Submission to the Inquiry into the *Reserve Bank Amendment (Enhanced Independence) Bill 2008*

Follow-Up Statement: A modified selection process for the RBA Board

Associate Professor Steve Keen
School of Economics & Finance
University of Western Sydney
Locked Bag 1797 Penrith NSW 1797
www.debtdeflation.com/blogs
June 1st 2008

Senator Hurley,

Chair, Senate Standing Committee on Economics

Dear Senator,

Thank you for the opportunity to speak with the Committee, and the request to suggest a mechanism to get a wider representation of views on monetary policy at the RBA Board. To remind the Committee, this suggestion arose in response to observations by Senator Bushby:

> Senator BUSHBY—If that is a trend which continues and economists in general are more accepting of that particular view, do you think that there is a need to ensure that the Reserve Bank has members on it who understand that better and have an ability to apply the modelling that will come out of that side of things?

And Senator Murray:

> Senator MURRAY—One of the things that the electorate does with the parliament is throw up a natural, creative, internal tension which is very productive because you get competing and contesting philosophies and ideas. What you are suggesting is that the Reserve Bank also needs that mechanism within it to keep it up to the mark and keep it sufficiently alert to alternative views and alternative prospects. The only way in which I can see that happening —I cannot see it happening from a staff point of view—is at the board level. One of the options we as senators always face with bills is whether to suggest a better way to proceed ... *I wonder if perhaps you have some thoughts as to how the appointments mechanism for the board could be improved.*

The discussion of this topic raised a number of important issues and caveats about an alternate selection process:

- It should improve on the range of views canvassed about the functioning of the financial system;
- Though a greater range of views was desirable, it should result in "people of independence, strength and intellectual rigour" being appointed (Sen. Murray) , rather than cranks or populists;
- It should not be dominated by the political party in power—as happens with many Senate-mediated official appointments in the USA (Sen. Hurley); and

- It should enhance the "stability of economic management... we need more openness and accountability, but we also need ... economic stability and security, not just a free-for-all robust economic debate..." (Sen. Webber)

The current selection process appoints the Governor and Deputy Governor of the RBA and the Secretary of the Treasury to the Board, and then gives the Treasurer power to make 6 further appointments (five of whom must not be Public Servants or RBA staff members). Their appointments are for a maximum of 5 years (no minimum is specified), and they can be removed by the Treasurer.[1] No requirements are imposed on the backgrounds that members should have, and the current membership of the Board includes five business persons and one academic economist.

The discussion in the Hearing focused on the desire to have a mechanism that keeps the RBA "sufficiently alert to alternative views and alternative prospects" (Sen. Murray), and alternatives such as the "Financial Instability Hypothesis" and "Behavioural Finance" were noted. This necessarily suggests a selection process weighted towards academic appointments—though at the same time, one that succeeds in canvassing a range of approaches to economics.

However it is also important to have representation from the general community on the Board, so that experience is also taken into account as well as academic knowledge.

I doubt that both a breadth of economic perspectives, and adequate community input, could be achieved with the current size of the Board. A change that expanded the range of views of economics canvassed, while preserving the input from practical experience, would require an increase in the size of the Board to, say, eight to ten non-officio positions. A proportion of these should be reserved for community members, and the remainder should be chosen to reflect both expertise in economics and a range of perspectives on economic issues.

I doubt that any more than four persons would be needed to represent a broad range of academic economic views on how monetary policy should be conducted. There are, broadly speaking, three perspectives on money extant amongst academic economics, with two factions within one of them:

1. The dominant "neoclassical" position that money is largely "a veil over barter". Monetary variables are seen as have no long run impact on the economy, though perhaps a short-run impact on output and employment. This perspective dominates economics in general and modelling within the RBA in particular, with key models such as that detailed in RDP2005-11 being "non-monetary in nature" (RDP2005-11 Abstract & p. 1). Within this there are however two modern strands of thought, which could result in differing perspectives being put on monetary policy:
    1. "New Classical" modelling that sees prices as flexible
    2. "New Keynesian" modelling that sees prices as "sticky downwards"
2. "Austrian economics", which is critical of the very institution of Central Banking and argues that this distorts the price system. Their preference is for a system of private banks issuing money and often for a gold-based monetary system
3. Schools of thought such as "Behavioural Economics" and "Post Keynesian economics", which see the money supply as not being controlled by the Central Bank but as "endogenous"—

1 The Treasurer can remove a Public Servant or RBA staff member without having to show cause (Section 14.3), while other members "hold office subject to good behaviour" (Section 14.4).

generated by the financial system in response to demands for money from firms and households. This approach has many sub-themes—including the proposition that most economic behaviours are not strictly rational, and therefore that finance markets are more driven by emotion than reason, and the "Financial Instability Hypothesis", that there is an innate tendency for finance markets to indulge in debt-financed speculation that culminates in a financial crisis.

Of course, one could not ordain in an Act that there should be one representative of each such economic perspective on the Board—especially since developments in economics may render these classifications irrelevant over time, and bring in new attitudes (as is happening already with the intrusion into economics by physicists, known as "econophysics"). Instead, a mechanism is needed that will ensure that a representative range of professional views is represented.

As noted at the Hearing, the Australian and UK governments are considering how to improve the selection of judges:

> Senator MURRAY—The British Attorney-General and now the Australian Attorney-General, and their respective governments, have looked to improve the appointment of judges. That has been a fascinating debate over many, many years. Essentially, what they are going to is a broader advertisement mechanism and nominations, and then an expert panel puts forward a short list of nominees. Do you think that, since that works for another arm of government in which we demand and need absolute independence, that sort of mechanism for improving judges could work for improving the variety and calibre of the board of the Reserve Bank? (p. 17)

A system like this could be attempted in the selection of professional academic economists. However, as I commented at the Hearing in response to Senator Murray, majority (neoclassical) opinion in economics can be dismissive of minority positions (Austrian and Post Keynesian), even though there are individuals who follow those perspectives (such as Professor Davidson and myself respectively) who have achieved recognition as academic economists.

Nonetheless, I think that a procedure of that nature is the most workable. Some of the squabbles that take place within academic economics reflect the luxury that these have no apparent impact outside academia itself. Were this instead something that fed directly into a very important institution in Australian society, I hope that the economics profession could rise above this tendency and make truly representative recommendations.

The Act could require the relevant professional body—say the Economics Society of Australia, or a specially constituted sub-committee—to suggest a short-list of eligible nominees. The selection procedure could specify:

- The minimum qualification required—say, to be of the rank of Associate Professor or above;
- The need to have a record of publication on issues of monetary theory or policy in academic journals;
- The need for the group nominated to reflect in its composition the range of views held about monetary policy at that time; and
- A broad characterisation of the current range of views, and an identification of individuals

within the nominated group with those views. As noted above, generally three groupings would cover the range of views held by academic economists at any one time.

The Act could then enable the Treasurer—or the Governor-General acting on the advice of Cabinet—to select the academic economic members of the RBA Board, on the condition that at least one representative of each perspective be selected.

When this request was first put to me, I also considered the possibility of using something like the electoral system for the Senate itself. My thought was that a set of nominees could be put to the Senate, and the Senate would then vote on them, with a quota being applied to determine the members of the RBA. Thus, if there were 10 positions to be filled, the Senate would vote on them in an exhaustive preferential vote, and any individuals receiving $1/11^{th}$ plus 1 vote of the Senate would be selected.

I am now inclined to see this as somewhat cumbersome, and also something that would possibly further politicise the RBA, when the objective of the change as not to make the Board a political institution, but to have it canvass a range of views.

However, there remains the issue of getting community representation on the Board—as well as getting a range of professional economic views. There is definitely community disquiet that the RBA is not giving sufficient attention to the impact of its policy on indebted households at present—and the present composition of the Board does nothing to assuage community fears on this front.

Currently, there is no requirement at all on appointments, and the majority have been business-persons (though once a trade unionist, Bill Kelty, was appointed). The current system would allow a government to attempt to "stack" the Board with its own supporters, which is an undesirable aspect of the Act.

However, if there was a selection process of the kind discussed above for the non-academic membership of the Board, then it would be possible to ensure at most times that the community representatives on the Board reflected a range of community knowledge about the impact of monetary policy, and not merely that of the business community.

With,say, an 11 person Board—3 ex-officio and 8 nominated—it would be possible to reserve 4 positions for academic economists, selected as outlined above, and 4 for community representatives. These could then be selected from a pool nominated by peak business, union and community groups (say, the Business Council of Australia, the ACTU, and ACOSS). The selection could be either by the Treasurer or Governor-General, or perhaps by a proportional vote of the Senate, as outlined above.

My preference would be for the latter, since with just 4 quotas to be filled, it is highly likely that representation would always involve at least one person from each of business, trade union and community groups. This would give the RBA Board the benefit of feedback from a much broader range of Australian society than it currently enjoys.

Summary of recommendations

In summary, my recommendations are:

1. That the size of the Board be increased from 9 to 11;
2. That the three ex-officio members remain as is;

3. That four of the remaining 8 positions be chosen from professional economists, where
    1. The nominees were made by the Economics Society of Australia
    2. All nominees were of the rank of Associate Professor or above;
    3. All have a record of publication on monetary theory and policy;
    4. The Sub-Committee charged with making the selection was directed to provide a pool of nominees reflecting the range of professional opinions on monetary policy
4. That the remaining four positions be chosen from the broader community, with:
    1. Nominations being made by at least three peak social groups
    2. Selection from within this panel being made by the Senate following an exhaustive preferential voting system.

Yours sincerely,

[redacted]

Steve Keen