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Reshaping the Reserve: The Political Economy of Central Banking in Australasia

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Christopher John Eichbaum
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Abstract

Changes in the relative influence of state and market in the final quarter of the twentieth century are no better evidenced than in the institutional evolution of the central bank. Central banks are increasingly possessed of a large measure of independence from political authorities, set the limits on economic growth and on employment, and to a very large extent the parameters within which governments exercise taxation and expenditure decisions.

In 1989 the New Zealand Parliament passed the Reserve Bank of New Zealand Act. The Act mandated the Bank to focus exclusively on one objective - price stability - and provided the Bank with complete operational independence to pursue that objective. The New Zealand legislation is perhaps the cleanest expression of an institutional prescription supported by the rational economics literature. Central bank independence - by which is meant operational independence to deliver price stability - is seen as the remedy for a democratic distemper in which politicians will manipulate policy levers in an opportunistic manner, and with adverse economic consequences.

The statute repealed by the 1989 New Zealand legislation offended against the rational economics prescription - the Bank was required to direct policy towards multiple objectives and was dependent on the government of the day for much of its operational direction. That earlier statute had much in common with Australia's Reserve Bank Act 1959 which required the Reserve Bank of Australia to protect the stability of the currency, maintain full employment, and contribute to economic prosperity and welfare, and vested policymaking in a Board combining officials and lay members variously drawn from business, labour, and the academic community. That statute, largely unchanged since 1945, remains in force today.

The early 1990s would see a political contest for the Australian central bank, a contest which would see the appropriateness of the Coombsian post War institutional scheme questioned, and the 'New Zealand model' cited as the exemplar of institutional best practice. In 1999 that contest is over, the legislation has not been revisited, the Coombsian scheme remains intact, and it enjoys bi-partisan political support. The institution has been reshaped, but within the context of the Coombsian scheme.

The thesis takes as its point of departure the fact of institutional difference, and illuminates the causes and consequences of two markedly different trajectories of
institutional reshaping. A most similar systems research strategy provides the methodological framework, with the theoretical base provided by a political economy model which posits that particular institutional configurations and trajectories of institutional reshaping will reflect the relative influence of actors within the political economy. The model seeks to remedy what is a principal deficiency in the rational economics literature, namely the treatment of central bank independence as exogenous. By situating institutional reshaping within the political economy, the nature of choices relating to institutional form and trajectories of institutional reshaping are made endogenous. Elements from both rational-choice and historical institutionalism are imported into the model, which posits that a condition of institutional equilibrium condition will obtain where attributes of the institutional mix serve to maximise endowments of credibility and legitimacy. Credibility of institution and of policy is a requirement in order to remedy any dynamic inconsistency constraint, and typically is advanced by operational independence and a focus on price stability. Institutional and policy legitimacy posits both that independence be balanced with appropriate accountability provisions, and that economic growth, macroeconomic stability and an appropriate measure of policy co-ordination form part of the central bank mandate. Institutional credibility and legitimacy are manifest both in particular attributes of institutional form - policy objectives and governance arrangements in particular - and in the conduct of relations between central banks and actors within the political economy.

For the first time, the thesis articulates a comparative political economy of central banking in Australasia, and illuminates the causes and consequences of differing trajectories of institutional reshaping within an integrated model. The thesis advances an explanation for the markedly different trajectories of institutional reshaping, and foreshadows the likely trajectory of future reform under circumstances of institutional dis-equilibrium. The thesis extends and modifies the institutionalist literature on the political economy of central banking, and is an original contribution in keeping with what Sharpf has identified as the positive and normative import of policy research - producing effective and legitimate solutions to policy problems.
Preface

The social sciences can never be value free, but equally there is a risk of the total surrender to subjectivity, in which the discourse becomes personal and indulgent. While what follows is both positive and normative, this Preface provides an opportunity to record some personal observations and thanks, the objective being to then let the balance of this work speak for itself. I will be comfortable if, in what follows this Preface, the person and personality of the author is relegated to the realm of the exogenous.

The choice of this area of inquiry reflects a number of factors. In part the choice reflects a personal commitment to scholarship which is grounded in policy research, and which speaks, in the present case to the interests of those who live with the implications of macroeconomic decisions, and the institutional framework within which those decisions are made, as well as to the members of policy communities, and communities of scholars. Throughout the process of completing this thesis I have been acutely aware of, and motivated by, the 'public good' dimension to policy research. This thesis could not have been undertaken without the support of the New Zealand and Australian taxpayers who have funded the institutions in which I have studied and been employed.

The thesis reflects a personal interest in the design of 'public' institutions, and the institutions of macroeconomic management in particular. That interest alone would have sustained this inquiry, but has been given an added dimension by the relative lack of scholarship - Political Science and Public Policy scholarship in particular - in this field. That scholarship that does exist is reviewed in the pages that follow, and I feel particularly honoured that many of those who have contributed in this field have played a direct role in supervising this research, or have assisted in other important ways.

With the benefit of hindsight I can now reflect on a number of events and experiences that contributed to a desire to address one of the more interesting puzzles in contemporary Australasian public policy. As someone directly involved with national wage negotiations in the mid to late 1980s I wrestled with what I now understand to be a dynamic inconsistency constraint - in those days it presented itself in attempts to recover real wages lost, and to secure some measure of security in terms of the future relationship between wages, prices, and employment. I was on the staff of the Private
Office of the Prime Minister of New Zealand when the Reserve Bank of New Zealand Bill was reported back to the Parliament and passed into law in December 1989 and subsequently observed, from a reasonably close vantage point, the problems of monetary and fiscal policy co-ordination over the course of 1990. And in September 1990 I was one of those involved in the negotiation of the 'Growth Agreement' - a Government initiative in which, in return for an agreement on the part of the central organisation of workers to place an upper limit on wage movements, and an undertaking on the part of the Government to review expenditure plans (and provide opportunities for state employees and their unions to be actively involved in the review process), the Reserve Bank undertook to revisit monetary policy settings - the expectation at the time being that a reduction in inflationary pressures would permit an easing in policy, reductions in wholesale and retail interest rates, and a higher rate of economic growth over the short to medium term.

In October 1990 an opportunity was provided to take the time to make some sense of the politics and the economics of the New Zealand process of structural reform, including the significance of the Reserve Bank of New Zealand Act 1989. A number of my colleagues provided sound advice at this point, in particular the former Head of the Department of Prime Minister and Cabinet, Simon Murdoch. My sense at the time, somewhat intuitive, but confirmed by the published work of Professor Frank Castles, was that making sense of the process of structural reform might be assisted if the comparative framework was an Australasian one. A period as a student in the Graduate program in Public Policy at The Australian National University over 1991 and 1992 provided an opportunity to acquire the conceptual and intellectual tools to start that assessment.

I am particularly grateful to the staff and students of the Public Policy Programme for their wisdom, their wit, and for their collective commitment to the highest standards of scholarship. This thesis reflects the interdisciplinary nature of Public Policy as a domain of inquiry and the contributions of those who breathed life into that inquiry at The Australian National University. Professor Rolf Gerritsen was instrumental in conveying a sense of the importance of institutions within the political economy; Dr John Uhr's exhortation to examine the 'quest for accountability' raised the issues of institutional design and accountability within a public sector context; Professor Raja Junankar encouraged his students to view economics as anything but a 'dull science' and encouraged me to make the connections between the politics and the economics of institutional design; and the Head of the Program at that time, Professor Frank Castles, conveyed a sense of the potential of the comparative method, and in
particular the exciting possibilities posed by the use of a most similar systems research strategy in an Australasian context. Robin Creyke of the Graduate Program in Public Law was an inspiring teacher, and I want place on record my thanks to the administrative staff in the Public Policy Programme - Rosemary Gill, Margot Martin, and Susan Lindsay.

Education, whether formal or informal, is a cumulative process, and I have benefited over the years from having been taught and mentored by some very talented individuals. In terms of those who taught me as an undergraduate and graduate student at Canterbury University, Nigel Roberts first introduced me, as an undergraduate, to the work of Anthony Downs, and Geoff Fougere to game theory and collective action dilemmas. I can recognise the influence of others such as David Thorns, Bob Gidlow, John Henderson, Pat Walsh and Keith Ovenden in the pages of this thesis.

I want to acknowledge the members of my supervisory team - Professor Ian Shirley (School of Social Policy and Social Work, Massey University Albany), Dr Paul Dalziel (Department of Economics, Canterbury University), and Professor Frank Castles (Political Science, Research School of Social Sciences, The Australian National University).

Paul Dalziel has made a signal contribution to the supervision of this thesis. His own scholarship in this field has been vitally important, and is reported in the pages that follow. As a supervisor he has brought not only his keen intellect, but an eye for detail, and an acute sense of the totality of the project. He possesses the ability to affirm that which is good, or shows potential, to caution against what one other member of my supervisory team has, in the past, referred to as an inclination on the part of the author to be tempted down 'the primrose path of dalliance', and to encourage a sense of personal responsibility for, and ownership of one's work. I am indebted to Dr Kirsten Lovelock, now on the staff of Otago University, who, as a colleague, offered her assistance at a crucial time, and was instrumental in securing Paul Dalziel's involvement as a supervisor.

Professor Frank Castles earlier contribution has already been acknowledged. Frank Castles took the time to provide detailed comments and suggestions on an earlier draft of the thesis, and this final product is the better for his involvement at that point.
Professor Castles was also a very agreeable host when in the early part of 1997 I was awarded a Visiting Fellowship in the Research School of Social Sciences (RSSS) as part of the Reshaping Australian Institutions (RAI) Project. That Fellowship provided an opportunity to carry out full-time research, much of which is reported in this thesis. Stephen Bell was also based at the RSSS for a time, and I would like to record my thanks for his constructive comments on my earlier work, for signalling productive lines of inquiry that have been acted upon and are reflected in this work, and for sharing his own research data. Stephen Bell alerted me to the importance and relevance of the work of William D. Coleman, and the influence of the work of both Stephen Bell and William Coleman is clearly in evidence in what follows. I would also like to record my thanks to the other staff in the Economics and Politics Division of the Research School of Social Sciences, in particular Professor Barry Hindness, Professor Bob Gregory, Mary Hapel, and Gillian Evans.

I thank, without in any way implicating, all those who have offered comment and advice. Responsibility for any deficiencies in this final product rests with the author alone.

I want to record my very grateful thanks to my respondents, a number of whom are listed in the Appendix to this thesis, and others of whom, of necessity, shall remain anonymous. Without exception those respondents were generous with their time, provided considered and careful answers to my questions, and, through their interest and engagement with the issues traversed in this thesis, provided an important source of affirmation along the way. I would particularly like to record my appreciation to the Governors and senior staff of the two Reserve Banks who, either directly, or indirectly, through their co-operation and assistance, contributed to the quality of the research process, and to the intrinsic satisfactions associated with the carrying out of the research.

My thanks are due to my students and my colleagues who have, in lectures and in seminars, provided opportunities to test the ideas that have both informed and been shaped by the research reported in this thesis. My friend and colleague Richard Shaw has been a constant source of support, encouragement, and scholarly advice over a period when constancy was at times in short supply. I hope to be able to reciprocate. Simon Nash, who has assisted in the development and delivery of internal and extramural teaching to students of Politics and Labour Studies has also been a source of support and encouragement.
My colleague in the School of History, Philosophy and Politics, Sharon Cox, has transformed my draft manuscripts into this final product with patience, care, and good humour.

I want to record my appreciation to my partner, Pamela Madge Horncy, for her love and support, which was offered even when, at times, the author was deserving of neither.

My late father Francis Cameron Eichbaum served his country in peace time and in war. It is in the spirit of a shared sense of service to the public, that I dedicate this work to his memory.
This thesis seeks to address a significant gap in the existing body of scholarship on central banking in Australasia. As a contribution to the discipline of public policy, and specifically comparative public policy the scope of the inquiry is by its very nature one that traverses the boundaries of the disciplines that together constitute public policy as an inter-disciplinary domain. More specifically the thesis is a contribution to comparative political economy, which may be viewed as a sub-set or sub-literature of one of the schools of the 'new institutionalism' - a body of middle-range theories and empirical studies focusing on the intermediate level of institutions. In seeking to advance a political economy of central banking in Australasia, and to account variously for institutional difference and discontinuity the thesis is a contribution to historical institutionalism.

The thesis draws a distinction between the rational economics and political economy literatures. The intention is not to add to the existing economic literature but instead to rehearse the theoretical and empirical underpinnings of the case for central bank independence as a precursor to the elaboration of a model which seeks to illuminate the causes and consequences of differing trajectories of institutional reshaping. In referring to this literature and the normative import of it as reflecting the tenets of 'rational economics' a variety of approaches within the discipline of economics are conflated into this one 'short-hand' term.

The essence of the distinction between 'rational economic' and 'political economy' approaches, as articulated in this thesis, is captured in the treatment of the processes of institutional shaping and reshaping. Quite simply the rational economics literature treats central bank independence (or more accurately particular trajectories of institutional reshaping) as exogenous, whereas the political economy model that we elaborate is one predicated on the endogeneity of institutional shaping and reshaping.

The 'rational economic' case for central bank independence is one premised on both theoretical and empirical foundations. It is, in essence, a case designed to remedy a credibility deficit that accrues when policy is discretionary and subject to a time or dynamic inconsistency constraint. Central bank independence, as a particular institutional prescription, seeks to remedy a credibility deficit by making the conduct of monetary policy operationally independent of elected officials, and by tasking central banks to focus on the achievement and maintenance of price stability.
The bridge from rational economics to political economy is largely provided by the necessity of the political. There are three dimensions to this. The first is to be found in the application of economic assumptions to the conduct of politics. What we will refer to as a Downsian calculus is fundamental to the rational economics literature out of which the case for central bank independence emerges. In the discussion of the dynamic or time inconsistency case for central bank independence our emphasis is on the political and institutional consequences of the normative prescription that is underpinned by the literature. Dynamic inconsistency in monetary policymaking and macroeconomic policymaking more generally is a function of the fact that politicians will privilege electoral benefit over economic welfare with, as the literature notes, a positive weighting given to employment and/or partisan preferences, and a negative weight given to inflation.

In one sense the dynamic or time inconsistency argument for central bank independence is predicated on economic rationality on the part of price setters, and a measure of irrationality on the part of the electorate. In the absence of an electoral remedy, a particular institutional remedy, typically central bank independence, is required to impart a commitment to price stability through credible policy. The question then becomes, under what circumstances are politicians prepared to surrender discretion in policymaking in favour of optimal economic outcomes. If one resiles from Downsian assumptions in favour of a benign politics which elevates the public good and economic welfare over short-term political advantage, the remedy is clear – politicians may well legislate to limit policy discretion - but the case for central bank independence, other than on the basis of the restoration of credibility lost, arguably becomes less compelling.

If one retains Downsian assumptions the question becomes, under what circumstances is the ‘rational’ politician prepared to surrender policy discretion in favour of central bank independence. The conditions under which there may be some surrender of policy discretion are simply not illuminated by the theoretical and empirical literatures that make the case for institutional reform. While within the comparative political economy literature insecurity of political tenure is suggested as a possible driver of institutional change, more substantively the second dimension to the political is given by the fact that, in liberal-democratic societies institutional remedies typically require political codification in statute.

The third dimension to the political is given by the fact that credibility of policy and performance is a function of accountability, and that the accountability of central banks and bankers for their performance is tied to procedures which have their genesis in legislation and which are conducted within the formal political system.
In essence the case for central bank independence is one that is largely prosecuted out of the economic literature, albeit a literature which takes as its point of departure the application of economic assumptions to the conduct of politics. The remedy is one that requires political codification and accountability. The explanation as to why, under what circumstances and with what kinds of consequences particular trajectories of institutional reshaping are adopted is illuminated by the political economy model elaborated in this thesis.

The thesis illuminates two markedly different trajectories of institutional reshaping, and advances an explanation, which posits that both the trajectory of reform, and the specific features of a given set of institutional arrangements will reflect the underlying configuration of interests within the political economy. The point of departure is one of difference, but whereas the narrative is one that seeks to advance an understanding of the determinants and consequences of difference, the imperatives are towards convergence around a politically viable (or legitimate) and economically credible institutional equilibrium.

The logic of historical institutionalism suggests that institutions both shape and are shaped by the preferences of actors within the political economy. While the perceptions of actors and interests as to what is or is not credible and/or legitimate may be a consequence of the particular features of a particular set of institutional arrangements, and while perceptions may conflate the formal (statutory) elements of an institution and the conduct of policy within a given statutory framework, the attributes or endowments of a given set of institutional arrangements are manifest in particular and empirically verifiable elements of that set. In specific terms the demands of credibility and/or legitimacy are reflected in the formal charters and governance arrangements of central banks. Institutions are shaped by, and in turn shape perceptions and preferences within the political economy.

Historical institutionalism provides the disciplinary context for an explanation of the markedly different trajectories of institutional reshaping of the central banks of Australia and New Zealand over the final two decades of the twentieth century.

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1 Note that in New Zealand a distinction is made between the statutory requirements of the Reserve Bank of New Zealand Act 1989 and the provisions contained in the Policy Targets Agreement signed by the Treasurer and the Governor. Throughout this thesis, both components are considered together when addressing issues of legitimacy.