Chapter 2

Central bank independence

Background

2.1 It is now part of the economic canon that central bank independence is desirable to achieve low inflation and maximise longer run economic growth.[1]

2.2 The explanatory memorandum for the bill refers to central bank independence as being 'regarded as international best practice'. This was supported in evidence to the inquiry. For example, Professor Sinclair Davidson, representing the Institute of Public Affairs, stated:

> Broadly speaking, the economic literature is in agreement or shows a consensus that central banks that are more independent are more likely to be associated with low levels of inflation.[2]

2.3 Then Reserve Bank Governor Bernie Fraser put it this way in a 1996 speech:

> The usual argument for an independent central bank is that governments and politicians cannot be trusted to do the right thing with interest rates. They are assumed to be driven by the electoral cycle, and prone to manipulate monetary policy for short-term political gains…The corollary of this argument is that an independent, expert body not bound up in the electoral cycle would do a better job than politicians in conducting monetary policy. This seems to me to be the strongest reason for entrusting responsibility for monetary policy to an independent central bank.[3]

2.4 Economist Saul Eslake explained how more independent central banks may lead to lower inflation:

> …inflation expectations are…informed by people's understanding of how economic policy will react to a rise in inflation. If it is widely believed that those responsible for economic policy are unwilling to take firm action in response to an acceleration in inflation, or that they will be unable to sustain that action in the face of an adverse public reaction to slowing economic growth and rising unemployment, or that they will postpone a response

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1 The consensus is that central banks should have *instrument independence* (sometimes called 'economic independence') but not *goal independence*. This means that the government sets the (inflation) target for the central bank but allows the central bank to adjust interest rates (and other instruments) as they see fit to achieve this target. An important aspect of central bank independence is that the central bank does not need to approach the government for its funding. This is true of the Reserve Bank of Australia and this bill does not alter that.

2 Professor Sinclair Davidson, *Proof Committee Hansard*, p.2.

3 Bernie Fraser, 'Reserve Bank Independence', talk to the National Press Club, 15 August 1996, reprinted in *Reserve Bank Bulletin*, September 1996, pp 14–20.

> because of an imminent election, then people will expect inflation to accelerate and hence will seek to take actions to protect themselves against it – actions which will make a further rise in inflation more likely.[4]

2.5 He continued:

> As the significance of inflation expectations to the inflationary process became more widely recognized and understood among economists, the importance of policy credibility to influencing inflation expectations gained more recognition. 'Policy credibility' means the belief that those responsible for formulating and implementing economic policy have both the intention and the ability to achieve their stated policy objectives, even if it entails some political or other costs. In the context of monetary policy, 'policy credibility' has come to be associated with central bank independence – that is, the ability of central banks to set monetary policy without any requirement to seek approval or permission from elected officials for their proposed course of action. [5]

2.6 If the central bank is perceived as independent, financial markets, businesses and employers and employees are less likely to revise up medium-term inflationary expectations when there is inflationary shock to the economy such as a jump in petrol or food prices. This means that the central bank does not have to keep interest rates as high or for as long to return inflation to its target band.

2.7 Associate Professor Steve Keen is less impressed by the performance of independent central banks. While they have performed well on keeping inflation low, he argues they have not maintained the stability of the financial system.[6]

Empirical studies of the impact of central bank independence

2.8 There is now an extensive body of econometric research on this topic. The majority of studies conclude central bank independence is associated with lower inflation.[7] This does not in itself prove that central bank independence *causes* low inflation. It could be that countries with a particular aversion to inflation would tend to have both independent central banks and low inflation and the correlation between the two overstates the degree of causality from central bank independence to inflation.[8]

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4 Mr Saul Eslake, *Submission 1*, p. 2.

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6 Associate Professor Steve Keen, *Submission 3*.

7 There are admittedly a minority of studies that question whether there is any correlation. Ahsan, A., Skully, Prof. M., Wickramanayake, J., Department of Accounting and Finance, Monash University, *Central Bank Independence and Governance and Inflation in Asia Pacific*, http://www.melbournecentre.com.au/Finsia_MCFS/2007/AhsanA.pdf, p. 5.

8 For example, hyperinflation in the Weimar republic fuelled the rise of Nazism and left Germans particularly averse to inflation. This might be why they both gave substantial independence to the Bundesbank (central bank) and ran sufficiently tight macroeconomic policies to keep inflation low.

2.9 These studies involve quantifying the degree of central bank independence. For example, a study by some International Monetary Fund economists shows that, in terms of institutional autonomy, the RBA scores as 'independent' on only two out of eight criteria, ahead of only Japan and Korea, whereas the European Central Bank scores a full eight and the central banks of Sweden and Switzerland seven.[9]

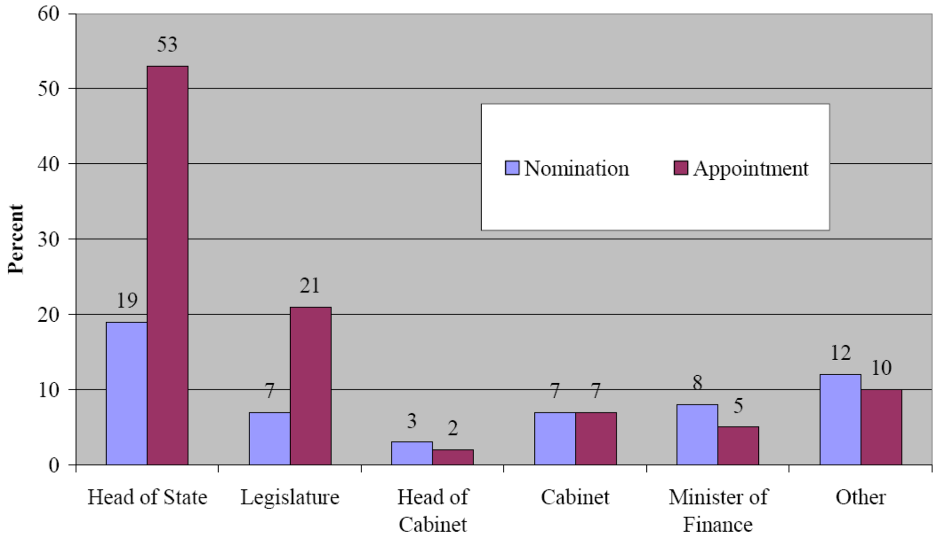
2.10 A similar study by Princeton University academics showed that in an examination of legal indicators of independence, Australia's score varies depending on the indicators used.[10]

Overseas practice in appointment and dismissal of governors

2.11 A variety of practices is evident in a study of the appointment of the governors of 98 central banks worldwide, although as shown in Chart 1 the most common procedure is appointment by the head of state (although for some countries this is also the head of government).

Chart 1 – Party who nominates or appoints [11]

The chart shows who appoints and – in case a second body is involved – nominates the governor [Source: IMF/Lybeck, N=98].



2.12 Similarly, a study of the dismissal of central bank governors showed that this is most commonly done by the head of state (Chart 2).

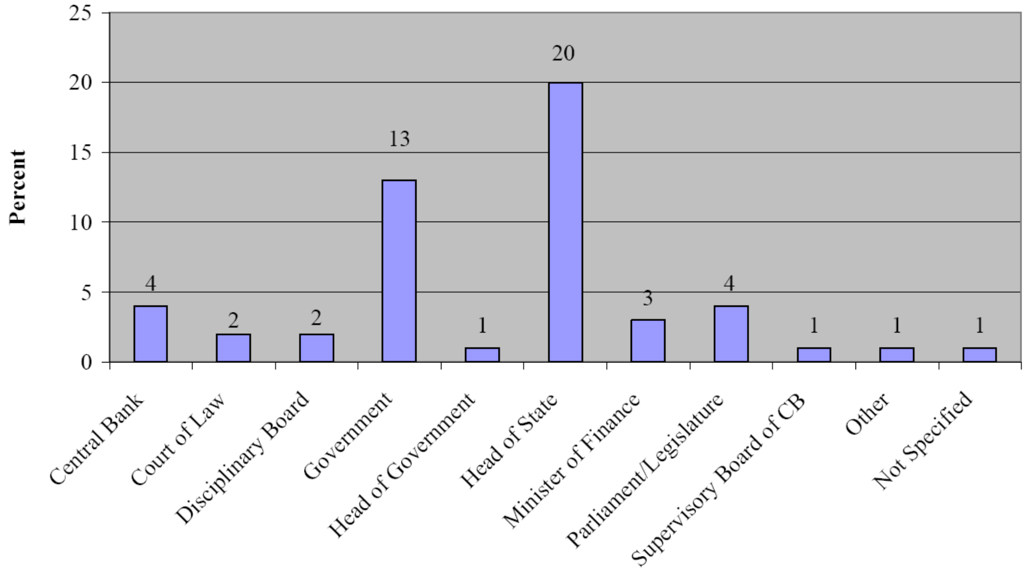
9 Marco Arnone, Bernard J. Laurens, Jean-François Segalotto, and Martin Sommer, 'Central Bank Autonomy: Lessons from Global Trends', *IMF Working papers*, no 07/88, April 2007.

10 Eijffinger, S. and De Haan, J., 'The Political Economy of Central-Bank Independence', *Special Papers in International Economics* No. 19, May 1996, International Finance Section, Department of Economics, Princeton University, Princeton New Jersey, p. 23.

11 Frielal, L., Roszbach, K., Spagnolo, G., Sveriges Riksbank, 'Governing the Governors: a clinical study of central banks', *Sveriges Riksbank Working Paper Series* 221, Figure 14, p. 22.

Chart 2 – Party who dismisses [12]

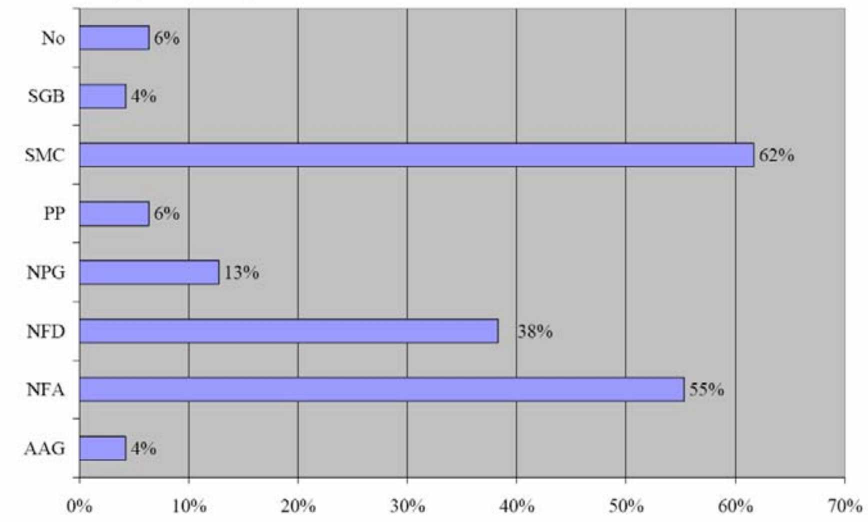
The bars show by whom central bank governors can be fired. The numbers sum up to more than 100% because more than one body in a country may be able to do so [Source: Frisell Roszbach Spagnolo, N=47].



The grounds for dismissal of governors of central banks also vary. (Chart 3)

Chart 3 – Grounds for dismissal [13]

The bars show what events are explicitly mentioned in the statutes of central banks as possible reasons for dismissal (expressed as a percentage of all banks in the sample). Multiple grounds are possible. Key: No: No Precise Definition/ Reports no reason for dismissal; SGB: Governor holds office subject to good behavior; SMC: Serious misconduct or conviction for a serious criminal offence; PP: Poor performance; NPG: Dismissal possible but no precise definition of grounds; NFD: Non-fulfillment of duties: NFA: Non-fulfillment of requirements for appointment or for the performance of duties; AAG: Acting against government policy; [Source: Frisell Roszbach Spagnolo, N=47].



12 Frielal, Roszbach and Spagnolo (2008) Figure 15, p. 22.

13 Frielal., Roszbach and Spagnolo (2008) Figure 16, p. 23.

The reality and perception of central bank independence

2.13 Even when the central bank is effectively independent, the perception of independence may be easily damaged. A famous example was the effect of then Treasurer Paul Keating's 'Placido Domingo' speech of December 1990. Speaking at a supposedly off-the-record function, the day after the death of his Treasury Secretary and friend Chris Higgins, an emotional Keating said:

> ‘I have Treasury in my pocket, the Reserve Bank in my pocket, wages policy in my pocket, the financial community both here and overseas in my pocket’.[14]

2.14 No-one present thought that Keating literally had the global financial community under his complete control. But the phrase about the Reserve Bank was lifted out of context. As then Reserve Bank Governor Bernie Fraser commented about the phrase:

> I believe Mr Keating regretted being associated with those throwaway lines and, to my knowledge, he never repeated them. On more than one occasion, he complained that the Bank had acted in ways which were contrary to his own preferences – clear enough evidence, I would have thought, that the Bank was not in his pocket. I also have denied that the alleged ‘in the pocket’ jibe was ever an accurate description of the relationship between the Treasurer and the Reserve Bank, as did my predecessor, Bob Johnston. The original quip was unfortunate enough, but its repetition ad nauseam, in the face of all the denials, was even worse in my view; it certainly did nothing to enhance the Bank’s standing in financial centres around the world.[15]

2.15 Almost two decades later, the phrase is still trotted out.[16] It is this difficulty in maintaining a reputation for independence that leads to attempts to convince outside observers of the central bank's independence by grounding it in legislation.

Cross-party support for central bank independence

2.16 An independent Reserve Bank has cross-party political support in Australia. Both the current and previous Treasurers have signed agreements with the Reserve Bank Governor publicly expressing their 'common understanding…on key aspects of Australia’s monetary policy framework'. It includes a commitment by the Government which 'recognises the independence of the Reserve Bank and its responsibility for monetary policy matters'.[17]

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14 Cited by William Coleman, 'How the Bank got its groove back', *Agenda*, vol 12, no. 1, 2005.

15 Bernie Fraser, 'Reserve Bank Independence', talk to the National Press Club, 15 August 1996, reprinted in *Reserve Bank Bulletin*, September 1996, pp 14–20.

16 See, for example, Hon Malcolm Turnbull, MHR, *House Hansard*, 14 May 2008, p. 2773.

17 Statement on the conduct of monetary policy, by the Treasurer and the Governor of the Reserve Bank of Australia, 6 December 2007 on RBA website, www.rba.gov.au.