Reforming the Reserve Bank of Australia: how much independence is appropriate?

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The bill implements those changes recommended by the Review of the Reserve Bank which require legislation.[1] There are three main aspects, covering the goals of the Bank, the creation of a new 'monetary policy board' and removing the ability of the government to overrule decisions of the Bank.

Background and the Review

The Reserve Bank of Australia has a good record. Since it adopted an inflation target in the early 1990s[2], inflation in Australia has averaged in the middle of the 2-3 per cent medium-term target with fewer recessions than experienced by our peers; Cornish (2022), Cornish and Hawkins (2022). But even a good performance can be improved and even modest improvement is worthwhile.

While some aspects of the Reserve Bank's operations were reviewed by the Campbell and Martin reviews, there had not been an overall review of central banking in Australia since the Royal Commission in the 1930s.

The new treasurer, Jim Chalmers, announced the Review of the RBA in July 2022. He appointed three distinguished economists to the Review panel; Dr Gordon de Brouwer (Secretary for Public Sector Reform and a former RBA staff member), Professor Renee Fry-McKibbin (from the Australian National University) and Professor Carolyn Wilkins (former deputy governor of the Bank of Canada). We were fortunate such capable but busy people agreed to undertake the review.

[1] Many recommendations, such as changing the frequency of board meetings, did not require legislation and are already in the process of being implemented.

[2] The target was phased in, rather than being announced with a flourish, so there is no exact date for its introduction; Cornish (2019).

The *Review* advocated more an evolution than a revolution, which is a good thing; Hawkins (2023). The *Review* (2023: 3) acknowledged that flexible inflation targeting 'worked well over three decades, contributing to lower, more stable inflation and unemployment'. The *Review* (2023: 84) recommended that the medium-term inflation target should remain at 2-3 per cent. It also recommended that the Reserve Bank should 'aim for the midpoint' of the target, as it already does.

Goals of the Bank

The *Review* (2023: 77) supported 'dual monetary policy objectives of price stability and full employment' with the full employment objective affecting the time frame within which inflation is returned to the target.

There was some confusion caused by the Review's (2023: 85) reference to giving 'equal consideration' to inflation and employment. At face value, this sounds like a regime that would be as much 'employment targeting' as 'inflation targeting'. Respected commentators such as Garnaut and Vines (2023: 39) and former treasurer Peter Costello[3] certainly interpreted it as giving greater weight than presently to employment, equal to that accorded inflation. But this was apparently not the review panel's intention. In a later attempt at clarification, panel member Fry-McKibbin (2023) wrote that being given equal consideration 'does not mean equal weight' and 'it also does not mean adopting a full employment target'.

The bill replaces the current goal of 'stability of the currency' with 'price stability'. This is an improvement as the current term could be confused with a fixed exchange rate. Better still might have been 'low inflation', as 'price stability' could give the misleading impression the Bank should be aiming at zero inflation.

It retains the term 'full employment'.

The existing *Reserve Bank Act* has a third goal of promoting the 'economic prosperity and welfare of the Australian people'. This is somewhat vague and the bill proposes moving it to being an 'overarching objective'.

[3] See Wootton and Kehoe (2023).

A new monetary policy board

The bill implements a key recommendation of the *Review* (2023: 108-113) that there be a separate board devoted solely to the setting of monetary policy. Like the current board, it would continue to have nine members; the governor, deputy governor, treasury secretary and six others. But rather than what Gross (2023) termed 'monetary policy amateurs', the six independent members would be monetary experts.

The six external members would now be expected to spend the equivalent of a day a week on monetary policy considerations. There may a problem finding outsiders willing to do this. It would be challenging for a company CEO for example. This has led Macfarlane (2023: R6) and Edwards (2023) to suggest the board would become dominated by academics.

The current RBA board has tended to be dominated by business leaders. But the review panel seemed unconcerned by this lack of diversity of life experiences.

Under the current system there have not been formal votes on the RBA board. But this does not necessarily mean that the governor always got his way. He may just not have brought to the table a recommendation he thought likely to be rejected.

There is a Rashomon-like difference of views about how the current RBA board has operated. The *Review* (2023: 108) claimed that 'many consulted by the Review were concerned that the Reserve Bank Board as currently set up can provide only limited challenge to the view of the RBA executive'. But former governor Lowe commented 'the idea that the board members sit there meekly and accept the recommendation that I put to them is very far from the reality that I've lived as the governor' and outgoing board member Mark Barnaba commented 'in my experience, the way this board operates is diametrically opposed to a simple rubber-stamping'; Kehoe (2023: 17). It is hard to be definitive on this. We have not been in the room during the Board's deliberations – but neither had the review panel members.

As former RBA governor Ian Macfarlane (2023) and board member John Edwards (2023) have commented, this recommendation for a separate monetary policy board is not grounded in empirical evidence. It has an element of 'cultural cringe' (Phillips, 1950). There is an ongoing presumption that the

Reserve Bank of Australia should copy the pattern of the Bank of England or other western central banks. It is reminiscent of old attitudes from the Menzies era and earlier that 'British is best'.

This idea of patterning ourselves on overseas exemplars could be justified were they to have performed better. But our Reserve Bank has actually out-performed the supposed role models; Kehoe (2023: 17). It achieved an average inflation rate in the middle of its medium-term inflation target with a better record on economic growth; *Review* (2023: 3), Hawkins (2022). Until the Covid lockdowns Australia had not had a recession during the inflation targeting era. This was arguably the longest uninterrupted economic expansion in history; O'Brien (2019).

The *Review* (2023: 6) itself concedes 'Australia's very good performance is at least on par with other comparable economies'. Indeed, other central banks have moved towards the Australian model of a flexible medium-term framework. Ironically, the Bank of England itself is facing calls for reform as its model of operating is seen to have led to 'complacency' about the level of inflation; Fleming (2023).

Journalist John Kehoe (2023: 17) has commented that 'it is not obvious that Australia would have had materially different outcomes had the proposed new dual board system and other RBA reforms been in place during the pandemic'.

The bill also proposes a Governance Board consisting of the governor, the new position of chief communications officer and five external members. The Review (2023: 184) had recommended that one of the external members chair this board but the treasurer has decided that, at least for the first five years, it will be chaired by the governor.

Reserve Bank independence

The *Review* (2023: 74) recommended that 'the Government should remove the power of the treasurer to overrule the RBA's decisions'. It is not clear what problem this is meant to address. It also seems undemocratic.

Paul Tucker's weighty tome, summarised and placed in an Australian context in Cornish (2018), addressed the question of how much independence is appropriate for a central bank. This former deputy governor of the Bank of England, now a senior fellow at Harvard, argued that central banks should not seek to be 'over-mighty citizens' and warned against societies' drift towards technocracy. He would be alarmed at the *Review*'s recommendation to remove the government's power to over-rule the unelected board of the RBA.

It is important to note this veto has existed in central bank legislation since 1945 but has never been used. This is likely because exercising it would involve a large political cost to the government. The legislation has since 1951 required the government to table in parliament the Bank's explanation of why they regard the government's action as misguided. So it is a power only likely to be exercised in extreme circumstances. Its use has been considered on some occasions, especially during the Fraser Government, but in each case one side backed off or a compromise was reached between the then government and the Bank; Cornish (2010).

But just because it has not been used thus far does not mean it should be unavailable in such circumstances. This would be to ignore the lessons from earlier history. Millmow (2023) has told the story of how the chair (at the time, different to the governor) of the Commonwealth Bank, the predecessor to the Reserve Bank, exacerbated the great depression of the 1930s by refusing to help the Scullin Government fund public works.

Garnaut and Vines (2023: 39) argued this suggestion had 'no place in democratic Australia'.

It also needs to be understood that both Labor and Coalition governments in the past have agreed that where irreconcilable differences exist between the central bank and the government on matters of monetary policy the government's position must prevail. The 1945 *Commonwealth Bank Act* - introduced by a Labor government - and the 1951 *Commonwealth Bank Act* and the 1959 *Reserve Bank Act* - introduced by Coalition governments – all agreed that responsibility for monetary policy should ultimately rest with the government and not with the central bank. A similar view was adopted by the famous Royal Commission on the Australian Monetary and Financial Systems, which reported in 1937, and by the Campbell Committee, which reported on the Australian Financial System in 1981. The Campbell Committee declared, for instance, that 'the Government properly has ultimate responsibility for the determination of overall monetary policy'; it saw 'no need to change the existing provisions in the legislation governing policy relations between the Reserve Bank, the Government and the Parliament.' Its conclusion was that the 'present arrangements appear to have provided a good framework, and are appealing from a number of viewpoints'; Campbell Inquiry (1981: 20).

Reserve Bank Governors have also supported the existing arrangements. Dr Coombs, the Bank's inaugural Governor, frequently asserted that a central bank Governor could not be both private adviser to governments and a public critic of government policy, regarding the two roles as 'incompatible'. Sir Harold Knight, another Governor of the Reserve Bank, reminded the Campbell Committee that a stream cannot rise higher than its source. As he put it, 'the parliament, of course, is where the government is located, so if in this country the central bank sought to rise higher than its source, the natural effect would be legislative change. I think we have to work within that framework; we do work within that framework.' No governors of the Reserve Bank have advocated the removal of the government's ultimate responsibility for monetary policy.

Recommendation: The existing provisions of section 11 of the* Reserve Bank Act *allowing the government to overrule the Bank be retained, but otherwise the bill be passed.

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