on other central banks to follow suit. Given significant agreement amongst central bankers on the appropriateness of an inflation target, it is important to set up institutional arrangements so as to ensure the best possible outcome.

This paper has argued that the Reserve Bank of Australia should have a single objective for monetary policy focused on a legislated inflation target. Analysis of the evolution of the current approach suggests that Australia's approach is evolving in the right direction. But comparison with the approach adopted by other central banks suggests that there is still room for significant improvement. The paper has made five specific suggestions for future development.

In conclusion, I would like to focus on the title of this paper. An earlier working draft was entitled: 'The Reserve Bank of Australia's Current Approach to Monetary Policy: An Evaluation'. Subsequent revisions saw a change to the current title, which recognises the pivotal role of government in setting in place a legislative framework. Many of the suggested changes can only be instituted by an incumbent government. On the one hand, governments may be tempted to reject any approach which restricts their use of monetary

policy as an instrument for stabilisation. This paper has argued that, in practice, it is not possible to use monetary policy to achieve desirable stabilisation objectives. Attempting to use monetary policy for this purpose may actually do more harm than good. On the other hand, by handing over operational responsibility and making hard decisions about interest rates the responsibility of an independent individual or group of individuals, a government may also be able to distance itself from some of the more unpalatable economic decisions. Recent changes at the Bank of England are evidence that, increasingly, governments are beginning to acknowledge the benefits of a legislative approach.

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