Reserve Bank independence and inflation

Submission to the Senate Committee on Economics, Inquiry into the Reserve Bank Amendment (Enhanced Independence) Bill 2008

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We then have to ask what are the motivations of those who control the manufacture of money, the motivations that keep them adding to the stock of money.

The first and strongest motivation is not to be shot and the second motivation is not to be fired. – Fritz Machlup[1]

This submission into the proposed Reserve Bank Amendment (Enhanced Independence) Bill has three sections. In the first section we set out our views on sound money. The Institute of Public Affairs is committed to sound money. We believe that sound money forms part of the foundation to a free and prosperous society. The second section examines the arguments for Central Bank Independence. Following the economic literature, we differentiate between Economic Independence and Political Independence. The Reserve Bank of Australia already enjoys a high degree of Economic Independence, while the proposed legislation will enhance the Political Independence of the Reserve Bank. There is no relationship between Political Independence and inflation; consequently we expect this reform to have no economic impact on Australian inflation. The third section discusses issues of moral hazard and democratic accountability that the proposed legislation raises. The amendment substitutes a blunt legislative instrument for the existing checks and balances of a robust democracy.

An Appendix provides some empirical analysis.

[1] Quoted in Leland Yeager, 1997, *The fluttering veil: Essays on monetary disequilibrium*, Liberty Fund, Indianapolis, pg. 44.

Summary

- Sound money is an important protection of liberty.
- Central Bank Economic Independence is an important institution and is associated with low levels of inflation.
- The Reserve Bank of Australia already enjoys a high level of Economic Independence.
- Central Bank Political Independence does not have any relationship with inflation.
- The Proposed Legislation will enhance Political Independence but not Economic Independence.
- The Proposed Legislation increases the moral hazard associated with Reserve Bank appointments.
- Australia already has in place a system of checks and balances to monitor the conduct of monetary policy.
- The Proposed Legislation will weaken the already existing checks and balances.

1. The Importance of Sound Money.

The Institute of Public Affairs is committed to a society characterised by private property rights and the rule of law. Inflation, in our opinion, undermines a free and prosperous society.[2] The economic effects of inflation are well-known; inflation undermines price signals, leads to short-term planning, discourages both savings and investment, and favours debtors over creditors. By discouraging savings it contributes to poverty, and further inflation is a tax on the poor. Inflation undermines civil society.

> Business and personal habits … have been based on the assumption of stable prices and are not easily broken; yet leaving them unbroken in the face of severe inflation creates obvious distortions. Accounting and tax systems, and even the general legal system, have also been based on the assumption of stable money. Rapid changes in money's value twists them out of shape.[3]

Milton Friedman is famous for arguing that inflation is always and everywhere a monetary phenomenon. We agree in that assessment. Excessive growth in the money supply is the cause of inflation. It is widely recognised that unexpected inflation can deliver temporary benefits to government – indeed, some economists have argued that inflation is always a consequence of government policy or government institutions. Inflation ultimately constitutes the expropriation of private property and inflationary policies should be resisted. It is widely accepted that independent Central Banks contribute to maintaining low rates of inflation.

There are costs associated with controlling inflation. Decreased economic activity is associated with high interest rates. Controlling inflation requires a balance between maintaining stable prices while ensuring economic growth and employment are maintained at high levels. In other words, Central Banks tend to have the policy objective of minimising inflation subject to economic growth or full employment. Following Friedrich von Hayek we believe this is sensible economic policy.[4]

> The concrete issue today is whether [the central bank] ought to keep stable some level of employment or some level of prices. Reasonably interpreted and with due allowance made for the inevitability of minor fluctuations around a given level, these two aims are not necessarily in conflict, provided that the requirements for monetary stability are given first place and rest of economic policy is adapted to them.

At present this state of affairs accurately describes the Australian environment. The Reserve Bank of Australia (RBA) has a range of policy objectives, but primacy is given to the maintenance of price stability.

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[2] Our arguments in this section drawn on the economic literature, especially from Milton Friedman, Ludwig von Mises and Friedrich von Hayek.

[3] Yeager, as above, pg. 35.

[4] F. A. Hayek, 1978, *A tiger by the tail: The Keynesian legacy of inflation*, Second edition, Institute of Economic Affairs, London, pg. 94 – 95.

2. Central Bank Independence.

In the first instance, different types of independence must be defined.

Political Independence (sometimes referred to as goal independence) refers to the policy objectives that central banks must achieve and the appointment and dismissal procedures for the Governor and/or controlling body of the central bank.

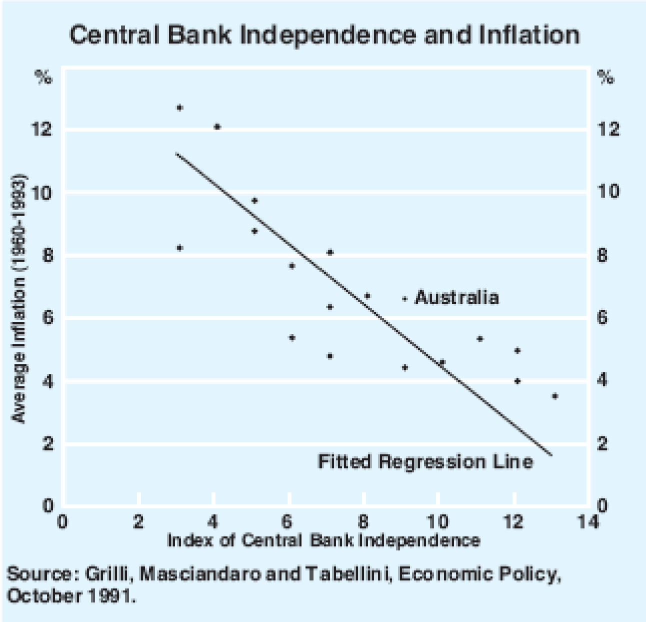
Economic independence (sometimes referred to as instrument independence) refers to how monetary policy targets are achieved.

CBI is measured through the use of proxy variables. Some academics have looked at the laws that govern the central bank and derived proxies of independence from those laws. This type of measure is often referred to as 'legal' independence. The difficulty with these types of measures is that they ignore local conventions that may arise over time. Other studies have looked at actual independence, for example how often is the Central Bank Governor replaced? While yet more studies have used survey instruments to establish the level of perceived independence Central Banks have.[5]

Central Bank Independence (CBI) indices are negatively correlated with inflation, but are not correlated with real growth rates, unemployment, or real interest rates.[6] An independent central bank is an inexpensive mechanism for lowering inflation.

The broad economic consensus on CBI is illustrated in the graph below. Those economies with higher levels of 'independence' have lower levels of inflation. This graph was used by former Reserve Bank Governor Bernie Fraser in a 1994 presentation on CBI.[7] The data on CBI were collected from a classic article by Grilli and co-authors.[8] This data relate to industrialised economies only. Australia is an industrialised economy and this submission will not delve into the details of the economic literature that apply to other types of economies.

[5] See Alex Cukierman, Steven Webb and Bilin Neyapti, 1992, Measuring the independence of central banks and its effect on policy outcomes, *The World Bank Economic Review*, 6(3), 353 – 398.
[6] Recent survey articles are Helge Berger, Jakob de Haan and Sylverster Eijffinger, 2001, Central bank independence: An Up date of theory and evidence, *Journal of Economic Surveys*, 15(1), 3 – 40, and Bernd Hayo and Carsten Hefeker, 2002, Reconsidering central bank independence, *European Journal of Political Economy*, 18, 653 – 674.
[7] B. W. Fraser, 1994, Central bank independence: What does it mean?, *Reserve Bank of Australia Bulletin*, December, 1 – 8. The article is somewhat dated but the principle remains the same – an update is provided in the Appendix.
[8] Vittorio Grilli, Donato Masciandaro and Guido Tabellini, 1991, Political and monetary institutions and public financial policies in the industrial countries, *Economic Policy*, 6(2), 341 – 392.



Source: Bernie Fraser, 1994 (Using CBI data from the Grilli study).

The Grilli study differentiates between the effects of political independence and economic independence. Australia scores 3/8 on political independence and 6/7 on economic independence. They are able to show a very strong negative relationship between inflation and economic independence over the period 1950 – 1989, but no relationship between political independence and inflation over that period.[9] In other words, the relationship shown in the diagram is driven by economic independence – where Australia already performs well. The Bill under consideration purports to increase the political independence of the RBA Governor; as such we anticipate it will have little economic impact.

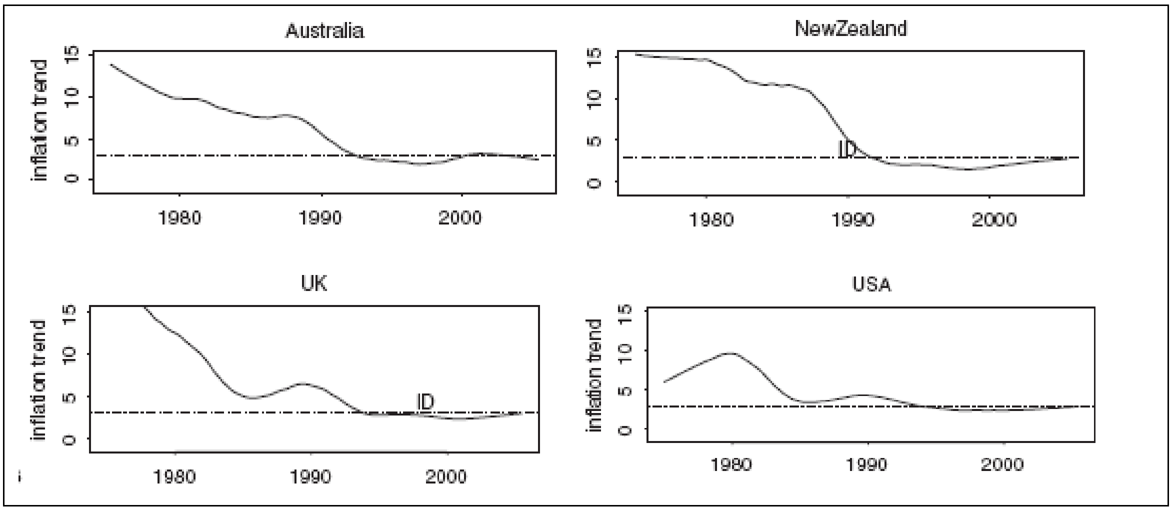
A major concern with this type of analysis relates to causality. The question being, "Does having an independent central bank lead to lower inflation, or do those economies more likely to have lower inflation also choose to have independent central banks?"[10] This is not a trivial question; a whole host of academic studies have addressed this issue.[11] One study concludes, "CBI is neither necessary nor sufficient for monetary stability", while another published the same year argues "the negative relationship between CBI and inflation is quite robust".[12]

A study forthcoming in *Oxford Economic Papers* addresses this issue directly.[13] It investigates instances where 24 of 29 OECD economies (including Australia) have strengthened the independence of their central bank. The earliest such event occurred in New Zealand in 1990 and the latest in Iceland, Norway,

[9] Grilli, as above, Table 14, pg. 372.
[10] Technically this is known as endogeneity – so that correlation has no implication about causation.
[11] The basic idea can be *illustrated* as follows: In the diagram the CBI Index could have been calculated using data from the 1990s and plotted against an average for the period 1960 – 1993. If that were the case then we would have demonstrated correlation but not causation (that would be an illustration of look-back bias). As it turns out the CBI index in that study was calculated using data derived from a previous study published in 1967.
[12] Hayo and Hefeker, as above, and Berger, de Haan and Eijffinger, as above.
[13] Sven-Olov Daunfeldt and Xavier de Luna, 2008 (forthcoming), Central bank independence and price stability: Evidence from OECD-countries, *Oxford Economic Papers*, Advanced Access published online February 23, 2008.

and Turkey in 2001. Five economies, (Australia, Canada, Denmark, Germany and the US) have had no independence reforms (as defined in the paper).[14] The paper then established when price stability occurred in each of the 29 economies relative to the CBI events. In 15 of the 24 instances where CBI events had occurred price stability was realised *before* the CBI event. Similarly, in the five instances where no CBI events had occurred price stability had also occurred. For example, they indicate Australia has enjoyed price stability since the fourth quarter of 1992.

The box below highlights the results. Four economies are shown; Australia and the US have achieved price stability without any CBI events while New Zealand and the UK have had CBI events. Price stability occurred in New Zealand after a CBI event (denoted ID on the diagram) and price stability occurred in the UK before a CBI event.



Source: Sven-Olov Daunfeldt and Xavier de Luna.

Australia already enjoys price stability *and* the RBA already enjoys a very high level of economic independence in its actions. The proposed Bill will not change either of these features of the Australian institutional framework and subsequently will have little or no impact on Australian inflation outcomes. This Bill will increase the political independence of the RBA governor, but the classic study in this area indicates that political independence has no impact on inflation. In short, this is a symbolic change of no substance.

[14] The 1996 reform was not legislative and so does not qualify for inclusion as a CBI event.

3. Moral Hazard and Democratic Institutions

Currently the appointment of the RBA Governor and the Deputy Governor is covered by sections 24 *and* 25 of the *Reserve Bank Act 1959*. For our argument, we examine section 24(1) only.

Section 24(1) states:

"The Governor and the Deputy Governor:

(a) are to be appointed by the Treasurer; and

(b) shall be appointed for such period, not exceeding 7 years, as the Treasurer determines but are eligible for re-appointment; and

(c) hold office subject to good behaviour."

Section 25 states (emphasis added):

"If the Governor or the Deputy Governor:

(a) becomes permanently incapable of performing his or her duties; or

(b) engages in any paid employment outside the duties of his or her office; or

(c) becomes bankrupt, applies to take the benefit of any law for the relief of bankrupt or insolvent debtors, compounds with his or her creditors or makes an assignment of his or her salary for their benefit;

the Treasurer **shall** terminate his appointment."

It appears that the proposed Bill will modify section 25, but not 24(1)(c). The 'Governor-General' shall substitute for the 'Treasurer' in sections 24(1)(a) and 24(1)(b) – presumably the Governor-General shall act on the advice of the executive in those appointments. There is an ambiguity relating to the status of 24(1)(c). The new section 25 may set out the only conditions for termination, or the Governor-General may, on the advice of the executive, remove the RBA Governor or the Deputy when in breech of the 'good behaviour' provision of the Act. If the latter is the case then there is little difference from the current arrangement. If the former is the case then substantial moral hazard is introduced to the appointment of the RBA Governor and the Deputy Governor.

All of the conditions set out in section 25 are objective and verifiable. At present the Treasurer is required to terminate the employment of the RBA Governor or the Deputy Governor should any breech of that section occur. The amendment, however, substantially weakens the existing safeguards; for example, a bankrupt may remain as RBA governor if the Parliament so chooses. The government has not articulated any argument why this may be good policy. It is inconceivable that anyone who was incapacitated, or bankrupt, or engaged in paid outside work should continue as RBA Governor, or Deputy Governor. The government has not explained what additional considerations the Parliament would bring to bear that the Treasurer would be unaware of – as already indicated these are objective phenomena.

In short, the amendment as it currently stands, does not appear to change the executive government's ability to remove the RBA Governor or the Deputy Governor from office under section 24(1)(c), and substantially weakens the safeguards in section 25.

If the government wishes to strengthen the political independence of the RBA Governor and the Deputy Governor, they should leave section 25 as it stands, but make section 24(1)(c) subject to Parliamentary approval.

We have already argued that strengthening the political independence of the RBA Governor and the Deputy Governor would have little economic impact on inflation. We now turn to other non-economic considerations.

(a) The RBA Governor occupies a highly visible appointment in Australia. Monetary policy has high political visibility. One of the reasons for this is the nature of the Australian mortgage market – most mortgages have floating rates that respond very quickly to official interest rate changes. The greatest protection the RBA governor has is the visibility of his position to both the electorate and financial markets. Removing the RBA Governor from office is very likely to be both economically and politically risky for any government. The RBA governor is in a very different position to, say, the Tax Commissioner, or the Government Statistician. Special protection is given to those two latter positions that is not accorded to the RBA Governor. Populist discontent with the Tax Commissioner is blunted by legislation, while the electorate is blissfully indifferent to the Government Statistician. The RBA, Australian Bureau of Statistics and the Australian Tax Office are very different institutions that undertake very different functions. There is no inherent reason why the institutional arrangements that govern the appointment of their chief executives need to be the same.

(b) Responsible economic management is required of all governments. This amendment attempts to place all responsibility for monetary policy beyond the control of any given government. At present the government can remove an RBA Governor from office under section 24(1)(c). This ensures that ultimately, the elected government is responsible for the conduct of monetary policy. The proposed legislation shifts that accountability; an unelected government official will now become unaccountable to the Parliament, and ultimately unaccountable to the electorate. It is not clear that this is good policy and it is not at all clear that the electorate would agree to such a change. Of course, elected governments do not need to have an electoral mandate for each and every piece of legislation; nonetheless a change of this magnitude for a position of such economic importance requires substantial debate and acceptance in the community.

The current arrangements represent a series of checks and balances that are appropriate in a parliamentary democracy. The RBA is responsible for the conduct of monetary policy. The government can, under section 11 of the *Reserve Bank Act 1959*, over-rule the RBA should a policy difference arise. This requires a declaration to the Parliament. Were such an event ever to occur, it is likely to cause much debate within the media, and a response from the financial markets. The Official Opposition and the electorate would take a close and keen interest in the matter. Similarly, at present, the elected government can remove the RBA governor under section 24(1)(c) but again would have to justify themselves to the international financial markets, domestic capital markets, the Parliament, the media and ultimately the voters. To all intends and purposes, it is unlikely that any government would opportunistically dismiss the RBA Governor or the Deputy Governor. In this regard, Australia could *already* be close to best practice. A review article in *The Economic Journal* states,[15]

> Another way of ensuring accountability of monetary policy is to shift the final responsibility to government through an override mechanism. Although political interference clearly comprises central bank independence, it could be beneficial … and harmful effects could be limited by an explicit override procedure based on checks and balances.

The override mechanism already exists in section 11, while political interference could be further enhanced by making any action under section 24(1)(c) subject to parliamentary approval.

[15] Petra M. Geraats, 2002, Central bank transparency, *The Economic Journal*, 112, F532 – F565, pg. 560.

Conclusion

The proposed change to the RBA Act is unlikely to have any impact on inflation.

The proposed change to the RBA Act is likely to add to moral hazard.

The current institutional arrangements are appropriate, sensible and should be maintained.

APPENDIX

This appendix updates the Grilli study. That study was published in 1991 and it could reasonably be argued that events since then have overtaken the data and the results may no longer hold. In order to investigate that argument, the Economic Independence and Political Independence measures were captured from the Grilli study. Similarly the Legal Independence measure was captured from the Cukierman study. Inflation data for the 18 OECD economies in the Grilli study was captured from the IMF. The average inflation rate for the period 1980 – 2007 was calculated for each economy. Table A.1 shows the results of this exercise.

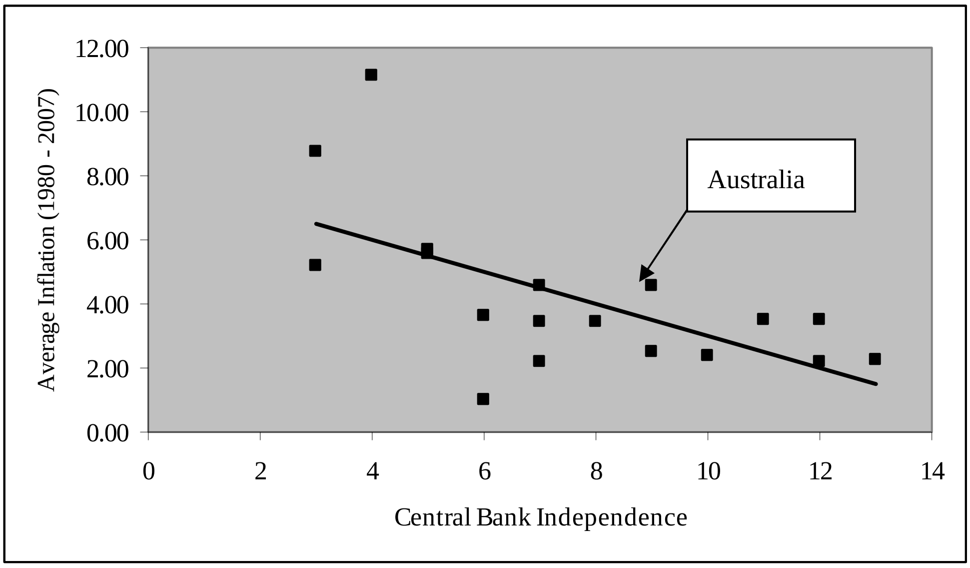
Table A.1: CBI Indices and Inflation Data

	Grilli		Cukierman	
	Political Independence	Economic Independence	Legal Independence	Average Inflation (1980 - 2007)
Australia	3	6	0.36	4.57
Austria	3	6	0.61	2.51
Belgium	1	6	0.17	2.18
Canada	4	7	0.45	3.50
Denmark	3	5	0.5	3.46
France	2	5	0.24	3.47
Germany	6	7	0.69	2.25
Greece	2	2	0.55	11.11
Ireland	3	4	0.44	4.59
Italy	4	1	0.25	5.55
Japan	1	5	0.18	0.99
Netherlands	6	4	0.42	2.38
New Zealand	0	3	0.24	5.20
Portugal	1	2	0.41	8.72
Spain	2	3	0.23	5.72
Switzerland	5	7	0.64	2.20
UK	1	5	0.27	3.63
US	5	7	0.48	3.48
Correlation with Inflation	-0.3177	-0.7162	0.0320	

Source: Grilli, et.al, Cukierman, et.al, IMF.

Figure A.1 shows the updated relationship between CBI and inflation. Similarly to the figure presented by Bernie Fraser, the relationship is clearly negative – those economies with higher CBI have, on average, lower rates of inflation. In one sense that is very satisfying, yet it also highlights the problem alluded to before. Indices that were calculated using institutional relationships in the 1960s are still showing the same (negative) relation to inflation – this suggests that those economies already likely to have low inflation are also likely to have higher CBI.

Figure A.1: Central Bank Independence and Inflation (Updated)



The correlations between the three measures of CBI and inflation were calculated (recall that correlation does not imply causation). Only one of the three correlation coefficients, Economic Independence and Average Inflation, was statistically significant at the 5 percent level. The correlation between the Cukierman proxy for CBI and average inflation was positive – directly contrary to the stylised facts of the literature.

As a final check, the analysis reported in Table 14 of the Grilli study is replicated and shown in table A.2.

Table A.2: Replication of Grilli Table 14. Dependent variable is Average Inflation. Standard error in parenthesis * indicates statistical significance at the 1 percent level.

Explanatory Variable	1980 - 2007
Intercept	8.9650*
	(1.7449)
Economic Independence	-0.9468*
	(0.2946)
Political Independence	-0.0399
	(0.2806)
EMS	-0.2753
	(1.0609)
R^2	0.5164
SE	1.8989

Consistent with the previous results, Economic Freedom is associated with lower levels of inflation, while there is no relationship between Political Independence and inflation.