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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The statute repealed by the 1989 New Zealand legislation offended against the rational economics prescription - the Bank was required to direct policy towards multiple objectives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 (RSSH) 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 RSSH 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.

Prologue

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.¹ 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.

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.

Chapter 1

Introduction

Prologue

In 1961 a young economics and arts graduate of the University of New England joined the Commonwealth Public Service in Canberra. Interviewed some thirty six years later he would reflect on the formative influences on him at that time:

" ... I joined the public service in January 1961 and in September 1960 there was, by those standards, an almighty credit squeeze directed towards inflation ... unemployment shot up ... It took quite a while to recover from this onslaught of credit policies and it was a salutary lesson for me really. I had come in and began to ... observe, at this early stage, how to grind inflation down. You could hit it with a sledgehammer, and that would hit inflation, but it had a much more powerful effect on employment and activity. From that time on, and there have been other episodes, whenever monetary policy on its own has tried to control inflation, it's either been pretty ineffectual, because the inflationary pressures have arisen from things that monetary policy can't always get at, or when it has been effective it has had a pretty high social cost in unemployment" (personal interview, 1997).

That graduate - Bernard (Bernie) William Fraser - joined the Treasury in 1963, and by 1984 was Treasury Head, and, in that capacity, a member of the Board of the Reserve Bank of Australia.

Australia's central bank is given formal status in a statute which has remained largely intact since 1945. It is a statute which enjoins the bank to pursue multiple objectives by means of a 'dualist' charter - stable prices and full employment; which vests the Board of the Bank with responsibility for the development and implementation of policy; and which, while providing a measure of independence for the Bank, maintains a reserve power of override for the government of the day, subject to any matters in dispute being placed before the Parliament. In July 1991 Bernie Fraser was appointed Reserve Bank Governor. Fraser was, in the lexicon of the times, an 'economic rationalist', a supporter of deregulation and - within limits - privatisation, and policies designed to reduce the reliance on instruments of domestic protection and expose the Australian economy to the forces of international competition. He supported the floating of the Australian dollar and financial sector liberalisation, advocated tax reform, and favoured a move towards enterprise level bargaining. He was, in very many respects, orthodox in his policy preferences. But he was extremely wary of the power of interest

rates. Moreover, as Craig McGregor noted in a profile published in the last week of November 1991,

"far from being a free-market hawk ... Fraser believes intensely that government should intervene to protect ordinary people who suffer from the system, wants better 'safety nets' for them, thinks the idea of screwing down the inflation rate at the costs of worse unemployment and bankruptcies is 'crazy' ... [and] believes in the independence of the Reserve Bank ..." (The Age, 28 November 1991)."

Fraser summed up his own mission in the observation that: "I like the public bit of being a public servant" (The Age, 28 November 1991).

In September 1988 Dr Donald (Don) T. Brash was appointed as Governor of the Reserve Bank of New Zealand. Born in Wanganui in September 1940, Don Brash has undergraduate and graduate degrees from Canterbury University and a PhD in economics from the Australian National University, with a thesis on American investment in Australian industry. He served with the Reserve Bank of New Zealand from 1961-2, and the World Bank in Washington from 1966-71, before becoming Chief Executive of Broadbank (1971-81), the New Zealand Kiwifruit Authority (1982-86), and the Trust Bank group (1986-88). Dr Brash was a member of the New Zealand Monetary and Economic Council from 1974 to 1978, a member of the Committee of Inquiry into Inflation Accounting in 1975, Chairman of the Economic Monitoring Group, 1978-1980, a Foundation member of the New Zealand Planning Council, Chairman of the advisory panel on the Goods and Services Tax, 1985, and chairman of four subsequent consultative committees on taxation reform, on behalf of the New Zealand Government.

Like Bernie Fraser, Brash was an economic moderniser. Unlike Fraser Brash's career trajectory had taken him into the finance and banking sector, and, for a time, into politics. In February 1979 he gave a speech in which he encouraged the then Prime Minister, Robert Muldoon to address the nation's economic difficulties - "'a combination of external factors and policies followed by governments of both political parties over many years'. What was needed, he said, was 'a package of measures' to rectify the situation. He suggested devaluation accompanied by a phasing out of all export incentives. Import controls as a major means of protecting New Zealand's industry should be abolished, along with price controls and barriers to foreign investment. Brash suggested a progressive switch to indirect taxation, and a 'vigorous

attempt' to cut government spending ..." (Bassett, 198: 348).¹ The unsuccessful National Party candidate for the Auckland seat of East Coast Bays in a by-election in September 1980, Brash's failure to win the seat was viewed as attributable in large part to a lack of support from National Party Leader, and Prime Minister, Robert Muldoon.

As Reserve Bank Governor Don Brash had a large measure of influence over the development of the Reserve Bank of New Zealand Bill 1989, which came into effect in March 1990, replacing a statute which in many respects mirrored the Australian legislation. The new Act substituted a single objective - price stability - for an Australian styled dualist charter, and tasked the Governor of the Bank with realising the objective which was codified by means of a performance contract with the Governor in a Policy Targets Agreement (PTA). The first PTA required the Bank to achieve price stability - an annual rate of inflation of between 0 and 2 percent - by December 1992, a target which the Bank would achieve in 1991, notwithstanding that in 1990 the incoming National Party Government extended the time-frame for meeting the target out to December 1993.

On the 21 November 1991 the Australian Federal Opposition Liberal and National Parties released a 340 page reform agenda - "'Fightback!', Taxation and Expenditure Reform for Jobs and Growth" (1991b). The package committed an incoming Coalition Government to a comprehensive package of reforms, including significant changes to tax, tariff, industrial relations and infrastructure policies. However the first item in a twenty point programme went to the objective of price stability, which was to be pursued by way of changes to the Reserve Bank Act. The Coalition committed itself, "to the medium term objective of price stability" - an objective which, it was asserted, was "universally conceded to be an inflation rate of 0-2 per cent" - pursued by a Reserve Bank which, by way of amendments to the Reserve Bank Act, was to be, "formally guaranteed its independence within the context of the Government's overall economic management" (1991b: 129-130). That independence, and an end to a "sorry saga of compromise" and lack of public accountability was to be provided by legislative changes in the first year of a new government, legislation modelled on the 1989 New Zealand statute. The Bank's dualist charter would go in the name of an exclusive focus on price stability.

The contest for the Australian central bank was joined, and it was a contest in which the Bank itself, in the person of the Bank's Governor, Bernie Fraser, would be a player.

¹ Bassett comments that Brash's advice, "bore a similarity to decisions that were taken after the election of July 1984" (1998: 348).

Fraser's concerns about the elements of the 1991 Coalition manifesto will be discussed at length in the chapters that follow. The passion with which those concerns would be articulated is captured in a profile of Fraser published two days after the release of 'Fightback!':

"'It's not that easy to change the charter of the Reserve Bank,' Mr Fraser said. 'I won't go just to appease some dickhead minister who wants to put Attila the Hun in charge of monetary policy'"(Sydney Morning Herald, 23 November 1991).

The Coalition failed to win the 1993 election, and in the aftermath of what was a totally unexpected defeat changes were made to both Coalition personnel and policy. On the 3 June 1994 the new Leader of the Opposition, Alexander Downer, resiled from his predecessor's commitment to change the Reserve Bank's charter, and shortly after the 1996 election - won by the Coalition - the incoming Treasurer stated that the new government would respect the Bank's independence. The Reserve Bank Act was not amended by the incoming government, the 'theatre' instead provided by an exchange of letters - an agreed statement on the conduct of monetary policy - between the Treasurer and, his term as Governor expiring in September 1996, Bernie Fraser's successor, former Deputy Governor Ian Macfarlane. The exchange of letters re-affirmed the Bank's statutory charter objectives, and explicitly committed Bank and Government to a price stability 'target' developed by the Bank itself under Bernie Fraser's stewardship.

Both central banks have been reshaped - one by means of a radical and comprehensive change in statute, the other, in a more incremental manner. However the Australian statute, which has remained largely intact for over half of the twentieth century, and within which the reshaping of the institution has occurred, may well continue in force into the next millennium. The same measure of confidence may not necessarily extend to the New Zealand statute which, from its earliest inception, provided an important backdrop to the Australian policy debates of the 1980s and 1990s. The summary signposts of those debates suggest the nature of the inquiry to which this volume is directed.

The Dimensions of Difference:

The inquiry seeks to account for and explain institutional difference - why it is that certain institutions have been shaped or reshaped in certain ways - and the logic of institutional reshaping. The extent and specific manifestations of that difference, as the following chapters will demonstrate, vary over time. The codification of formal

institutional rules in statute provides an accessible point of difference, and a point of departure for that which follows. But, after Hall, we adopt a concept of institutions which situates the formal within the relational. For Hall:

"The concept of institutions ... [refers] to the formal rules, compliance procedures, and standard operating practices that structure the relationship between individuals in various units of the polity and economy. As such, they have a more formal status than cultural norms but one that does not necessarily derive from legal, as opposed to conventional, standing ... [T]he emphasis is on the relational character of institutions; that is to say, on the way in which they structure the interactions of individuals. In this sense it is the organisational qualities of institutions that are being emphasised ..." (1986: 19).

Indeed the thesis, which we elaborate below, posits that the formal - including statutory - elements of the institution of the central bank, derive from, and are a reflection of, the broader context of state-society relations within which the central bank is situated. Moreover, while we take as the point of departure difference in the formal statutory arrangements within which central banks are located, it is entirely possible - to anticipate the argument that we develop below - that institutions may be reshaped, or reshape themselves, within the political-economy, without such reshaping being reflected in statute. That said however, the political-economy code that shapes or reshapes the institutions of central banking is suggested by elements of the statutes governing the two Australasian 'banks of reserve'.

The two central banks are respectively the Reserve Bank of Australia (RBA), and the Reserve Bank of New Zealand (RBNZ). The specific elements of difference are examined in some detail in subsequent chapters. For the moment it is sufficient to note that, while until 1989 both institutions were formally given status and function by statutes that did not, in substantive terms, differ significantly, so far as institutional form is concerned, that changed with the passage of the Reserve Bank of New Zealand Act 1989. The differences between this Act, and the corresponding Australian statute, the Reserve Bank Act 1959 are captured in elements of the formal institutional arrangements which go to the development and implementation of monetary policy - the charter of the central bank which prescribes the objective(s) to which policy shall be directed; the governance arrangements which prescribe who or what is accountable for policy development, implementation, and institutional governance more broadly, in pursuit of the objective(s); and thirdly, the accountability arrangements through which those tasked with these responsibilities are held to account for the performance of those duties, and which, at the level of policy goals, define the relationship between the bank and the government of the day.

The functions of the Reserve Bank of Australia are detailed in section 10 of the Reserve Bank Act, the wording of which clearly indicates the status of the Board of the Bank in terms of its statutory authority in both policymaking and governance:

"10 (1) Subject to this Part, the Board has power to determine the policy of the Bank in relation to any matter and to take such action as is necessary to ensure that effect is given by the Bank to the policy so determined.

(2) It is the duty of the Board, within the limits of its powers, to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia and that the powers of the Bank under this Act, the Banking Act 1959 and the regulations under that Act are exercised in such a manner as, in the opinion of the Board, will best contribute to:

- (a) the stability of the currency of Australia;
- (b) the maintenance of full employment in Australia; and
- (c) the economic prosperity and welfare of the people of Australia" (Section 10, Reserve Bank Act, 1959).

This charter is similar to that which formerly obtained in the Reserve Bank of New Zealand Act 1964, section 8(2) of which provided that monetary policy "be directed to the maintenance and promotion of economic and social welfare in New Zealand, having regard to the desirability of promoting the highest level of production and trade and full employment, and of maintaining a stable internal price level".

By contrast the charter prescribed in the Reserve Bank of New Zealand Act 1989 directs the Bank to a single economic objective:

"The primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices" (Section 8, Reserve Bank of New Zealand Act, 1989).²

We have already foreshadowed the defining element of the Australian policymaking and governance arrangements. The Australian statute provides that the Board of the Bank has the power to determine the policy of the Bank.³ The composition and role of

² Moreover a number of other elements of the institutional framework are clearly subject to this single charter objective. Section 9 of the New Zealand statute requires the Minister to negotiate policy targets with the Governor, "for the carrying out by the Bank of its primary function..." (Section 9(1), Reserve Bank of New Zealand Act, 1989); and the override facility, which we examine in more detail below, requires that a manifestly public and transparent process be followed in seeking to provide, for a finite period, that policy be directed to, "any economic objective, other than the economic objective specified in section 8 ..." (Section 12(1) Reserve Bank of New Zealand Act, 1989).

³ The membership of the Board is detailed in Section 14 of the Act:

the Reserve Bank Board is more fully explored in a number of subsequent chapters, but it is sufficient to note at this point that it is the Board, and not the Governor alone, in which the power of policymaking resides, and that, typically, in making appointments to the Reserve Bank Board successive governments have sought to bring a range of interests to the task of policymaking, including, at various times and to varying combinations, manufacturing, pastoral, mining, and employee interests, and academic economists.

By contrast, the policymaking arrangements within the New Zealand context are premised on a set of contractual arrangements between the government of the day, through the Minister of Finance or Treasurer, and the Governor of the Bank, and subject to the Bank's primary objective. While the primary objective, or goal of monetary policy is prescribed in the statute, the specific target to which monetary policy is directed is codified in a policy targets agreement between the Minister and the Governor, and it is the Governor who is tasked with ensuring, "that the actions of the Bank in implementing monetary policy are consistent with the policy targets fixed under section 9 of [the] Act" (Section 11, Reserve Bank of New Zealand Act, 1989). The Governor is appointed by the Minister on the recommendation of the Bank's Board of Directors, (Section 40, Reserve Bank of New Zealand Act, 1989), and is duty bound, "to ensure that the Bank carries out the functions imposed on it by [the] Act" (Section 41, Reserve Bank of New Zealand Act, 1989).⁴

"14. (1) The Reserve Bank Board shall consist of:

- (a) the Governor;
- (b) the Deputy Governor;
- (c) the Secretary to the Department of the Treasury; and
- (d) 7 other members, who shall be appointed by the Governor-General ...

(2) Of the 7 members appointed under paragraph (1) (d), at least 5 shall be persons who are not officers of the Bank or of the Australian Public Service ..." (Section 14, Reserve Bank Act, 1959).

The Governor and the Deputy Governor are appointed for terms of up to 7 years by the Governor-General, and are eligible for re-appointment. Significantly, the Act precludes from membership of the Board, "a director, officer or employee of a corporation (other than the Bank) the business of which is wholly or mainly that of banking ..." (Section 17 (d), Reserve Bank Act, 1959).

⁴ While the Bank has a Board of Directors, the role of the Board is largely directed to ensuring that the Governor of the Bank fulfils the terms of the contracted policy targets agreement:

"the Board of the Bank shall ...

- (c) Keep under constant review the performance of the Governor in ensuring that the Bank achieves the policy targets agreed to with the Minister ..." (Section 53 (c), Reserve Bank of New Zealand Act, 1989).

Section 56 of the Act specifies that in making an appointments of a non-executive director to the Board the Minister shall have regard to:

The statute prescribes the grounds on which a Governor may be removed from office, either on the initiative of the Minister or on the recommendation of the Board, grounds which include a failure to achieve contracted policy targets, and actions inconsistent with the Bank's primary function (Sections 49 and 53, Reserve Bank of New Zealand Act, 1989).

The accountability requirements for both central banks are detailed in statute, and, in the case of the Reserve Bank of Australia have evolved in ways consistent with the statute, and have in recent years been codified in an agreement between the Governor and the Treasurer. Both banks publish reports or statements on the conduct of monetary policy, and both appear before committees of the respective parliaments. And both statutes specify the rights of bank and government in policy determination, and in the event of the government of the day requiring the bank to significantly modify the course of a preferred policy path. In the case of the New Zealand statute the Reserve Bank Governor and the government of the day codify agreed policy targets in a Policy Targets Agreement (which must be consistent with the Bank's principal target). However the government possesses a residual power to direct the Bank to formulate and implement policy for any economic objective, other than the economic objective specified in section 8 of the Act (the principal, objective), for a period (Section 12, Reserve Bank of New Zealand Act, 1989). This provision has, to date, not been actioned by any government. The Australian statute also provides for an override or disputes procedure. Section 11 of the Reserve Bank Act requires the Board of the Bank to inform the government of Bank policy from time to time, and specifies that:

"... In the event of a difference of opinion between the Government and the Board, whether that policy is directed to the greatest advantage of the people of Australia, the Treasurers and the Board shall endeavour to reach agreement.

...If the Treasurer and the Board are unable to reach agreement, the Board shall forthwith furnish to the Treasurer a statement in relation to the matter in respect of which the difference of opinion has arisen.

... The Treasurer may then submit a recommendation to the Governor-General, and the Governor-General, acting with the advice of the Federal Executive Council, may, by order, determine the policy to be adopted by the Bank.

... The Treasurer shall inform the Board of the policy so determined and shall, at the same time, inform the Board that the Government accepts responsibility for the adoption by the Bank of that policy and will take such action (if any) within its powers as the Government considers to be necessary by reason of the adoption of that policy.

"... [t]hat person's knowledge, skill, and experience, and
... [t]he likelihood of any conflict between the interests of the Bank and any interests which that person has or represents" (Section 56, Reserve Bank of New Zealand Act, 1989).

... The Board shall thereupon ensure that effect is given to the policy determined by the order and shall, if the order so requires, continue to ensure that effect is given to that policy while the order remains in operation.

... The Treasurer shall cause to be laid before each House of the Parliament, within 15 sitting days of that House after the Treasurer has informed the Board of the policy determined ...

(a) a copy of the order determining the policy;

(b) a statement by the Government in relation to the matter in respect of which the difference of opinion arose; and

(c) a copy of the statement furnished to the Treasurer by the Board .." (Section 11, Reserve Bank Act, 1959).

This provision too has yet to be formally enacted by either the Board or a Treasurer, although, as subsequent chapters will indicate, the possibility has at times been entertained. So far as this third element of institutional form is concerned, while the institutional regime in which the override or disputes provisions are situated differ, the guiding principle informing each - transparency of process - is common to both, and there are common procedural elements.

However, these similarities noted, substantively and qualitatively the two institutional regimes are quite different. This is manifest in statute, but these differences are also evidenced in the advocacy of the merits of those particular institutional forms by actors within the two institutions. Reserve Bank of New Zealand Governor Don Brash suggested in an interview that the distinctive contribution of the New Zealand model was:

" ... the attempt to leave a decision about the objective of policy to the elected government while still retaining operational independence in the hands of the central bank bureaucrat. There is no other central bank that I am aware of where that's so clearly built into the institutional structures - or at least it wasn't in 1989. It has become more common. The RBA itself has now virtually got a very, very similar framework. The Bank of England has a similar framework, Sweden has a similar framework, but even in those cases I've mentioned there is some aspect of the New Zealand model they haven't got - but the key issue from this point of view is that the government defines the inflation target. The bank is left independent to deliver that target. In the New Zealand case the law has two additional dimensions. One is the requirement by law to make the government's target unambiguously public. That's of course what other banks have also done - I mean Australia and Canada - but the law in our case requires there be a written agreement which must be in the public domain and that's a very important constraint in the behaviour of both politicians and bureaucrats. We can't conspire to crank up the inflation rate in order to achieve a short term political end. So mandatory transparency and, matching the operational independence, a high degree of accountability with reference to the law" (personal interview, 1998).

And former Reserve Bank of Australia Governor Bernie Fraser for his part has identified four elements of the Australian institutional framework which, in his assessment, help

"to protect the Bank's independence and encourages it to be exercised in a balanced way. The four pillars of this framework are ...

Multiple objectives ...

A flexible inflation target ...

Consultations between the Bank and the Treasurer

A good Board ..." (RBA Bulletin, 1996: 17-18).

The thesis

In seeking to account for and explain institutional difference - institutional continuity in one jurisdiction, and a paradigm shift in the other - the thesis posits that particular institutional forms reflect the influence of the political-economy, a dynamic and shifting set of relationships between state and society, specifically economic actors and coalitions of economic interest. In what follows we argue that the institutional context and development of central banking may best be understood in terms of a model that we derive from a political economy perspective.

The thesis focuses on the 1980s and the 1990s, a period during which the intellectual climate of the times - within the rational economics literature in particular - supported a specific institutional prescription. Central banks were to be operationally independent of elected governments and tasked to deliver and maintain price stability. However the rational economics case for central bank independence takes the political process of institutional shaping or reshaping as a given - central bank independence is the prescription, but the rational economics literature has largely treated it as exogenous. The process through which the theoretically and empirically informed prescription is codified into public policy - the shaping or reshaping variously of statute and institution - is outside of the scope of the rational economics inquiry. The absence of the 'political' stands in stark contrast to the theoretical assumptions that inform the diagnosis and the prescription. The diagnosis is one of a contamination of institution and policy by elected politicians who, it is assumed are motivated by a rational utility maximising calculus - they will exploit any policy instruments or levers they have at their disposal to retain political power. The result of this expedient opportunism on the part of politicians is a democratic distemper which the prescription - institutional independence for central banks - seeks to remedy. That

distemper manifests itself in dynamically inconsistent policymaking - short-term and opportunistic political interventions erode the credibility of policy, and result in price setters building in a risk premium. The result is positive inflation. The institutional prescription involves limiting the capacity for elected policymakers to exploit the policy levers and instruments of macroeconomic management they have at their disposal. Politically porous policymaking lacks credibility - credibility requires institutional independence, including an exclusive focus on securing and maintaining price stability. And therein rests a contradiction inasmuch as because the institutions of central banking are creatures of statute - institutional design or redesign requires political codification - logically it requires politicians to act so as to limit their own capacity for opportunistic policy interventions in order for there to be any statutory surrender of policy discretion. Why, and under what circumstances politicians will choose to legislate for central bank independence is one of the issues that our model seeks to illuminate. The model makes the 'political' endogenous.

In essence the prescription suggested by the rational economics literature is designed to maximise institutional and policy credibility. An independence central bank is a credible institution, and one better placed to impart credibility to the development and conduct of policy. That credibility is also enhanced by accountability arrangements that hold the central bank to account for its performance in meeting its mandated or contracted policy objectives. The imperatives are both economic - transparency of process increasing endowments of credibility - and, within a liberal democratic political system, they are also political - in a formal sense accountability arrangements reflect the fact that the mandate or contract emanates, in the final analysis, from the legislative branch of government.

There is a third political dimension, and that is given by the fact that, within the rational economics literature - although to varying degrees - it is acknowledged that in the conduct of monetary policy there is a requirement to balance the need for stable prices with other macroeconomic considerations - such as macroeconomic stabilisation over the short-run. Such balance may be best prosecuted through political 'checks' within the accountability regime. This third dimension provides a bridge from institutional and policy credibility, to the second imperative that our model illuminates - institutional and policy legitimacy. A credible policy may be one that focuses on price stability - but that policy will fail to satisfy the test of legitimacy if the quest for credibility results in collateral damage through adverse impacts on the level or variability of output. In the absence of an appropriate set of incentives and constraints for policymakers, it is entirely possible that policy and policy outcomes will fail to

build 'credibility' with non-financial actors, a form of credibility which, we will argue is best conceptualised as institutional legitimacy. Institutional legitimacy may be a function of how a central bank meets the economic needs of actors in the non-financial sector, and equally it may be a function of the extent to which the preferences of actors regarding the nature of the policymaking and implementation processes are met - for example the extent to which those processes are consistent with democratic principles. Institutional and policy legitimacy is about the economics, and the politics of institutional design and the conduct of monetary policy.

In the model that we elaborate in the chapters that follow, particular institutional arrangements admit of different forms of accountability, and differential endowments of credibility and legitimacy. In the event of a deficit occurring as regards either credibility or legitimacy, we will argue, it is entirely possible that societal interests - the political-economic base on which particular institutional arrangements are built - will seek to prosecute changes to institutional arrangements, including by means of the political process. In this sense we would argue that seeking to illuminate the causes and consequences of institutional arrangements, and trajectories of institutional reshaping requires much more than the assumption of a rational self maximising calculus on the part of politicians - in short it requires the elaboration of a political-economy framework through which to illuminate particular institutional regimes and trajectories of institutional reshaping. We elaborate that framework more fully in Chapter 3, and detail a set of propositions which inform the development of the thesis, and the consideration of research data in the chapters that follow.

The Australasian experience provides an interesting case study in the logic, consequences, and durability of institutional reshaping. In 1989 New Zealand implemented an institutional reform that was based largely on the rational expectations model, and which was codified in statute on the basis of bi-partisan political support. By contrast, institutional reshaping in Australia was, over the period reviewed in this work, the subject of partisan contestation, and an extended political debate over two election campaigns. Australia ended up with a different institutional solution. The argument of this thesis is that the trajectory of institutional reshaping in Australia can be understood by incorporating the imperative of institutional legitimacy into a political-economic analysis.

The thesis speaks to scholars of central banking, to those responsible for the design and/or maintenance of institutional arrangements, and to those responsible for the development and/or implementation of macroeconomic policies, and monetary policy

in particular. The capacity for an institution to influence the trajectory of macroeconomic policy - and, more specifically key outcomes such as the price level, and the level of economic output and employment - is not, in and of itself sufficient reason to place the examination of such an institution on the social science research agenda. However, with the Australasian community of scholars in particular, the failure of those social scientists working within the traditions of political science and political economy to offer insights into the genesis and consequences of institutions such as central banks can only be an egregious omission. With very few exceptions, which we note in Chapter 3, scholars have expended considerable energy detailing the working of systems of political mobilisation and representation, and yet have failed to account for those institutions which, by their very nature, are designed to constrain the influence of the political on the economic.

The thesis therefore represents a significant contribution to scholarship on central banking within the social sciences because it focuses on an institution that has been largely neglected by social science scholars - with the exception of those in the field of economics - the deficit being particularly marked in Australasian research. The fact that the New Zealand institutional arrangements have been widely cited as an exemplar of institutional best practice in and of itself suggests the need to widen the range of disciplinary perspectives through which those arrangements are illuminated.

More importantly however, the political-economy model is a contribution to the wider body of scholarship in the contemporary political-economy of central banks, and, located as it is within the framework of comparative public policy, will move the literature beyond case studies of particular central banks and comparative studies that have relied too heavily on statute-based indices of central bank independence as an independent variable. The political-economy framework, and the model that we elaborate below, serves to account for and explain differences in the trajectories of institutional reform and establishes a causal nexus between institutional reshaping and the political-economic environment within which particular institutions are located.

At one level the model illuminates the political-economic context within which central banks and central bankers manage relations with financial and non-financial actors. At this level the model makes explicit that which is largely implicit in the conduct of central banking. To the extent that central bankers perceive the process of managing those relations as one in which credibility and legitimacy are to be optimised, the model will simply confirm a logic which informs the practice of central banking. However, to the extent that central banks and central bankers fail to appreciate the

nature of the political-economy within which they are situated, the model serves to explain the conditions under which some central bank and bankers risk a formal revisiting of the formal arrangements within which they operate. In this sense the model possesses not only descriptive and analytical, but also a predictive capacity. The model, we will argue, suggests that the present New Zealand arrangements will increasingly come under pressure from societal and political interests concerned to ensure a more appropriate balance of institutional and policy credibility and legitimacy.

For those tasked with shaping or reshaping the institutions of central banking the political economy framework highlights the dangers of institutional choices which fail to optimise credibility and legitimacy within particular configurations. In a normative sense the model suggests why it is that optimising both credibility and legitimacy is both good economics, and good politics.

From difference to similarity: The research strategy

Australia and New Zealand are 'most similar' nations, in terms of their genesis as sovereign states, shared legacy of colonial exploitation and settlement, social and economic structure, political institutions and norms, and cultural values and key totems of national identity. That similarity is both explained by, and evidenced in a common logic of public policy formation characterised as the 'politics of domestic defence' (Castles, 1988: 91).

"'Domestic defence' had three major components, each involving strong regulative intervention in the economy, but rather little in the way of state ownership on the British model ... First, tariff policy and/or import controls were used to protect domestic manufacturing from overseas competition. Second quasi-judicial powers of compulsory conciliation and arbitration of industrial disputes were used to regulate the labour market with the aims of simultaneously achieving a social policy minimum (a 'fair' wage sufficient to support a breadwinner and family) and of adjusting wage levels to take account of fluctuations caused by dependence on highly unstable primary commodity markets. Third, migrant intake was regulated in order to adjust labour supply in the hope of minimising unemployment and protecting the wage levels decided on through the arbitration system. The 'domestic defence' strategy may be characterised in terms of its 'conservative social welfare function', by which any decline in real income was minimised, the government provided insurance against income loss, and social peace was protected by ensuring that 'no significant income shall fall if that of others is rising' (Corden, 1974: 108)" (Castles, 1993: 8).

Indeed the fact of a shared logic of economic development and close parallels in the trajectory and substance of public policy supports the inclusion of the two members of the antipodean community into a 'family of nations' (Castles, 1993: xvii). However our interest in this study is less the contrast between this family of nations and others, a contrast which is more fully illuminated elsewhere (see Castles, 1993), as much as it is explaining what we would contend is a significant element of divergence within the Australasian family. While the seeds of the unmaking or modification of the politics of domestic defence were sown in advance of the election of labour party governments in the 1980s, it is under those governments that the paradigm is revisited, and revisited in such a manner as to quite properly evoke the notion of a revolutionary shift in public policy, and particularly in the role of the state. In both Australia and New Zealand labour party governments came to power in the mid 1980s, the Hawke Australian Labor Party Government in 1983, and the Lange New Zealand Labour Party Government in July of the following year. Both governments adopted reformist programmes, and while the similarities of those two programmes can be overstated (Easton and Gerritsen, 1996), common to both, and to the English-speaking nations more generally, was a policy transformation of two types:

"... a retreat from the socially protectionist welfare state and a shift away from economic nationalism or 'domestic defence' towards internal economic deregulation and/or freeing up of trade barriers. In each case, the general thrust of policy change and its particular manifestation may be interpreted, at least, in part, as a response or reaction to the peculiar character of existing policy strategies. Nonetheless, what is of particular interest is the overall contrast between these countries and the other advanced Western nations in which a redefinition of the role of the state did not surface on the political agenda as serious issues on anything like the same scale" (Castles, 1993: 11).

What is common makes that which is different all the more remarkable, and invites the use of a most similar systems strategy (Przeworski and Teune, 1970; Castles, 1991; Bray and Walsh, 1992; Collier, 1993). As Castles notes there are two possible strategies by which a comparativist may seek to illuminate the causes and consequences of difference or similarity:

"A most different strategy is that which is used when we are seeking to understand patterns of similarity. If we can locate some particular feature which very diverse nations have in common, we are entitled to suggest that it is attributable to one of the few other attributes they share...The mark of a study employing a 'most different' strategy is a conscious effort to increase potential diversity in the group of nations under investigation, since each additional country with new characteristics added to the sample rules out further alternative explanations.

A 'most similar' strategy is that which is used when we are seeking to understand patterns of diversity. If we can locate some particular feature in

which otherwise very similar nations differ, we are entitled to suggest that it is attributable to one of the few other factors distinguishing them ... Studies employing the 'most similar' strategy generally, but by no means invariably, tend to focus on fewer cases than those using a 'most different' one for the obvious reason that for each attribute on which nations are matched - how rich they are or whether they are democratic for instance - more and more are ruled out. Which attributes are matched is, of course, a matter of the question we are asking" (1991).

The 'most similar' systems strategy parallels the use of the classical experimental model in which seeking to explain difference, one controls for all common variables, and identifies that independent variable in which causality resides. But, as Castles notes,

" ... no group of nations is ever anything like that similar, so that there are always alternative sources of difference competing as the rival explanations of diversity..." (1991:7)

Australia and New Zealand offer a 'classic example' of a most similar systems research design (Bray and Walsh, 1992), and accordingly provide the opportunity to identify that variable or set of variables which might explain an element of difference. We have then two most similar nations within which, it has been argued, the development and policy trajectory of each has been influenced by a common logic, and manifested in the politics and the policies of domestic defence. And we have a logic of comparative inquiry, which, in the case of the 'most similar systems approach, lends itself to the explanation of difference.

Structure

The argument is developed in four parts. In Part I we review two sets of literatures (the rational economics literature in Chapter 2 and the political-economy literature in Chapter 3), develop a model within the framework of political-economy, and articulate a set of propositions which are then tested in the following chapters. Chapter 2 provides an exposition of the theoretical and empirical foundations of the rational economic case for central bank independence. That case is predicated on the endogeneity of the political, in the sense that the normative case for central bank independence is informed by the objective of limiting the capacity for opportunistic policymaking on the part of political incumbents seeking to retain office. Chapter 2 reviews the theoretical and research literatures which underpin the normative case for central bank independence. That case, we argue is informed by the requirement that the development and implementation of monetary policy satisfy the test of credibility - and in particular credibility in the eyes of those financial actors with whom the central

bank interacts within finance markets, and credibility in the eyes of those setting prices in forward contracts. But Chapter 2 also signals an on-going debate within the rational economics literature regarding the influence of monetary policy on the real economy over the short run, and over the long run. While the orthodox case for central bank independence is predicated on the assumption of the neutrality of monetary policy over the long-run, that assumption is not an uncontested one. Moreover, even if, as the orthodox case would have it, monetary policy should have a medium term focus on price stability, the fact that, over the short-run, the Phillips Curve is not vertical, suggests that the practice of central banking, and possibly the design of the institutions of central banking, should reflect the possibility of tension between the objective of price stability on the one hand, and issues of macroeconomic stabilisation on the other.

In the context of the thesis as a whole the rational economics literature provides a common backdrop to the environment within which policymakers responsible for the institutions of central banking in Australian and New Zealand have exercised choices over the shaping or reshaping of those institutions. Intellectual opinion has evolved over the period reviewed in this research, but there has been a constant theme in the intellectual climate - and that constant theme has been the desirability of central bank independence. The rational economics prescription was evidenced very clearly in the development of the Reserve Bank of New Zealand Act 1989, which conformed to the intellectual climate of the times, and received its clearest expression in that statute. By contrast the Australian model was, and is, at variance with a number of defining features of that orthodox institutional prescription.

Chapter 3 reviews the political-economy literature on the institution of central banking, and develops an argument predicated on the endogeneity of the political. That argument reflects the fact that Downsian assumptions import a rational economic calculus to the conduct of politics, and that in remedying the problems created by opportunistic policymaking the solution involves political arrangements - political in the form of accountability regimes designed to ensure that policy is credible, and political in the sense that the formal codification of institutional form typically involves the legislative process. But the endogeneity of the political is elevated by a further step, and that is to assume that choices over institutional form - over the shaping or reshaping of institutions - reflect the political-economy within which those choices are made. The rational economics literature suggests that the development and implementation of monetary policy - in short the institution of the central bank - will need to be credible. The political-economy literature suggests a further necessary quality of policymaking and of institutions - that they be perceived as credible, and

legitimate. Accountability is therefore seen as a sub-set of both credibility and legitimacy, and the political-economy literature, in viewing institutional forms as the superstructural manifestation of the underlying configuration of interests in the political-economy, suggests the kind of imperatives at work in the shaping and reshaping of institutions, and the conditions under which both credibility and legitimacy might be optimised. The framework serves as the basis for the development of a set of propositions which are detailed at the close of Chapter 3, and which inform the discussion in the chapters that follow.

Part II of the thesis illuminates two contexts - the historical context within which the institutions of central banking in Australia and New Zealand have been shaped, and the context out of which the Reserve Bank of New Zealand Act 1989 emerges. Both contexts allow for the testing of a number of the propositions advanced in Chapter 3. Chapter 4 provides a capsule history of the institutions of central banking in Australia and New Zealand up to the decade of the 1980's. In part the chapter situates the past as prologue, seeking to explain the present - and anticipate the future - as a function of accumulated policy experience over time. But this chapter also provides an opportunity to test for prima facie evidence of the political-economy model elaborated in Chapter 3, specifically the extent to which particular societal interests and coalitions of interest seek to prosecute preferences regarding institutional form through the political process, and also the extent to which preferences and policies conform to a partisan pattern over time.

Chapter 5 focuses on the genesis and passage of the Reserve Bank of New Zealand Act 1989. This episode of significant institutional reform - the shaping of a new set of institutional arrangements - provides an opportunity to test propositions relating to the conditions under which such reform might occur. The political-economy model suggests that reform consistent with the rational economics prescription for central bank independence - in which central banks are for the purposes of the conduct of monetary policy, operationally independent of governments - requires a coalition of private economic interests sympathetic to and supportive of a change of this kind, and a government, more likely a government with little prospect of (or interest in) continued tenure in office, concerned to tie the hands of its successor. The case of the Reserve Bank of New Zealand Act 1989 provides an opportunity to test propositions relating to institutional disequilibrium and change. The Reserve Bank of New Zealand Act 1989 is also of interest because it provides the backdrop for the debates over the Reserve Bank of Australia over the period from the late 1980s. The case for some reshaping of the Australian arrangements predated the passage of the New Zealand legislation, but

was provided with a greater measure of focus and precision once the New Zealand model was in place.

Part III of the thesis illuminates the debate within Australia over the institutions of monetary policy in the period from 1983 to the present. Part III consists of three chapters, the first of which traverses the period from the Whitlam Government of 1972-75 through until the end of Bob Johnston's tenure of Governor of the Reserve Bank of Australia in September 1989. This period is of interest for a number of reasons. The experience of the Whitlam Government was an important influence on those within the Australian labour movement concerned to avoid a repeat of the stigma of macroeconomic mismanagement which attached itself to that government. Further, the Fraser Government's adoption of orthodox monetarist techniques - the first government to embrace monetary base targeting, and well in advance of the more celebrated 'monetarist' programmes of the Thatcher/Reagan era - served to influence the development of a 'labourist' alternative which included credible anti-inflation policies.

Chapter 7 focuses on the period from late 1989 through until September 1996, at which point Bernie Fraser's term as Governor came to a close, with his successor as Governor, former Deputy Governor Ian Macfarlane, negotiating an agreed statement on the conduct of monetary policy with a new Treasurer, Peter Costello. The period is one during which the contest over the institutions of central banking in Australia was joined with a vigour and a passion not seen since the contests over the nationalisation of the banking system in the immediate post-war period. As we have already noted the New Zealand model would provide an important back-drop to that debate, the contest being very much one as between the relative merits of two increasingly divergent approaches to the institutions of central banking.

Chapter 8 provides an evaluation of that contest, an evaluation which takes as its point of departure some of the defining features of the Australian model, and which, by means of material generated from interviews with a number of the key actors involved, provides a further test of propositions derived from the political economy model - propositions which hold that the conditions of institutional continuity are to be found in the political-economy in which central banks are situated (and which they have a capacity to influence). Institutional equilibrium, it will be argued is a function of a supportive societal coalition, and the existence of such a coalition is in turn dependent upon a central bank managing relations with private economic interests and coalitions such that both credibility and legitimacy are optimised.

Part IV of the thesis draws together the elements of the preceding chapters in a concluding Chapter 9. The Chapter reviews the theoretical framework, the findings reported in earlier chapters, and draws out the implications of those findings for scholars of central banking, and public policy practitioners. The conclusion locates the trajectory of institutional reform in both countries - the shaping and reshaping of the central banks - within the political-economy model, anticipates the likely trajectory of policy over the short to medium term, and foreshadows new lines of theorising and research in the political-economy of central banking.

Chapter 2

The Economics of Central Banking

Introduction

This chapter will focus on the economic imperatives driving institutional design and reform, imperatives which have their genesis in both theory and in empirical evidence. Chapter 3 will focus on the political economy of central banking. In part the rationale for developing the argument in this way rests on a distinction between a technical/economic analysis, and a political economy approach - in the former central bank independence is treated as exogenous, whereas in the latter the determinants of particular institutional arrangements are explored (Bowles and White, 1994: 241). The technical/economic analysis, "reduces complex institutional structures to a single variable, 'central bank independence'", while the political economy approach,

"... examines the relationship between the various politico-economic forces and interests which act to constitute and maintain institutions The political economy approach ... stresses that the evolution of the status of the central bank is not ordained by natural factors, nor can it be explained in terms of simplistic imputations about the behaviour of governments, but is rather the outcome of more complex and dynamic political processes" (Bowles and White, 1994: 241).¹

For the purposes of the discussion in this and the following chapter we draw a distinction between the rational economics literature (or a 'technical/economic' analysis) and a political economy approach. Clearly however the conceptual boundaries between the disciplinary domains of economics and politics are indistinct, and the fact that the normative import of the former - as regards institutional design - is given practical effect in the latter suggests that the arbitrary imposition of disciplinary boundaries will be limiting.²

¹ The rationale is also reflected in part by the distinction that has been drawn between a 'social welfare' and a 'political' approach to central bank behaviour:

"The recent literature on monetary policy games has given two competing interpretations to the objective function of monetary policymakers ... One part of the literature regards this function as a social welfare function and the central bank as a benevolent social planner ... The other part views the central bank as a mediator between different interest groups that try to push monetary policy in various, not necessarily consistent, directions ... " (Cukierman, 1992: 43-45).

² Moreover, within the discipline of economics, while 'rational economics' constitutes the prevailing orthodoxy - and has, in a normative sense informed the institutional design of central banks - a range of contesting or heterodox positions have also been advanced, including from economists of a Post-Keynesian persuasion (see for example the minisymposium in the Journal of Post Keynesian Economics, Vol. 18, No. 2, Winter 1995-96).

As we noted in the preceding chapter, at the level of the formal institutional arrangements there are quite marked differences in the statutory provisions that obtain in the Australian and the New Zealand jurisdictions. Whatever the reasons for the formal institutional divergence - and that is the issue to which the balance of this work is directed - the New Zealand arrangements are clearly consistent with the prevailing economic paradigm, and there are, by contrast, resonances with an earlier macroeconomic disposition in the Australian arrangements. The distinction between the prevailing orthodoxy and the earlier 'Keynesian moment' rests on the latter's assumption of an exploitable Phillips Curve relationship between inflation and employment - that policymakers faced a choice between higher inflation and lower unemployment, with any trade-off being both durable and stable over time. The expectations augmented Phillips Curve demonstrated that any such trade-off was neither durable, nor stable over time. And the implications for policymakers were manifold - with, arguably, there being no trade-off over the long-run, a rate of unemployment below the 'natural' or 'non-accelerating inflation rate of unemployment' (NAIRU) would result in accelerating inflation. Moreover there were two further implications for the design of institutions and the conduct of monetary policy - monetary policy was neutral in its effects on the real economy over the long-run, and should be exclusively directed to stabilising prices in the economy.

The analysis that follows seeks to further illuminate aspects of the prevailing paradigm, the implications for the design of monetary policy institutions (including relations between politicians and non-elected policymakers), some of the caveats that may constrain the case for institutional design, and the challenges posed by institutional design and the conduct of policy within democratic polities. The institutional prescription places a premium on a rules based over a discretionary policy regime. And the essence of the normative case is the advocacy of central bank independence - a set of institutional arrangements within which the conduct of monetary policy is undertaken independently of elected policymakers.

In this chapter the focus is on the economics of central bank independence, and the theoretical and empirical underpinnings of central bank independence as an institutional prescription. To rehearse the argument that is developed below, the conduct of monetary policy is subject to a 'dynamic inconsistency' constraint, which results from a combination of politicians implementing monetary policy according to a Downsian calculus (Downs, 1957), lags in the implementation of policy, and adaptive behaviour on the part of price setters in markets. The institutional resolution is seen in distancing the operation of monetary policy from politicians, vesting that responsibility

in independent central banks and bankers, and operating policy within a medium to long-term framework.

We open the discussion by examining the theoretical case for central bank independence, reviewing issues of dynamic inconsistency, credibility, and reputation; and then review some of the empirical evidence on Political Business Cycles. The discussion then turns to the notion of central bank independence, reviews some of the conceptual, definitional, and measurement issues, and concludes by noting some critiques of the standard measures of central bank independence. The next section reviews the literature on central bank independence and macroeconomic outcomes, and then turns to a consideration of two caveats to the prevailing orthodoxy - the neutrality of monetary policy at zero inflation, and the validity of the NAIRU (the non-accelerating inflation rate of unemployment). The following section provides a reprise on the various institutional remedies to the inflation 'bias', and we then examine the challenges posed by remedies which risk sub-optimal outcomes.

The concluding sections of the chapter use the concept of central bank independence to exercise some leverage on the notion of central bank accountability, and a two-fold conception of accountability is introduced. The chapter closes with an assessment of the relationship between independence and accountability, and we suggest that a political economy approach may serve to further illuminate the determinants and consequences of both central bank independence and accountability.

Credibility, dynamic inconsistency, and reputation

Support for central bank independence has been nurtured and sustained by the contributions from the economic 'credibility' literature (Kydland and Prescott, 1977; Barro and Gordon, 1983b; Rogoff, 1985; Blackburn and Christensen, 1989; Swinburne and Castello-Branco, 1991; and the review in Argy, 1988). The literature makes assumptions about the preferences of monetary authorities under conditions of greater or lesser independence from short-term political imperatives. This work is premised on a number of assumptions. It is assumed that inflation is an economic bad. It is further assumed that monetary policy ultimately affects only the general price level, and that unexpected fluctuations in monetary policy can induce temporary effects on output and employment. When the assumption that increases in output are attractive to voters, and hence to politicians, is factored in, the result is an incentive for politicians to fool price setters by encouraging a reduction in expectations, and to then loosen

monetary policy (for example by way of a stance accommodating of some fiscal expansion) to produce electorally favourable economic circumstances by way of increased output (Capie and Wood, 1991:28).

Simply put, the game that politicians and voters play is as follows: politicians attempt to reduce expectations of future inflation such that price setters in the markets assume a future rate and lock that rate in. There is then an incentive for the government to engineer an electorally propitious set of circumstances in a pre-election period by way of stimulation that increases output, but also produces a 'surprise' inflation. The result is assumed to be a positive electoral outcome for the incumbent (depending of course on where the balance of electoral advantage rests - the extent to which the median voter is more responsive to a surge in output than a (subsequent) increase in the price level). The 'time inconsistency' constraint is a variation on the same theme. If it is assumed that private sector agents are able to calculate the government's incentives in advance, an announced commitment to price stability will not be credible since it is 'time-inconsistent' with the government's (Downsian) post-announcement incentives. Agents will then form positive inflationary expectations and factor these expectations into price setting and risk premiums. In a review of the rules versus discretion debate Argy illustrates the dimensions of 'time inconsistency' by way of the following example:

"The central bank announces for a given year a low money growth, low inflation target. Workers faced with this announcement have to decide what their wages policy should be for the year (say the annual contract). They have two options but there are four potential outcomes. Workers can opt for a low wage policy consistent with the announced money growth and expected inflation or they can opt for a high wage policy inconsistent with the announced money growth plan and implicit inflation. In turn the monetary authorities can (a) stick with the original game plan (b) modify their game plan in the light of actual settlements" (Argy, 1988: 169).

Turning to the normative or prescriptive import of the 'credibility' thesis, the cure for this malaise rests in a set of institutional arrangements through which the policy maker is constrained. Typically having a central bank independent of government is seen as an appropriate institutional constraint (Capie and Wood, 1991:28). While in their seminal contribution Kydland and Prescott stop short of recommending a specific institutional form for central bank/government relations, the implications of their preference for rules based over discretionary arrangements are clear:

"[T]he implication of our analysis is that policy makers should follow rules rather than discretion. The reason that they should not have discretion is not that they are stupid or evil but, rather, that discretion implies selecting the decision which is best, given the current situation. Such behaviour either results in consistent but suboptimal planning or in economic instability...

There could be institutional arrangements which make it a difficult and time consuming process to change the policy rules in all but emergency situations"(Kydland and Prescott, 1977:487).

Rogoff's 1985 paper, to which we return below, makes the case for institutional arrangements which place a premium on the realisation of price stability objectives by central banks - the so-called 'conservative central banker' solution:

"[i]t can be entirely rational for society to structure its central bank in such a way that the monetary authorities have an objective function very different from the social welfare function. Whenever a distortion causes the time-consistent rate of inflation to be too high, the society can be made better off by having the central bank place "too large" a weight on inflation rate stabilisation" (1985:1187).³

The 'reputation' solution represents a variation on the theme (see Barro and Gordon, 1983b, Barro, 1986, and the discussion in Blinder, 1998). In essence this solution rests less on particular institutional forms than on sufficient transparency in the conduct of monetary policy allowing a central bank to reveal its own preferences, reduce preference uncertainty in the markets, and reduce any 'inflation bias' (Briault, Haldane and King, 1996). A further institutional remedy, which is also the subject of more detailed examination below, involves the use of an optimal performance contract by means of which an elected policymaker (the principal) can specify the policy outputs required of a central bank governor and/or board (the agent), and in which the latter is provided with the requisite technical or operational independence (see Fischer, 1996:201; Rogoff, 1985; Walsh, 1995a; Persson and Tabellini, 1993).

Support for institutional arrangements limiting the discretion of political authorities is further provided by the contributions of the political business cycle literature discussed in the following section.

Political business cycles and institutional remedies

The political business cycle literature makes explicit assumptions about the preferences of politicians only alluded to in our earlier discussion of the economic credibility literature.⁴ The conceptual antecedents of the literature can be traced to Anthony Downs and the incorporation of the economic assumptions of methodological individualism to the study of political behaviour (Downs, 1957). Indeed Downs'

³ See also Lohmann, (1992), the discussion in Briault, Haldane and King, (1996: 21), and the critique of the credibility thesis by Forder (1998).

⁴ The Political Business Cycle literature has been subject to a measure of critical scrutiny (see for example, Alt and Chrystal, 1983; Whynes, 1989; Elliot and Whiteley, 1990).

advocacy of a common methodological currency between economics and politics allowed government to become endogenous to the models used: "The party which runs (the) government manipulates its policies and actions in whatever way it believes will gain the most votes" (Downs, 1957:31).⁵

Common to much of the literature is the assumption that the economy is subject to manipulation by way of short-run Phillips Curve trade-offs. Politicians enjoy the facility of economic manipulation, and exploit the myopic propensities of the electorate. Accordingly, voters, " ... vote for the incumbent if the economy is doing well (low unemployment, high growth, low inflation) immediately before election" (Alesina, 1989:63).

Empirical support for the existence of political business cycles was suggested by Nordhaus, who in a seminal paper reported evidence of a cycle in the case of six of the nine countries included in his analysis, and concluded by advancing five remedies for the 'biases' inherent to the democratic system.⁶ The first is the 'classical' political solution of providing perfect information to voters; the second, changing the length of the electoral period, thus reducing the amplitude of cycles; the third, the development of an incomes policy approach to economic management; the fourth broadening the basis of participation in economic policy making; and the fifth, "entrusting economic policy to persons who will not be tempted by the sirens of partisan politics" (1975:188).⁷

And while Alesina concedes that there may be trade-offs associated with central bank independence, he suggests that, "one institutional mechanism to enforce policy rules could be provided by independent agencies (such as Central Banks) not subject to each government's discretion" (1989:82). Alesina argues that institutional arrangements

⁵ Downs subsequently resiled from some of the arguments advanced in "An Economic Theory of Democracy" (See the discussion in Stretton and Orchard, 1994: 26-31).

⁶ The initial Nordhaus formulation was advanced by the incorporation of ideological and opportunistic political parties in Partisan Theories, (Hibbs, 1987, 1990, Nordhaus, 1989), and by the incorporation of the tenets of rational expectations, and the consequential development of Rational Partisan Theories (Alesina, 1989). These recent contributions have continued to add to the normative import of the literature. Alesina reports evidence of a an 'excessive variability' in policy making as a result of partisan manipulation, and suggests that a rules based approach to macro-economic policy management is superior: "...commonly agreed policy rules, such as a monetary rule and/or a budget balance rule can bring about some degree of 'inter-temporal' policy coordination' between governments in office at different times in a particular country" (1989:82).

⁷ It is noteworthy, in the context of debates over how best to ameliorate the adverse implications of expedient or opportunistic political intervention in economic management, that among the remedies that Nordhaus suggests are a number which seek to broaden participation in the process of economic policy formulation, not just to limit the scope for such intervention by way of institutional reforms that effectively insulate policy instruments.

could conceivably limit executive discretion while at the same time elevating the role of the legislature (1989:83), and notes that an optimal rule, far from being a 'monetarist fixed growth rule' (see Friedman, 1959), may provide,

"... a certain degree of discretionality in policy making to avoid the risk of being institutionally locked into a monetary rule which becomes highly inefficient in a particularly exceptional time... [T]he institutional design... should target the optimal point in the trade-off between rigid rules and discretion." (1989:83)

But in both the early and more recent contributions to the political business cycle literature, there is the acknowledgement that institutional reform is not without its attendant down-side risks. For Nordhaus, it is questionable whether those risks are sufficiently justified:

"It may be objected however that delegating responsibility to an agency which is not politically responsive to legislature needs is even more dangerous than a few cycles. The danger is frequently alleged regarding central banks which pay more attention to the 'soundness of the dollar' or the latest monetarist craze than to fundamental policy problems. The costs and benefits of independent policy determination are difficult to weigh" (1975:188).

These concerns are shared, in part at least by Alesina, who notes that included among the difficulties associated with placing the central bank on an independent footing, is the fact that,

"... one may not want to give up democratic control over monetary policy. Indeed society may want to make sure that the goals of an independent agency, such as a Central Bank, do not deviate from social objectives" (1989:83).

Defining and Measuring Central Bank Independence

Leverage on the issue of central bank independence can be exercised by an institutional approach, which seeks to illuminate the nature and consequences of independence by reference to cross-national variations in the formal or legal dimensions of central banking arrangements and variations in performance, and/or alternatively, by a behavioural approach which lends itself more to the single national case and the historical method.⁸ The discussion that follows draws on the institutional approach,

⁸ The behavioural approach, examined in more detail in the following chapter, is exemplified by Woolley's analysis of the United States Federal Reserve, and the German Bundesbank. For Woolley,

"a central bank can be considered to be independent if it can set policy instruments without approval from outside authorities, and if, for some minimal period of time, the instrument settings clearly differ from those preferred by the fiscal authority" (1985:321).

which has the advantage of lending itself to the comparative method, of indicating the preferences of legislators, and of signalling changes in those preferences over time.

Within the institutional literature there is however the acknowledgement that an exclusive focus on institutional arrangements risks failing to take account other imperatives that may be key determinants of central bank independence, and of the nature of relations between central banks and political authorities. As Cukierman *et al* note,

"[a]ctual, as opposed to formal independence depends on the degree of independence conferred on the bank by law, but also on a myriad of other less structured factors such as informal arrangements between the bank and other parts of government, the quality of the bank's research department and the personalities of key individuals in the bank and other economic policy making organisations like the Treasury" (1991:1, see also Grilli *et al*, 1991:365).⁹

Generally speaking institutional arrangements as between central banks and governments fall into one of three types (Holtfrerich, 1988:105). Integration characterises cases where the monetary authority forms part of the government, subordination where the government has the right to instruct the central bank and thus to control its actions, and autonomy where central banks are empowered to act on their own, independently of instructions either by government or any other institution. It is generally acknowledged that, in the final analysis, all governments possess at least some residual power to instruct the central bank (see Swinburne and Castello-Branco, 1991:5). What tends to differ is the extent to which national sets of institutional arrangements provide a measure of insulation from intervention. In some cases, and the Bundesbank is the most often cited case, the central bank enjoys a measure of autonomy not dissimilar to that typically afforded the courts and the judiciary in liberal democracies, in others, as we discuss below, the measure of independence and

Accordingly, central bank independence is evidenced in a situation in which,

"for some short but meaningful period of time the resources of the fiscal authority do not guarantee that its preferences dominate in monetary policy." (1985:321)

⁹ And quite clearly institutional indicators are by their very nature a rather blunt means of detecting changes in policy. To anticipate the discussion in subsequent chapters changes in the conduct of monetary policy in New Zealand, as but one example, anticipated by some five years the change in statute in 1989. The conduct of monetary policy over the period from late 1984 until the present has remained relatively consistent, notwithstanding the fact that the legislative changes in 1989 changed the formal institutional status of the Reserve Bank of New Zealand from being one of the least to among the most independent of the central banks in the OECD group of countries. Where the preferences of bankers and politicians converge, the formal institutional manifestations of independence - evidenced by means of the statute reading approach - clearly become less relevant.

central bank autonomy is somewhat more circumscribed.¹⁰

A number of studies have utilised an index of central bank independence developed by Bade and Parkin (1985) (for example Masciandaro and Tabellini, 1988; Alesina, 1989; Busch, 1992).¹¹ The Bade and Parkin four fold classification accounts for a number of the institutional characteristics of central banks, including, "the formal institutional relationship between the Central Bank and the Executive (for instance who appoints the head of the Central Bank, and how often, the presence of government officials on the executive boards of the Central Bank, and so on); the extent of formal contacts between the Executive and the Central Bank; and the existence of rules forcing the Central Bank to automatically accommodate fiscal policy" (Alesina, 1989:81). This definition combines aspects of control over the means, and the goals of monetary policy.¹²

Grilli *et al* differentiate between the political and the economic aspects of central bank independence, with the former defined as the capacity to choose the final goal of monetary policy, such as inflation or the level of economic activity, and the latter as

¹⁰ Holtfrerich makes the point that,

" ... formal subordination of a central bank to government control may restrict a central bank's room more manoeuvre much less than subordination to monetary policy rules...such rules ties the hands not only of central bankers but of governments at the same time. Therefore cases where the central bank is subordinated to the government and also subjected to monetary policy rules may have to be judged differently from rules where the bank is subordinated and monetary policy is left to discretion rather than rules" (Holtfrerich, 1988, emphasis added).

A non-contingent monetary rule (and arguably an inflation target) may be conceived of as limiting, not advancing the extent of a central bank's independence. In an earlier paper (Eichbaum, 1993) we advanced the suggestion that equating the existence of an exclusive price stability objective with central bank independence was confusing instrument and goal independence and that one needed to differentiate central bank independence from central bank autonomy. This distinction was based in part on that advanced by Grilli *et al* who have suggested that independence is typically conceived as going to the institutional nature of relations between government and central banks, or political independence, and to the capacity of central banks to effectively control the instruments of monetary policy, or economic independence (Grilli *et al*, 1991). This is consistent with the distinction between goal independence and instrument independence subsequently advanced (Fischer, 1995: 202, DeBelle and Fischer, 1995). Clearly the Reserve Bank of New Zealand, given this distinction, is goal dependent, while possessing instrument independence. This distinction notwithstanding, issues of independence and autonomy have been conflated in the literature, and measures of central bank independence have tended to equate goal dependence (where the goal is a price stability target) with central bank independence (and conversely, those banks that possess a degree of goal independence, which is to say those that have charters directing them to multiple objective, have typically been viewed as less than independent institutions (see the discussion in Eichbaum, 1993; Grilli *et al*, 1991).

¹¹ Bade and Parkin's initial study is generally referenced back to an unpublished manuscript, however details are canvassed in Parkin (1978).

¹² Maxfield takes the standard definition of central bank independence - "discretion over both the goals and tools of monetary policy .." (1997: 20), and, in addition, suggests that central bank independence may also be associated with central bank authority where the central bank is consulted, and has its views seriously considered by those policymakers responsible for policy tangential to, but potentially impacting on monetary policy (1997: 20).

the capacity to choose the instruments with which to pursue those goals (1991:366). Political independence is operationalised by way of three institutional aspects of the legislative regime, "(i) the procedures for appointing the members of the central bank governing bodies, (ii) the relationship between these bodies and the government; and (iii) the formal responsibilities of the central bank" (1991:366-367). The nexus between the economic credibility literature and the definition of 'independence' is quite transparent. While Grilli *et al* suggest that the independence to choose the goals of monetary policy (goal independence),

"can be defined without reference to the content of such goals... [i]n practice, however the main virtue of having an independent central bank is that it can provide credibility. This is why we identify independence with autonomy to pursue the goal of low inflation. Any institutional feature that enhances the capacity to pursue this goal, will, on our definition, increase central bank independence" (1991:367, emphasis added).¹³

Cukierman *et al* have suggested three measures of independence with the objective of developing, "unified and broadly based" measures of independence (Cukierman, Webb and Neyapti, 1991).¹⁴ Two indices of legal independence are developed (weighted and unweighted) on the basis of eight variables combining elements not dissimilar to the measures of political and economic independence identified by Grilli *et al*, and noted above.¹⁵ Cukierman *et al* follow the convention of giving weight to the presence of price

¹³ Details of the actual coding for political independence are to be found in Grilli *et al* (1989:368, Table 12) The index of political independence is a composite of scores for the nature of the appointment process (whether the central bank governor is appointed by the government, whether the governor is appointed for a period greater than five years, the extent to which board appointments are made by the government, and whether the board is appointed for a period greater than five years); the relationship with the government (whether there is mandatory participation by a government representative on the board, and whether government approval of monetary policy formulation is required); and the central bank's constitution (whether the bank's goals include the requirement to pursue monetary stability, and whether there are legal provisions that strengthen the bank's position in conflicts with the government) (Grilli *et al*, 1991:368).

Economic independence is defined by reference to two factors; the influence of the government in determining how much to borrow from the central bank, and the nature of the monetary instruments under the control of the central bank. These are in turn operationalised by way of seven factors, five of which relate to the monetary financing of the budget deficit, and two the control of monetary instruments, which combined give an index of economic independence. Grilli *et al* note that measures of political and economic independence are not always positively correlated, and suggest that, "a ranking that pays attention to only one of the two dimensions can give rise to very misleading international comparisons" (1991:370).

¹⁴ Cukierman *et al* suggest that measures of legal independence, notwithstanding the inescapable measure of subjective judgement exercised in their compilation, allow for a measure of engagement with other research, and have the ~~added~~ utility of suggesting the degree of independence legislators sought to confer on central banks (1991:7).

¹⁵ For Cukierman *et al* the legal characteristics are divided into four elements, the first of which relates to the appointment, dismissal and term of office of the Governor of the bank, the second to the provision of conflict resolution procedures in the event of conflict between the executive branch and the bank, and to the degree of participation of the bank in both the formulation of monetary policy and in the budgetary

stability objectives in determining independence, to the point of equating an exclusive mandate to pursue price stability with central bank independence:

"Central banks in which the only or main objectives of policy (as specified in the charter) is price stability are identified as being more independent in this dimension than central banks with a number of objectives in addition to price stability" (1991:9).

Two further indices of central bank independence are suggested by Cukierman *et al.* The first of these involves using the rate of turnover of central bank governors as a proxy for central bank independence - in effect developing a behavioural index - the authors suggesting that this measure overcomes the methodological weaknesses inherent in equating legislative provisions with actual behaviour (1991:17)¹⁶. The third measure of central bank independence is generated by responses to a questionnaire forwarded to 'qualified individuals' in 24 central banks. Questions asked went to five sets of issues; the legal aspects of central bank independence, the actual practice of bank independence (when it differs from the stipulation of the law), monetary policy instruments and the agencies controlling them, intermediate targets and indicators, and the final objectives of monetary policy and their relative importance. (1991:19)¹⁷

Central Bank independence and macro-economic outcomes

The better part of the comparative evidence that has been brought to bear on the relationship between central bank independence and economic outcomes has sought to demonstrate a relationship between the degree of independence and inflation performance (see the review in Eijffinger and De Haan, 1996). Typically the focus of research has been subsets of the developed nations of the OECD group, although the consequences of central bank independence have also been explored by way of more defined groups of nations (Kurzer, 1988; Uusitalo, 1984, Busch, 1992). Kurzer explores

process, the third to the final objectives for monetary policy provided in the bank's charter, and the fourth to the nature of the legal restrictions on the ability of the public sector to borrow from the central bank (1991:8).

¹⁶ Citing as an example, the case of Argentina where, while the legal term of office for bank governors is 4 years, traditionally the post is offered up whenever there is a change of government or finance minister. The authors do however note the caveat that a low turnover rate may imply a subservient governor.

¹⁷ Way suggests that three aspects of the institutional structure influence the capacity of central bankers to choose goals; personnel procedures (including who appoints the chair and members of the governing body, the length of appointments, and whether provisions for dismissal exist); rules governing the relations between the bank board and elective bodies, (whether a member of government oversees bank activities or sits on the bank board, and whether the cabinet has ultimate legal authority over policy in the case of conflict); and the legal mandate of the central bank (whether the bank has legally mandated objectives, such as the Bundesbank's writ to achieve price stability) (1992:14).

the relationship between what she describes as central bank 'autonomy', and labour market performance in Austria, Belgium, the Netherlands and Sweden, and attributes the lack of central bank autonomy to pursue any goal other than low inflation as the reason for the higher levels of unemployment in Belgium and the Netherlands:

"[B]ecause the Swedish and Austrian central banks are more integrated in the policy process and their countries are not members of the Common Market or the European Monetary System, social democratic governments have been able to go against the European trend of monetary restrictiveness and fiscal austerity" (1988:21).¹⁸

Uusitalo (1984) suggests that there is a relationship between central bank autonomy and the propensity for a monetarist or a Keynesian policy set to emerge:

"[T]he Nordic countries with a strong central bank autonomy have applied a more monetarist oriented economic policy, whereas those with a weaker central bank autonomy have applied a Keynesian economic policy" (Uusitalo, 1984:45).

With few exceptions most studies of the effects of central bank independence have focused on inflation performance. Alesina, for example suggests that more independent central banks are associated with lower levels of inflation. For his sample of central banks from 17 industrialised nations Alesina concludes that in the period 1973-1986, "the four most independent central banks (Japan, the US, and especially Germany and Switzerland) have been associated with four of the five lowest inflation rates" (1989:81).¹⁹ Alesina cautions however against viewing this association as a causal relationship, noting that, "it may suggest that countries with a preference for low inflation prefer to set up independent Central Banks as the most effective means of achieving this goal" (1989:82).

By contrast, in an earlier study, using a similar measure of central bank independence, Masciandaro and Tabellini (1988) explored inflation performance over three periods, 1970-74, 1975-79, and 1980-85 for the five 'Pacific Basin' countries (Australia, Canada, Japan, New Zealand and the US) and report only a weak relationship, with a rank correlation coefficient of 0.4 (1988). Capie and Wood (1991) examine the effect of 'bank/government' relations for fifteen countries on long-run inflation performance,

¹⁸ Although, Austria has adopted the policy of tying the value of the Schilling to the Deutschmark, which suggests a large measure of policy dependence.

¹⁹ Alesina's ranking of Japan's central bank has not gone uncontested. Capie and Wood (1991) note that when Japan is re-classified (from independent to dependent) the rank correlation coefficient for dependency and inflation performance changes from 0.9657 to 0.6679 (1991:42).

using a classification system sensitive to the marginal status of some central banks.²⁰ They conclude that, "what is striking is the remarkable similarity over such a long period between the performance of dependent and independent central banks" (1991:42). They report a 'moderately good relationship' between the degree of dependence and inflation performance, but note that, for their sample, the influence of Latin American countries distorts results, and their exclusion from the sample results in the statistical relationship becoming less robust (1991:42).

Grilli *et al* focus on the four decades from 1950-1989, and report that indicators of central bank independence have the expected sign, with their indicator of economic independence significant (at the 1% level) in periods of high inflation (1970-89) and for the period as a whole, and the indicator of political independence significant (at the 5% level) only in the decade of the 1970's (1991:372). In terms of our earlier discussion we can note that issues of goal independence (or dependence as the case may be) - control over the ends of monetary policy - would appear to be less important in influencing inflation trajectories.²¹ The authors conclude that, "monetary institutions matter, indirectly, through their effects on credibility, and directly, by shaping the central bank incentives" (1991:372), and note that their results confirm the previous findings obtained by Parkin and Bade (1982), and Alesina (1989). It is clear however that it is technical independence - control over the means of monetary policy - that exercises the influence on inflation performance, with goal 'independence', either directly or by way of the proxy of EMS membership, exercising little or no influence.

In an advance on the earlier research Grilli *et al* examine the relationship between central bank independence and macro-economic performance by way of the effect on the growth rate of real output. (1991:374). The authors report indeterminate results, noting that while, "central bank independence seems to be associated with lower output growth, the estimated effect is generally insignificant," (1991:374) and conclude that there appears not to be, "a sharp trade off in the design of monetary institutions. A more independent central bank brings about low inflation, but not necessarily worse real macro-economic performance" (1991:375). This is consistent with Alesina and Summers (1990) who examine the relationship between central bank independence and

²⁰ The Capie and Wood index is based on the Bade and Parkin (1985), and Masciandaro and Tabellini (1988) indices. The research examines the relationship between bank independence and inflation for the period 1871 to 1989, the authors suggesting that by the use of long-run data, "we illustrate how central bank dependency can change from time to time" (1991:39).

²¹ Interestingly the authors find that membership of the EMS exerts no significant influence on the relationship when a dummy for EMS membership is introduced; "the estimated coefficient is not significantly different from zero." (1991:372) EMS Membership is clearly apposite in that it acts as a proxy for the orthodox conceptions of central bank 'independence' that place a weighting on price stability objectives.

the level and variability of economic growth for a sample of 17 OECD countries over the period 1955-1988. At issue is the existence and extent of any real economy trade-offs associated with independent central bankers:

"On the other hand traditional arguments for monetary policies that are politically responsive stress that politically sensitive central bankers are likely to be more concerned than independent bankers with maintaining output, reducing unemployment, and reducing real interest rates. If monetary policy can achieve these objectives one might expect independent central banks to purchase lower rates of inflation at the price of inferior real economic performance" (1990:2-3)

Alesina and Summers report no relationship between central bank independence and the level and variability of economic growth. Moreover they report no relationship with measures of unemployment and conclude that, " ... the monetary discipline associated with central bank independence reduces the level and variability of inflation but does not have either large benefits or costs in terms of real macroeconomic performance" (1990:6). But the authors hesitate to endorse a rules based monetary regime suggesting that, while it may be possible for nations to achieve macroeconomic benefits by insulating the central bank from political control (i.e. technical independence), setting a monetary rule (goal dependence) may be counter productive:

"Our findings also have implications for the ongoing debate over the optimal rules governing monetary policy. Most obviously they suggest the economic performance merits of central bank independence. More subtly, they raise questions about the benefits of rule based monetary policies. Advocates of rule based policies typically stress that they avoid dynamic consistency inflation. The findings here suggest that it is possible for nations to achieve these benefits by insulating the central bank from political control but not setting a monetary rule ... While it is possible that rule based performance would be superior to discretionary performance on stabilisation grounds, Summers (1988) notes a number of reasons why this is unlikely including unforeseen events, and the possibility of an economy getting trapped in the neighbourhood of a suboptimal equilibrium around which stabilisation would be undesirable" (1990:6).

Subsequent research by De Long and Summers (1992) confirms a "near-perfect inverse correlation" between central bank independence and average inflation (1992). The authors pose the question - indirectly a test of the neutrality of monetary policy - as to whether inflation averse, independent central banks generate price stability at the expense of either high unemployment and/or low rates of economic growth. Based on a finding of a strong partial correlation between growth and central bank independence, the authors conclude that:

"There is surely no reason to suspect that inflation-averse central banks have significantly lowered growth rates in the OECD over the past generation: anyone wanting to make such a case would have to make the unconvincing argument that the negative effects of central bank independence on growth have been overbalanced by other factors that by coincidence just happened to also be present in economies with independent central banks. Some portion of the positive association between central bank independence and economic growth may well arise because an independent central bank and a low-inflation environment allow the price system to work more effectively" (1992).

A more recent review by Eijffinger and De Hann is more equivocal on the relationship between central bank independence and measures of economic output, concluding that,

"[m]ost empirical studies ... show that central-bank autonomy does not enhance economic growth and employment. Moreover, there is no proof that countries with relatively independent central banks have lower costs of disinflation than those with more dependent central banks. Indeed most studies suggest that central-bank independence is associated with higher disinflation costs" (1996: 54; see also Hutchinson and Walsh, 1998).

Further support for the proposition that central bank independence exercises an influence on inflation performance is provided by Busch (1992). Using the Bade and Parkin (1982)/Alesina (1989) index of independence and country data set (on the grounds that it provides broader country coverage than the Grilli *et al* set), Busch reports a strong negative correlation ($r = -0.80$) between central bank independence and the average rate of inflation between 1973 and 1986, and concludes that, " ... an independent central bank can apparently be a strong antagonist to government and is apparently capable of effectively holding down inflation" (1992:30).

Cukierman *et al* report that for the group of developed and less developed countries taken together the relationship between central bank independence and the rate of depreciation in the real value of money (1991:29) is not significant, and only becomes so when their 'turnover' variable (the rate of turnover in central bank governors) is added: "When the turnover variable is added... we can reject the null hypothesis that all the legal variables do not jointly contribute to the explanation of the variability (in the rate of depreciation in the real value of money)" (1991:30). The 'turnover variable' is significant only for the group of developing countries, and the authors conclude that, "[i]n developed countries, and in particular those which have been the object of previous investigations on CB (central bank) independence, legal independence is a relatively significant determinant of price stability" (1991:61). In contrast to the Grilli *et al* suggestion that EMS [European Monetary System] membership had no independent effect of inflation performance, Cukierman *et al* conclude that exchange rate based rules (currency linkages such as the ERM [Exchange Rate Mechanism]), "are used as

substitute devices to attain price stability even in the presence of low CB independence," (1991:62) and cite Belgium, Panama and the Netherlands in support of this proposition. The issue as to whether goal dependence is a substitute for technical independence is an unresolved one. The authors report that for a relatively small sample of countries, indicative results suggest that when questionnaire variables are used to explain variations in inflation, "there is not much additional information in either CB governors' turnover or in legal variables" (1991:63).

In more recent research Fischer uses the Grilli, Masciandaro, and Tabellini (GMT) measure of legal central bank independence for eighteen industrialised countries, and reports a "significant negative relationship between the average rate of inflation and central bank independence" (1994: 295). Moreover to isolate the relative impact of goal and instrument (in)dependence, Fischer recasts the GMT index of central bank independence into three components:

- the presence of a statutory requirement that the central bank pursue monetary stability among its goals
- those measure relating to the central bank's right not to finance the government, and to set the discount rate
- a combination of legal provisions relating to appointments and the central bank's relationship with the government,

and concludes that a "central bank's ability to use its instruments freely, is the single variable most highly correlated with inflation" (1994: 296). Reviewing the evidence on the relationship between central bank independence and economic performance, Fischer concludes that,

"[t]he evidence leaves little doubt that, on average, economic performance is better in countries with more independent central banks. The relationship between inflation and the elements of CBI is attributable mainly to the central bank's ability to use its policy instruments freely (instrument independence) and to the presence of a price stability goal (lack of goal independence). We further tentatively conclude that the causation in industrialised countries, where legal provisions are likely to have more force, runs at least in part from legal independence to lower inflation. As an analytic matter, we expect less price variability and greater output variability in countries with more independent central banks. Such a relationship is not visible in the aggregate data. The elements of a trade-off are present in comparing United States and German data, and there must be such a trade-off for an efficient central bank. Finally, central bank independence does not appear to bring a credibility bonus in the labour markets; even independent central banks have to fight hard and long to

bring inflation down after an inflationary shock has struck" (1994: 301, emphasis added).

More recently Eijffinger and De Haan have been somewhat more circumspect, concluding that,

"[a]lthough overwhelming evidence exists that central-bank independence and inflation are negatively related, one should be careful in jumping to this conclusion ... only limited support exists for the view that central-bank independence stimulates economic growth and that it does not reduce inflation costs. Furthermore, central-bank independence may be endogenous, in the sense that countries with a commitment to price stability may have a greater propensity for central-bank independence" (1996: 40).

The empirical evidence is inconsistent and at times contradictory. Reported relationships between central bank independence and macroeconomic outcomes are in part a function of the periods analysed, sensitive to the make-up of the country data sets, and to markedly diverse operationalisations of the concept.²² Some purport to demonstrate a strong and robust relationship between central bank independence and inflation performance (e.g. Alesina 1989; Busch, 1992; Way 1992; De Long and Summers, 1992; Fischer, 1994). Others suggest that the relationship is non-existent over the long-run (Capie and Wood, 1991) or indeterminate (Masciandaro and Tabellini, 1988).²³

²² Woolley takes issue with the methodological inexactitude of indexes of central bank independence, suggesting that they are incoherent:

"There is, at least as yet, no ability to say that some institutional features are necessary or sufficient for behavioural independence. Indeed, we can say more affirmatively that *current research shows that no institutional configuration is either necessary or sufficient to guarantee low inflation*" (1994: 63, emphasis in original).

²³ At one level the indices of central bank independence developed on the basis of the 'statute reading' approach are only as robust as the association between statutory appearance and behavioural reality will admit (see Woolley, 1984). Recent critiques of the statute reading methodology suggest an epistemological weakness in the construction of indices of central bank independence. Forder argues that,

"... the approach to testing the claim that 'central bank independence improves performance' which has been adopted in the literature is methodologically misconceived ... any measure of independence which is derived from the statutes of central banks will inevitably be a measure of something other than the concept which the theoretical claim concerns" (1996: 49; see also Forder, 1998).

Accepting, for the sake of argument, that the theoretical case for central bank independence is a robust one, Forder suggests that

"[w]hat needs to be recognised is that, for the purposes of testing the theory 'independent' is now defined to mean (amongst other things) 'not subject to (as many) 'short-termist temptations'. For the purposes of the discussion independent has become a technical term, the meaning of which is that long-term goals are pursued. This is the meaning that must be preserved when we test and implement the proposal" (1996: 41).

On balance however economic theory and the empirical evidence reviewed to date suggest a strong case for central bank independence. At the theoretical level the 'credibility' and 'time-inconsistency' literature suggest that the combined effects of rational utility maximising political authorities and adaptive price setting behaviour will be inflationary, and that the solution lies in removing policy discretion from political authorities and vesting it in an independent authority - a central bank/banker placing a relatively higher weighting on price stability, or principal-agent contractual arrangements in which a central bank is provided with operational independence and an appropriate mix of incentives and sanctions. At the empirical level there is clearly some support for the proposition that independent central banks (variously defined

There are three issues involved:

- the statutes do not determine who actually takes policy decisions - "This is a matter of established norms of behaviour and political realities. A Bank might not have the ability to set policy simply because it is established practice that it complies with the government's wishes. This might be called the problem of power versus (statutory) independence. A Bank may have statutory independence, but lack practical power" (Forder, 1996: 50)
- the Bank might be under implicit or explicit threat of legislation if it does not comply with the government's wishes, whatever the formal statute might provide (apparent versus actual independence)
- if a bank does possess the necessary power and independence it too might be influenced by short-term considerations (e.g. facilitating the election of a government better disposed towards the banks preferred set of institutional arrangements), (Forder, 1996: 50).

But there may be a further complication - if the issue is one of clarifying actual behaviour as distinct from the behaviour implied by statutory provisions and formal institutional arrangements, what are the 'drivers' for those financial actors with whom central banks engage? If the behaviour of those in financial markets is influenced by their reading of statutes, or commentaries on those statutes - then the behaviour of central banks may matter less than the veneer of institutional appearance - for financial actors independence may be what the indices 'measure', whatever the lack of congruence between those indices and actual behaviour.

Actual independence may be obfuscated by the appearance of institutional dependence of some kind, or, the suggestion of institutional arrangements which are politically porous. A 'credibility dividend' may be generated from a change which is more superficial (in the form of the statutory or the institutional arrangements) than substantive. In other words, credibility will be a function of perceptions of independence, and those perceptions in turn (particularly from a distance) may well be a function of a superficial reading of some formal index of institutional independence. As Woolley observes:

"We would like to be assured that the institutional arrangements actually make some difference at the level of policy instruments. We want to know that policy (not a macroeconomic outcome like inflation, which may have several causes) is different from what it would be in the absence of institutional arrangements. Demonstrating a cross-national association between institutional structure and inflation outcomes is a long way from showing that the institutional structure causes the differences in outcomes. Did the central bank ever *act* independently ..." (1994:63, emphasis in original).

In part the critique rests on a distinction between central bank independence operationalised on the basis of the statute reading approach, and a somewhat more dynamic conception of independence informed by central bank behaviour.

and operationalised) generate relatively more propitious macroeconomic outcomes. In summary the weight of theory and evidence suggests institutional arrangements in which central banks enjoy, at the very least, a measure of technical or operational independence from political authorities - the case for central bank independence, while not uncontested by the theoretical evidence, would appear to be a strong one.²⁴

A caveat: the neutrality of monetary policy?

Aspects of institutional design have been informed by two key assumptions - the first has been that monetary policy is neutral in its impact on the real economy over the long run, and the second that, as a consequence, targeting monetary policy at price stability is both an appropriate and, in terms of real economic activity, a costless strategy, superior to an approach more accommodating of 'moderate to low' levels of inflation. Debates within nations (and in relation to supra-national institutions, across nations) over institutional arrangements have spanned the domains of scholarship and policy making, and have been reflected in the latter by proposals to require central banks to pursue price stability to the exclusion of other policy objectives, with, in some cases, price stability operationalised as zero inflation. The introduction into the US Senate of an Economic Growth and Price Stability Act which seeks to replace the US Federal Reserve's multiple objectives with a single instruction that the Federal Reserve, 'should maintain a monetary policy that effectively promotes price stability' is a case in point (see Klesen, 1995).

Partly in response to policy initiative such as these, some recent research suggests that, contrary to the accepted view that monetary policy is neutral in its impacts on the real economy, and that, as a corollary, zero inflation is an appropriate target, there are costs associated with 'hard targets'. The argument is a variation of that first advanced by Tobin (1972). The policy import of the more recent research is that when low inflation is an appropriate policy goal, 'no inflation' results in attendant costs:

"Several studies have been done on the impact of going to zero inflation. Nearly all suggest that the costs would only be transitional. In addition it has been argued that inflation causes costly distortions in savings and investment, because investment income is taxed on the basis of its nominal rather than

²⁴ While the balance of the evidence on the relationship between central bank independence and macroeconomic outcomes would support greater central bank independence, research does suggest that countries with independent central banks face relatively higher costs in reducing inflation (Hutchinson and Walsh, 1998). Moreover Hutchinson and Walsh suggest that, counter to expectations, in the case of New Zealand the short-run output-inflation trade-off has been higher since the passage of the Reserve Bank Act 1989 (1998: 720-21).

inflation-adjusted or real value. These distortions are a permanent cost of even low inflation and could be avoided if the Fed achieved zero inflation. So, some argue, the benefits of achieving zero inflation exceed the temporary costs of getting there...

We have examined the costs of maintaining a zero inflation rate and find that contrary to previous work, the costs of zero inflation are likely to be large and permanent: a continuing loss of 1 to 3 percent of GDP a year, with correspondingly higher unemployment rates. Therefore, zero inflation would involve large real costs to the American economy" (Akerlof et al., 1996b).

The authors conclude that while a low rate of inflation is an appropriate objective for monetary policy, zero inflation is inappropriate as a policy target. The challenge posed to the prevailing economic and policy orthodoxy is summarised by Gordon in his critical commentary on the Akerlof et al research:

"By arguing that nominal wage rigidity eliminates monetary neutrality, Akerlof, Dickens, and Perry challenge a core element of both classical and mainstream macroeconomics. No longer is a change in nominal GDP growth neutral with respect to unemployment: as the inflation rate approaches zero, a deceleration in nominal GDP growth creates a permanent increase in unemployment, rather than the temporary increase that is usually fed into conventional measures of the "sacrifice ratio." For these authors, the sacrifice ratio no longer involves a trade-off between the permanent benefits of a lower inflation rate and the temporary cost of lower output. Instead the cost of lower output and higher unemployment is permanent and swamps the benefits of a zero inflation rate. If their argument is correct, the Fed, and indeed every foreign central bank, should abandon any attempt to achieve a zero inflation rate because the unemployment costs are so high" (Gordon, 1996: 60-61).

The principal costs are in higher levels of unemployment:

"The unemployment costs are not one-time but, rather, permanent and substantial. Comparing low inflation rates with a zero inflation rate, we are convinced that the unemployment costs outweigh the costs of tax distortions. We full appreciate the benefits of stabilising inflation at a low rate, and advocate that as an appropriate target for monetary policy. But the optimal inflation target is not zero" (Akerlof et al 1996a:52).

In a more recent review Hogan (1997) reprises the Akerlof Dickens and Perry argument, the popularised variants of that case advanced by Krugman (1996) and Fortin (1996), discusses the link from downward nominal wage-rigidity to unemployment and considers some of the issues that need to be addressed to determine whether a change in Canada's monetary policy is warranted.²⁵ Hogan summaries the prevailing orthodoxy thus:

²⁵ In February 1991 the Governor of the Bank of Canada and the Finance Minister announced that Canada would seek "price stability" and formalised this objective in joint announcements that the Bank will exercise monetary policy to target inflation within a specified range - currently between 1 and 3 percent. Over the course of 1998 Canadian policy makers were required to consider the merits of a change in the

- "1. In the long run, there is no relationship between inflation and unemployment. Thus, the maintenance of low inflation does not come at the cost of a permanently higher unemployment rate.
2. In the long run, the maintenance of low and stable inflation generates benefits to productivity. Therefore, targeting low inflation will produce higher output over time.
3. In the short run, however, there is a trade-off between inflation and unemployment as inflation can normally be reduced only at the expense of a temporary increase in unemployment and a corresponding temporary decline in output (or at least a slow-down in output growth)" (1997:2)

The question posed is two-fold - whether there are long-run trade-offs associated with zero inflation, and, if there are not, whether the long run benefits are worth the short run (transitional) costs:

"Krugman and Fortin suggest that, contrary to the conventional wisdom ... there is a long-run negative relationship between inflation and unemployment. Therefore, lower inflation can be achieved only at the expense of permanently higher unemployment and lower output" (1997:2).²⁶

The import of the Akerlof et al argument is that, at very low levels of inflation (as suggested by a 'zero inflation' policy target) there is a trade-off between inflation and unemployment. Moreover the Akerlof et al analysis constitutes a challenge not only to the neutrality of monetary policy, but equally to the validity of the concept of the non-accelerating inflation rate of unemployment or NAIRU. Paul Krugman has observed that, "[t]he standard view, embodied in the concept of the NAIRU ... is that there is no long-run trade-off between inflation and unemployment. But recent work ... makes a compelling case that this no-trade-off rule breaks down when inflation is very low" (Krugman, 1996). If monetary policy, when targeted at zero inflation, imposes output and employment costs that accrue over the long-run then the implication is that there is a long-run Phillips Curve. Moreover, to the extent that the long-run Phillips curve is other than vertical, the utility of the concept of a 'natural' rate of unemployment, (or NAIRU) - a rate of unemployment below which, ceteris paribus, the inflation rate will accelerate - may be limited.

The natural rate hypothesis was first advanced by Milton Friedman in his Presidential address to the American Economic Association in 1968 (Stiglitz, 1997a:6). As Stiglitz

target range (Hogan, 1997:1)

²⁶ Hogan argues that the Akerlof et al argument is predicated on the assumption of a successful money illusion - the acceptance of real wage cuts over nominal reductions - and suggests that, if the objective is to effect a reduction in real wages, variable profit sharing arrangements are preferable to the use of

observes, "... the natural rate hypothesis views changes in the inflation rate as a labour market phenomenon whose magnitude can be proxied by a particular measure of labour market slack: the unemployment rate" (1997a:4) If one accepts the policy and institutional design implications of the natural rate hypothesis, targeting monetary policy at any objective other than zero inflation is inappropriate. Moreover targeting monetary policy to deliver a rate of unemployment below the 'natural rate' compromises price stability. If the 'natural' rate hypothesis breaks down, the implications for policymakers are clear:

"Clearly we would like to get unemployment as low as possible, without inflation accelerating. If there is no clear, systematic relations between inflation and unemployment, why wouldn't policymakers simply keep trying to push unemployment lower and lower ... the more subtle question, put roughly is, "Should policymakers 'target' the NAIRU?" (Stiglitz, 1997a: 8).

The political (and policy) implications of continuing adherence to the 'natural rate' hypothesis have been interpreted as favouring a conservative approach to the conduct of policy (and by implication, institutional design):

"Since Friedman's speech, orthodox macroeconomics has virtually always leaned against policies to support full employment. In spite of stagnant real wages, it has virtually never leaned the other way ...

When a higher NAIRU accompanies higher unemployment, it cuts against the case for a policy of expansion, since a higher proportion of the existing unemployment is seen as necessary to preserve a stable inflation. When unemployment is falling, a downwardly sticky NAIRU bolsters the natural caution of many economists concerning pro-growth policy intervention. In consequence, policymakers are almost never presented with a clear case, based on natural rate analysis and supported by a consensus of NAIRU-adhering economists, for a pro-employment policy" (Galbraith, 1997: 102).

A corollary of the argument is that inflation is less a function of disequilibrium in the labour market than it is of episodic shocks:

"It would therefore be reasonable to approach anti-inflation policy in general as a matter, first and foremost, of designing circuit breakers for shock episodes, so as to reduce the cost of adjusting to a new pattern of relative prices and therefore the need to do it through the brute-force method of mass unemployment ... If this were done, then the very slow increases in inflation that might or might not happen as a result of pressure from low unemployment might be mitigated in benign ways" (Galbraith, 1997:105 - 106).

Moreover there are implications not only for the objectives to which monetary policy is directed, but also for the mix of policies and policy instruments deployed in response to an increase in inflation:

" ... when inflation hits, it can be repressed by recession and stifled by stagnation. The test of the policy, however, is to reconcile reasonable price stability with acceptable growth at the highest achievable levels of employment and to manage shocks with the least disruption.

To abandon the NAIRU as a construct in policy discussion is essentially to abandon the pretext of the impossibility of this task" (Galbraith 1997:107).

A Reprise: Theory and institutional remedies to the inflation 'bias'

A number of institutional resolutions to the 'inflation bias' have already been foreshadowed. Briault et al suggest that the four solutions which have attracted the most attention are non-contingent rules (fixed rules in which the authorities commit to a specified rate of growth in the money supply), the 'conservative' central banker model, solutions based on reputation, and the use of 'principal-agent' optimal performance contracts (Briault, Haldane, and King, 1996: 8-9).

The non-contingent rule, of which Friedman's k-percent rule is best known (Friedman, 1959), says little in effect about particular institutional arrangements, or central bank independence. It is difficult in practice, as Briault et al note,

" ... to pinpoint any real-world examples of a strict non-contingent rule having been adhered to by developed countries, at least over the post-Bretton Woods period. While many countries experimented with, for example, monetary targeting procedures in the 1970s and 1980s, in practice none of these frameworks worked in the rigidly inflexible fashion suggested by a non-contingent rule" (1996: 15).²⁷

This is not to suggest that the validity of rules per se (as distinct from discretionary policy regimes) is debased. As Blinder notes, a strong case is made in the literature for assigning central banks rules, based not on instruments (as is the case with the Friedman k-percent rule), but based on policy outcomes, such as inflation or nominal GDP growth targets (Blinder, 1998: 37): "The death of monetarism does not make it impossible to pursue a monetary policy based on rules. But it does mean that the rule cannot be a money-growth rule" (Blinder, 1998: 28).

²⁷ See also the discussion on 'feed-back' rules in Briault et al, (1996: 15)

We have already noted the institutional solution of the conservative central banker, in which the problem of an inflationary bias is overcome by entrusting monetary policy to a person or institution who places a greater weighting on price stability than on the social welfare function.²⁸ The logic of this approach in the Rogoff formulation would have politicians select central bankers who are more inflation adverse than the society as a whole, thus cancelling out the inflationary imperatives attendant upon dynamic inconsistency (Blinder, 1998).²⁹ Lohmann's (1992) enhancement provides for an override on the part of a government over a conservative central banker where, for reasons relating to either the economic context (a supply shock), or aberrant (over zealous) preferences on the part of the central banker, a government is required to intervene. Blinder suggests that,

"Lohmann's idea is correct in both economic theory and political theory. In a democracy there should, after all, be some checks on the behaviour of an over-zealous central bank. But its practical application is tricky, to say the least. No central bank can claim to be independent if its monetary policy decisions are routinely reversed" (1998: 48).³⁰

²⁸ Blinder suggests that the theoretical case has an applied 'ring of truth': " ... in the real world the noun 'central banker' practically cries out for the adjective 'conservative'" (1998: 46).

²⁹ Forder suggests an alternative, and somewhat less prescriptive interpretation of the 'Rogoff' thesis:

"Rogoff's world is not deterministic. There are stochastic supply shocks which occur after the determination of wages, but which the policymaker may offset. In principle, an ideal state contingent rule will lead to ideal policy, but Rogoff suggested that in this, more complicated, world a constitutional rule may present dangers. In that context, discretion may or may not be preferable to a suboptimal rule, but the discretionary policymaker should take on board the danger of an inflation bias.

This is an argument about the optimal conduct of policy, rather than the identity of the individual who conducts it. The argument claims that too strong a commitment to price stability is damaging and, in the absence of ideal rules, a balance must be struck. The idea of 'appointing an optimally inflation averse banker' can therefore be thought of as an analytic device rather than a policy. The best way to conduct policy, says the argument, is to behave as such an individual would. The treatment of Rogoff's argument as an institutional proposal suggests that monetary authorities pursue their own interests and we must select the individual who happens to offer the best outcome of the agency problem. But it is quite coherent to think of the model as describing the behaviour at which a public-spirited central banker, exercising discretion, should aim" (1998: 320).

³⁰ See in addition Lohmann (1994, 1998). Lohmann suggests that, as an alternative to a modified Rogoff solution "is to embed the central bank in the political system so as to encourage its 'capture' by inflation-averse interests, say, the financial sector ... Alternatively, politicians may design the internal decision-making environment of the central bank so as to support the development of an institutional culture that emphasises the importance of price stability over other goals" (Lohmann, 1998: 361). Recasting this in the context of the argument developed in the following, and successive chapters, the issues are two-fold - the capacity of politicians to design an institutional framework that allows policy to be developed and implemented within an inflation-averse policy network; and the sustainability of such a network (and institutional framework) over the long run.

So far as 'reputation' based solutions are concerned - and institutional arrangements which provide for greater transparency notwithstanding - the orthodox criteria used to determine the degree of institutional (in)dependence are of limited relevance. As Briault *et al* note,

"The Bank of Japan has no formal independence ... and so reputation is potentially all. So revealing information on inflation preferences through stability-oriented policy actions has arguably been central in helping to maintain low inflation in Japan, in the absence of formal central bank independence" (1996: 34).

The principal-agent approach is one in which the problem is overcome by way of a contract involving sanctions for the agent who fails to ensure that inflation is kept at the contracted level (see Fischer, 1996:201; Rogoff, 1985; Walsh, 1995, 1996, 1998; Persson and Tabellini, 1993). The institutional solution, as proposed by Walsh (1995) takes the form of a contract in which a linear tax is levied on the central bank for any out-turn in excess of the contracted inflation target, and, somewhat more problematically, a linear subsidy may well accrue if the out-turn is below the target (Briault *et al*, 1996: 25). Blinder suggests that,

" .. the genesis of the idea is simple. The Kydland-Prescott analysis suggests that the incentives of decision makers are distorted towards excessive inflation. Say the word 'distortion' and economists reflexively think of taxes and subsidies. So Walsh (1995) and Persson and Tabellini (1993) have proposed making the central banker's salary decline in proportion to inflation. They show that this particular incentive scheme induces the central banker to behave optimally ... " (1998: 44-5).³¹

In terms of the specifics of institutional design the theoretical models presage a range of potential solutions or remedies. These institutional remedies go in large part to different forms of central bank independence, and, in particular to institutional regimes in which inflation targets are imported into performance contracts.³² And in terms of the distinction between instrument (economic or operational) and goal (policy or political) (in)dependence,

³¹ The principal-agent literature has been particularly influential in shaping the design of central banking institutions, and indeed in the reshaping of public sector institutions more generally (see the discussion in Boston *et al* 1996). While the diagnosis is one that has been informed by public choice assumptions, the institutional prescription or remedy - as evidenced by the Reserve Bank of New Zealand Act 1989 and the (New Zealand) Fiscal Responsibility Act 1994 - owes more to agency theory.

³² There is a significant theoretical and research literature on the issue of inflation targeting and monetary policy (see for example, Haldane, 1995; Reserve Bank of Australia, 1997; Federal Reserve Bank of Kansas City, 1989, 1996; Mishkin and Posen, 1997; Kahn and Parrish, 1998; Cecchetti, 1998; Bernanke *et al*, 1999; Krugman, 1996, 1999).

"[t]he most important conclusion of both the theoretical and empirical literatures is that a central bank *should* have instrument independence, but *should not* have goal independence" (Fischer 1995:202, emphasis in original).

In practice however giving effect to the institutional import of the theoretical and empirical literatures is not without its problems. For example Blinder suggests that the binary distinction between credible and 'non-credible' central bankers suggested by the 'reputation' literature is simplistic:

" ... as soon as the bank allows high inflation, even once, the public concludes - with certainty - that it is a hopeless 'wet.' This is the feature of the model that strikes me as eccentric, if not downright silly. In reality, there are many types of central banker, not just two, and random shocks cloud the mapping from outcomes back to types. For these and other reasons, reputation is not like pregnancy: You can have either a little or a lot. For example, the Bundesbank's entire reputation as an enemy of inflation did not collapse when German inflation rose from about zero in 1986 to about 4% in 1992. Nor should it have" (1998: 44).

And the practical import of applying subsidies and disincentives by way of the linear tax suggested by optimal performance contracts (for example a tax which progressively imposes a direct pecuniary cost where a central banker fails to keep inflation within a contracted range) is equally problematic:

"[A] small decrease in salary is probably not much of a motivator for central bankers who are already voluntarily giving up a large proportion of their potential earnings to do public service ...

Second ... virtually no central bank explicitly ties its salaries to economic performance - not even New Zealand...

Third ... there is a severe problem with the party on the other side of the contract ... Congress is really an agent and not a principal. And members of Congress - who must stand for reelection - face even stronger incentives to reach short-term gains than do central bankers. So why would Congress propose a contract with the central bank that would eliminate the inflationary bias? And, more important, why would it want to enforce such a contract if the central bank deviated and thereby caused a little boom"(Blinder, 1998: 45-6).

Moreover there may be a danger in agents being somewhat too zealous in their pursuit of their contracted goals or targets In the following section we canvass issues of institutional design raised by the problem of inappropriate targets.

Too much price stability?

Whatever the state of the debate over the neutrality of monetary policy over the long run, it is agreed that there is a short-run trade-off - that the Phillips Curve is not vertical over the short-run:

"[t]he enhanced vigilance against inflation produced by conservative central bankers comes at a cost: Real output and employment are more variable than in the dynamically inconsistent solution. That is fine because it presumably moves society closer to the optimum. My point is just that the gains on the inflation front come at some cost. Appointing conservatives to the central bank board does not buy society a free lunch" (Blinder, 1998: 47).

The Lohmann enhancement of the Rogoff model suggests that there is the danger posed by a central banker who is over zealous in the quest for price stability. For Blinder the issue is relevant at the level of theory, and policy reality:

"[S]uch a central bank will fight inflation too vigorously and be insufficiently mindful of the short-run employment costs. This too rings true, though I will refrain from naming names. It suggests that there is an optimal type of person best suited to a central bank board" (1998: 48).

Fischer too has posed the question as to whether or not a central bank can be too independent:

"The answer is yes. As a matter of theory, both of the basic analytic models of central banking [the 'conservative' central banker and optimal contracts models] imply that the central banker can be too inflation averse, and too insensitive to the possibilities of stabilising output..." (1995:205).

Similarly De Long and Summers (1992), in posing the question as to whether there can be too much pursuit of price stability answer the question in the affirmative:

"At the grossest level, the answer to the question is surely 'yes.' Monetary policies in the early years of the Depression in the United States by allowing a deflation that penalized debtors at the expense of creditors surely contributed to the depth of the Depression. As historians of the Great Depression like Friedman and Schwartz (1962) and Temin (1990) have long emphasized, the U.S. Federal Reserve allowed the money stock to contract in Depression in large part because they feared the inflationary consequences of being seen to move away from the operating procedures they believed had been traditional under the gold standard. Even leaving dramatic instances of policy failure like the Depression aside, we suspect it would be a mistake to extrapolate the results on the benefits of central bank independence too far" (1992).

Moreover, in an argument that a strong resonance with the Akerlof et al analysis reviewed above, De Long and Summers foreshadow the case for moderate inflation accommodating real as opposed to nominal changes in prices:

" On almost any theory of why inflation is costly, reducing inflation from ten percent to five percent is likely to be much more beneficial than reducing it from five to zero. So austerity encounters diminishing returns. And there are potentially important benefits of a policy of low positive inflation. It makes room for real interest rates to be negative at times, and for relative wages to adjust without the need for nominal wage declines" (1992).

There are two additional issues which go the weighting placed on price stability. The first goes less to how much inflation will be tolerated, and more to the extent to which the speed at which monetary policymakers effect a return to 'price stability'. While it is generally accepted (with the caveats already noted) that there is no sustainable long-run trade-off between inflation and economic output (or employment in the classic Phillips Curve formulation), there is a relationship (and perhaps a trade-off) as between variability of inflation and variability of output.³³ That relationship is captured by the Taylor Curve:

"The Taylor curve plots the locus of combinations of inflation and output variability that can be attained by appropriate monetary policies. It is traced out by changing the relative weights on inflation and output variability in the central bank's 'loss function', or, in other words, by changing the implicit horizon for the inflation target. Moving down the curve from left to right is equivalent to choosing a shorter horizon over which to bring inflation back to target, thus lowering the variability of inflation and increasing the variability of output.

So a central bank has 'constrained discretion' about the horizon over which to bring inflation back to target; that is, a choice about how to trade-off variability of output against variability of inflation. This choice is no implications for the average level of either output or inflation, but reflects a choice about whether inflation or output should bear the strain of the initial impact of any shock. And it is at the heart of public debate over monetary policy" (King, 1999: 13, emphasis added; see also Taylor, 1979).

Clearly it is possible for the institutional framework within which the central bank or banker operates to encourage a situation in which too great a premium is placed on lowering the variability of inflation, at the expense of too high a level of variability of output in the real economy. The implications for the design of institutional

³³ And the absence of any sustainable long-run trade-off notwithstanding, as Friedman (1998) has noted: ""the tension created by the joint effect of central bank actions on inflation and on aggregate output, or employment, is usually of the essence whenever public policy discussion turns to monetary policy" (quoted in King, 1999).

arrangements, and more specifically for the determination of inflation objectives and the design of policy targets are clear.³⁴

The second issue goes to the nature of the 'risks' or 'uncertainties' faced by central banks and bankers, and the possibility that there may be some asymmetry in the perception of, and response to risks. Bank of England Monetary Policy Committee member, Professor Charles Goodhart has suggested that for central bankers the danger is principally one of excessive caution, of doing 'too little too late', or 'falling behind the curve':

"'Too little, too late', could, in principle be perfectly symmetric, in the sense that the response to deflationary pressures could be just as delayed and hesitant as the response to inflationary pressures ... Yet it is my personal opinion that this syndrome is likely to be somewhat asymmetric. Interest rates increases are rarely popular, while expansionary policies are so. In a world of uncertainty, where what you know is that you do not know either the future, or even really the present state of the economy, there is in my view an absolutely natural, and perfectly human, tendency towards delaying restrictive action for longer than expansionary measures. I must, however, add that an equally common public perception is that central bankers so hunger for 'credibility' that they have an asymmetric bias towards tightening..." (1999a: 109, emphasis added).

In a commentary on Goodhart, Bean distinguishes four types of behaviour characteristic of central banks - caution, conservatism, gradualism, and delay. By caution Bean refers to the tendency to move interest rates by only small amounts; conservatism suggests a tendency for central bankers to tighten policy when there may be little sign on inflationary pressure; gradualism suggests a tendency to make a large change in interest rates in a series of small steps; and delay suggests inaction on the

³⁴ Indeed Reserve Bank of New Zealand policymakers have acknowledged the dilemma, and that there has been a shift towards more of a medium term focus (assisted by a somewhat more accommodating policy target) within the New Zealand context:

" maintaining low and stable inflation is not incompatible with having a concern for maintaining stability in the economy more generally, for example, in real output and exchange rates ...

The policy dilemma is thus clear. If the bank is to be judged purely on its achievement of keeping inflation within the target range, then it is likely to favour a more active policy approach. Or, if the Bank is trying to establish credibility by achieving its inflation target at all points in time, then it is wise to favour a more active approach and a shorter policy horizon.

However a more active policy with short horizons implies more variability in both output and the instruments. This is why the Bank - and those who monitor its performance - recognised that, although the bank should be constantly *aiming* to meet the target, it is neither sensible nor realistic to expect that inflation will always be in the range. Indeed, as inflation expectations have become more anchored on the official target over recent years, there has been some shift further in this direction. The Bank has preferred to move towards a less active and longer-term horizon when targeting inflation. This approach may come at the cost of slightly more variable inflation outcomes, although the wider 0 to 3 percent inflation target reduces the probability of the Bank actually breaching the target" (Drew and Orr, 1999: 19; see also Sherwin, 1999).

grounds that a policy change might soon have to be reversed (Bean, 1999a: 115-116). Bean contends that there is an asymmetric quality to the conservative orientation:

"[C]entral bankers have a tendency to harp on about the dangers of inflation, but warnings about the dangers of recession or deflation are rare. Such conservatism can be rationalised as constituting optimal policy when the Phillips curve is convex (an x% positive output gap raises inflation by more than an x% negative output gap reduces it) and aggregate supply is imperfectly controllable or the natural rate of output is uncertain. This is a case of a 'stitch in time save nine': prompt and modest action now avoids taking much nastier medicine later. This explains why a rational central bank would aim to hold activity not at the natural rate, but rather a little below it. There is, however, a counter-argument to this line of thinking, which runs as follows: Suppose we are unsure of the natural rate, then some judicious probing of the limits to expansion may be worthwhile. This seems to be a pretty good description of what the US Fed has been doing in recent years" (1999a: 115).³⁵

Again, the import for institutional design is clear. The resolution to the problem of what may in terms of economic effect be economically and politically sub-optimal outcomes rests in the accountability regimes within which the institutional frameworks are situated:

" An important reason to expose central bankers to elected officials is that, just as the latter may have an inflationary bias, the former may easily develop a deflationary bias. Shielded as they are from public opinion, cocooned within an anti-inflation temple, central bankers can all too easily deny - and perhaps even convince themselves - that there is a short-run trade-off between inflation and unemployment, and that cyclical unemployment can be reduced by easing monetary policy" (Fischer, 1994:293)³⁶.

Enter 'accountability'

The issue of central bank accountability emerges from a confluence of the economic and the political. So far the former is concerned the argument is principally that while over

³⁵ And in a further commentary on Goodhart, Bank of Canada Deputy Governor Charles Freedman notes that:

"It is certainly correct that it is usually much easier to convince the public and most of the media of the appropriateness of a rate cut than of a rate increase. But financial markets sometimes respond in the opposite way, expressing concerns about overly easy policies and the need for more vigilance against inflation. Moreover, in countries in which the exchange rate plays an important role in the transmission mechanism, it can sometimes be more difficult to lower interest rates than to raise them. In particular, if there is a lack of confidence in the currency, lowering, or in some cases, even leaving unchanged the benchmark short-term interest rate can lead to a counterproductive rise in medium and long-term interest rates" (1998: 120).

³⁶ For a recent review of the issues in an Australasian context see the contributions to the Policy Forum : "Should Inflation Be the Sole Target of Reserve Bank Monetary Policy?", (The Australian Economic Review, Vol. 32, No. 1; Bean, 1999b, Bell, 1999, Johnson, 1999, Makin, 1999, McDonald, 1999)

the long-run there may be no sustainable trade-off between inflation and unemployment (as suggested by the classic Phillips Curve formulation) over the short-run (which may be a relatively long period in 'real time') the short-run Phillips curve is not vertical, which is to suggest that there may be adverse employment/output consequences attendant upon too great a focus on price stability. As Fischer suggests, "... every central bank continually faces the short-run trade-off between inflation and output" (1994:294).

This in turn suggests that, while the charter of a thoroughly modern and model central bank may direct the bank to pursue price stability, central bankers are required to factor in output and employment considerations:

"Nor is a price stability mandate a sufficient guide for any central bank. That is why central banks cannot merely be given the task of keeping inflation low: they have also to be made accountable for their performance, especially their counter-cyclical performance, to be asked whether they are making the right judgement about the speed at which to reduce inflation, or to return to full employment. They cannot take refuge in the fact that there is no long-run trade-off" (Fischer, 1994:294).³⁷

Similar sentiments have been recently expressed by Walsh, who has noted that:

"... central banks still face trade-offs as they balance short-run inflation variability, and this also needs to be recognised when evaluating the contribution of monetary policy to achieving macroeconomic goals" (1998).

The 'political' aspects are raised by the spectre of a democratic deficit - ensuring that the 'natural' proclivities of central bankers are constrained within appropriate accountability arrangements (and by implication ensuring an appropriate balance between what is optimal in terms of inflation performance, and what is optimal in terms of a social-welfare function). Central banking on this basis is, as some have suggested more an art than a science, and, by its very nature a political process. As Fischer observes:

"Central bank accountability, through the structure of the board, through reporting to and questioning by elected officials, and through the provision of information to and effective receptivity to criticism from the informed and general public, is therefore essential if monetary policy is to be shielded from inappropriate political pressures and sensitive to the real needs of the public" (1995:205)³⁸.

³⁷ As Keynes observed:

"Economists set themselves too easy, too useless a task if in tempestuous seasons that can only tell us when the storm is long past the ocean is flat again." (in Fischer, 1994: 294)

³⁸ In his 1994 paper Fischer expressed the same sentiments in somewhat stronger terms:

It is to the issue of central bank accountability that the discussion now turns. Clearly issues of institutional design traverse both economic and political considerations. Accountability is the issue that provides a bridge between the two.

Central Bank accountability and the politics of monetary policy

In observing that, "[t]he undemocratic nature of independent central banking requires a procedure for overriding the Bank's decisions", Fischer (1994:303) highlights the tension between central bank independence on the one hand, and accountability on the other. Indeed 'accountability' as such has been viewed in some quarters as inconsistent with central bank independence (Briault et al, 1996). The distinction between central bank goal independence and instrument independence referred to above (and see Fischer, 1994) explains why different institutional configurations (variously combining instrument and goal independence) will produce differing degrees of accountability (Briault et al, 1996:10). One interpretation is that, as central banks have become more independent (independence equated with the adoption of price stability targets and operational independence) one consequence has been a greater openness about the formulation and implementation of monetary policy. Accountability in this sense might be seen as a bi-product of the need to maintain credibility within the finance and banking sector, principally by means of greater transparency of policy and action. Moreover it might also be argued that the adoption of a single, and quantifiable policy target, in and of itself provides for greater accountability so far as the realisation of that target is concerned. Typically one argument against multiple targets has been that they risk some diminution of accountability - the failure to achieve one objective justified by reference to some other.

In a Bank of England study (which pre-dated the institutional reforms initiated in 1997 by Chancellor Gordon Brown) Briault *et al* examine the relationship between central bank independence and accountability, and explore the imperatives driving greater accountability and transparency in the conduct of monetary policy by central banks. In part, they argue, accountability has its genesis as much in the need to remedy institutional deficits in what are otherwise liberal-democratic polities:

"the convention has developed in empirical work of calibrating the independence of the central bank by the weight it places on inflation relative to output in its objective function. By this measure of independence, a central bank can be too independent by being too monomaniacal about inflation" (1994:288)

" ... greater accountability has run hand in hand with moves towards greater central bank independence: greater accountability is the government's quid pro quo for granting greater central bank autonomy.... Independence delegates responsibility for monetary policy to an ultimately unelected authority - the central bank. So making this authority accountable for its actions insures against a "democratic deficit"; it fulfils a fundamental political or even ethical demand for democracy" (1996:7).

However the fact that jurisdictions that share liberal democratic values and broadly similar politics produce a range of institutional configurations - variously higher or lower on independence and accountability - is suggestive of a number of institutional drivers. ³⁹ Briault *et al* suggest that variations in the mix of independence and accountability are explained, in large part by the fact that policymakers have drawn to varying degrees on the range of institutional prescriptions, with the rational economics literature suggesting four institutional remedies (Briault et al, 1996: 9):

- non-contingent rules', e.g. Friedman (1959)
- Rogoff's (1985) 'conservative' central banker
- solutions based on reputation such as Barro and Gordon (1983), Backus and Driffill (1985), Barro (1986)
- optimal performance contracts for a central bank(er) (Walsh (1995), Persson and Tabellini (1993))⁴⁰

Clearly the contractual nature of principal-agent models suggests a *de jure* form of accountability, but as Briault *et al* observe, accountability may take on a more subtle form:

"A formal contract is more transparent - its terms are written down rather than implicit; it can be enforced by statute - rather than by fear of loss of credibility, and the penalties it imposes are pecuniary - rather than deriving from embarrassment. Here we take a broad definition of accountability that goes beyond a formal legally binding performance contract, to encompass greater transparency and openness about monetary policy actions, intentions and objectives" (1996:11-12).

³⁹ Briault *et al* note that the independent German Bundesbank has few formal accountability 'burdens' imposed upon it, whereas the (pre 1997) Bank of England, while low on formal independence manifested a high degree of transparency.

⁴⁰ Briault *et al* suggest that:

"Each has - to a greater or lesser degree - some link with central bank independence. And each - implicitly at least - suggests greater or lesser degree of accountability and transparency. It is this, ultimately, which explains the complexity of the independence/accountability relationship observed in practice, since countries combine features of all four models when designing monetary institutions" (1996:9)

The optimal performance contract literature is however largely silent on the sanctions that might be applied where outcomes are below the contracted target range or are met in advance of a contracted time-frame. The notion of a linear tax tends to imply that less will always be better.⁴¹ Moreover, as we have already noted, certain institutional solutions may serve to diminish accountability in the name of greater central bank independence. The Rogoff conservative central banker model, which provides both instrument and goal independence, militates against accountability:

"If the central bank has goal as well as instrument independence, then accountability makes no sense: the institution is judged against targets it sets itself, so an accountability constraint on behaviour never binds. The conservative central banker just goes about his or her business in a largely unconstrained fashion" (Briault *et al*, 1996:19)

And one way in which 'accountability' could be compromised, as we have already noted, is under circumstances in which the 'independence' granted to a central banker results in a desire to target inflation below what Fischer (1994) has termed its 'socially optimal level'. We have noted above that the 'conservative central banker' or 'Rogoff' model can be tempered by way of the introduction of override provisions (Lohmann, 1992) and that principal-agent 'optimal contracts' (Walsh, 1995) can generate incentive arrangements that ensure compliance with stipulated targets. However the lags associated with monetary policy provide accountability only after the event, and it has been suggested that one way of ensuring greater accountability is to require a central bank to make public its forecasting model(s), and subject these to scrutiny within financial markets and the wider community (Walsh, 1996).⁴²

⁴¹ Although Briault *et al* do note that while there is no presumption that benefits will accrue to a central bank that undershoots its targets, this would be a logical implication of the Walsh model, and, "without it, the first-best collapses" (Briault *et al*, 1996:26). The authors also refer to the credibility depleting consequences of targets that are 'too hard' - an issue that is apposite to the New Zealand experience, and which is explored in subsequent chapters.

⁴² Briault *et al* suggest that the New Zealand arrangements most closely approximate the kind of contract suggested by Walsh:

"There, the Policy Targets Agreement is an explicit, and precisely specified, contract between the government and the Reserve Bank. Explicit penalties are written into this contract, in that the Governor can be dismissed for failures to meet the target; he or she is held directly accountable for inflation target misses.." (1996:27)

Walsh has however been critical of the fact that in shifting the focus of the Reserve Bank of New Zealand's inflation target from headline to underlying inflation, and where for the year ended July 1996 the PTA target range was exceeded in terms of the latter (2.3%), served to undermine the credibility of the Bank, and, the accountability arrangements:

"Letting the Reserve Bank define its own inflation rate, especially one that looked like it would peak at just under the 2% upper limit allowed under the PTA, would appear to have threatened the whole notion of accountability" (Walsh, 1996)

Moreover it has also been argued that within the context of an optimal contract model, the credibility of monetary policy (reflecting in part by the formal accountability arrangements) will be a function of the enforcement of any contract. Given this constraint the problem of time-consistency may be relocated from monetary to political authorities: "An inflation bias may then re-emerge because the public believes that the government might spring an inflation surprise by not enforcing the contract" (Briault et al, 1996:25). Conversely it might also be argued that optimal performance contracts impose accountability requirements on the principal as well as on the agent. As Solomon has noted in relation to the New Zealand arrangements:

"In the New Zealand experiment, the government set the central bank's inflation target. By doing so publicly however, it made itself accountable to the electorate and global financial markets. This effectively tied its own hands against later political interference" (1995: 503).

It would appear that such accountability arrangements as do exist are endogenous to the model informing the design of particular institutions. To the extent that any given model implies a democratic deficit, there is no suggestion of accountability disciplines that are exogenous in their origins. This suggests that while imperatives suggested by rational economics do influence the design of accountability arrangements, imperatives that originate within the political domain are much less apparent. In simple terms, while the literature would suggest that there are risks posed by institutional arrangements which have the potential to generate sup-optimal outcomes, these risks tend not to have given rise to accountability mechanisms designed to constrain goal independent central banks or bankers.⁴³

In a normative sense Briault et al suggest that both central bank independence and central bank accountability are required:

"Making the central bank independent imposes a constraint on government interference in monetary policy; while making the central bank accountable imposes a constraint on how it exercises independence. Both these constraints are generally viewed as desirable aspects of monetary policy-making" (1996:42)

⁴³ In the context of the European Central Bank, which has been closely modelled on the German Bundesbank, and which accordingly is possessed of a large measure of goal independence, this is seen as problematic, and for two reasons. In technical terms, if accountability (evidenced in greater transparency) is a proxy for credibility which has accrued over time, an institution without a track-record might be required to place a higher weighting on accountability. In political terms, the risks attendant upon a democratic deficit are arguably all the more greater when an institution is supra-national in terms of its mandate and operations.

Conclusion: two dimensions to central bank accountability

There are clearly two dimensions to the case for central bank accountability, the first endogenous to the models discussed above, and the second - suggestive of a broader political accountability - in which political imperatives are clearly not entertained by the rational economics literature. The first suggests accountability as a function of the need for credibility; the second accountability as the product of the need for institutional legitimacy. The first of these, in which it is conceptually useful to establish a nexus between optimal performance contracts and accountability arrangements, is suggested by the requirement on the part of the principal to monitor an agent's compliance with a contract. As Fischer observes,

"The concept of accountability can be addressed within the contracting approach. The general notion of accountability is that there be adverse consequences for the central bank or the central banker of not meeting targets. In the optimal contract, the central banker is responsible for achieving the target inflation rate, and is penalised for failing to do so. While the penalty in the formal models appears to be monetary, public obloquy would serve as well. Thus even a central bank with a more general mandate could be held accountable, for instance by being required to publish a monetary policy report, or through public hearings on its performance such as the Humphrey-Hawkins hearings at which the Chairman of the Fed testifies twice a year. A central bank that is not held accountable is more likely to behave in a dynamically inconsistent way than an accountable bank - indeed any organisation that is not accountable is likely to perform worse than one that is accountable" (Fischer, 1994: 293).

Relatedly the utility of 'reputation' based models is largely a function of credibility derived from transparency in the conduct of monetary policy. Again the particular requirement for transparency in process is endogenous to the model.

It is entirely possible to entertain a non-contingent or feedback rule regime in which a central bank is required to effect trade-offs as between multiple objectives (for example price stability and output variability, or price stability and cyclical unemployment). The imperatives here may in fact be technical - if one accepts Blinder's observations on the siren attractions that may compromise, then those principals too need to be held to account. Moreover if the preferences of the 'conservative central banker' are, by design, unrepresentative of those within the community more generally, accountability arrangements (such as the Lohmann override provision) may militate against policy producing a suboptimal policy equilibrium. But more generally there is the issue of a democratic deficit as a consequence of providing central banks with independence, whether that independence is technical or goal independence, or a combination of the two. Arguably the imperatives are greatest where a central bank possesses both

technical and goal independence, given that some measure of prescription in the latter implies at least one element of a contractual relationship.⁴⁴

This second conception of accountability, as we foreshadowed above, goes not so much to the technical credibility of policy (policy which in terms of objectives and conduct overcomes the problems of dynamic inconsistency) but to the legitimacy of the institution of the central bank, and of central banking, per se. It is this dimension to accountability that is raised by the admonitions of those who in suggesting that 'independent' institutions of macroeconomic management might provide a check against partisan manipulation, note the difficulties associated with weighing costs and benefits when institutional design and democratic principles intersect (see Nordhaus, 1975:188; Alesina, 1989:83).⁴⁵ However it would be inappropriate to view this second dimension of accountability - the need for institutional legitimacy - as simply a 'political' antidote to the 'excesses' of rational economics. While legitimacy goes to issues of democratic responsiveness, and specifically the need to militate against a democratic deficit, it also goes to the appropriateness of both policy objectives, and the preferences of central bankers. Accordingly, to reprise the Fischer admonition, a central bank may suffer a loss of legitimacy if, in the conduct of monetary policy the assumption is that the short-run Phillips curve is vertical and/or that monetary policy has no role to play in combating cyclical unemployment.

To conclude, for the purposes of the discussion that follows in this and in subsequent chapters, accountability has two distinct, if functionally inter-related dimensions. The first goes to imperatives of accountability that are endogenous to the theoretical models that place a premium on credibility and reputation. Verification of an agent's compliance with the requirements of the principal, and transparency of central bank(er) preferences and processes are suggested here. The second goes to the imperatives of accountability that are exogenous inasmuch as they relate to the constitutional, political, or ideational contexts within which particular institutional arrangements are situated. In this second context a central bank that is not accountable in a wider sense will risk a loss of legitimacy, and a revisiting of the formal institutional arrangements within which it is situated.

⁴⁴ Fischer has noted the potential risk associated with the goal independent Bundesbank - "there is very little to prevent it from pursuing a socially excessive anti-inflationary policy..." (1994: 293).

⁴⁵ In a contemporary context the issue has been raised by the establishment of the European Central Bank and the need to hold such supra-national institutions to account.

The rational-economics literature is suggestive of a strong normative case for central bank independence, more so as a function of theory than on the basis of consistent empirical evidence. The literature does however admit of the political in at least three respects:

- firstly, by importing the assumptions of rational utility maximisation to the conduct of politics and public policy in liberal pluralist democracies,
- secondly by virtue of the fact that the codification of institutional prescriptions is an explicitly political process,
- and thirdly, by requiring some measure of 'political' oversight in the name of holding agents accountable for the realisation of contracted targets.

In this sense we would argue that to deny the relevance of the political is to fail to fully comprehend the nature of institutional design, and the conduct of monetary policy. Moreover, the rational economics literature fails to account for diversity in institutional form and substance, and to illuminate why it is that some nations choose institutional configurations that are consistent with the normative import of the rational economics literature, while others choose alternative configurations. To illuminate the determinants of difference requires a complementary, and contesting approach that admits of both the economic and the political. It is to the elaboration of such an alternative, and both complementary and contesting approach that the next chapter is directed.

Chapter 3

A Political-economy of Central Banking

Introduction

In Chapter 2 we rehearsed the rational economics case for central bank independence. In a somewhat stylised form the theoretical case for central bank independence is as follows:

Elected policymakers (politicians) operate according to a short-term, and electorally expedient calculus. Incumbents will exploit whatever policy instruments they have at their disposal to expedite their re-election. While, all other things being equal, the long-run Phillips Curve is vertical, monetary policy can be exploited to effect short-run trade-offs as between inflation and employment. Depending on the particular partisan preferences of voters (ie more or less employment and/or inflation), politicians will seek to engineer an electorally appropriate set of macroeconomic outcomes by the manipulation of monetary policy. Voters are myopic and will support politicians and parties that are seen to engineer outcomes consistent with partisan preferences. However that myopia is constrained by a capacity for adaptive learning, and, over time, voters (and more to the point price setters within the economy) will, where 'surprise inflations' have been used to engineer electorally propitious economic circumstances, factor in a risk premium. In other words, over time the credibility of monetary policy will be subject to the corrosive effects of opportunistic interventions. As a result, expectations, and inflation outcomes, will incorporate a risk premium. Monetary policymaking will be subject to a dynamic consistency constraint. When the electorate learns that the government will engage in opportunistic behaviour, it reacts to this by assuming that there will be inflation, and price setters raise their prices by the expected rate of inflation. If the government accommodates these expectations the result is positive inflation, and if the government seeks to maintain zero inflation it can only do so by engineering a recession. The resulting pattern will be one in which policy is subject to politically engineered business cycles. Moreover, the cumulative impact of successive manipulations will, in economic welfare terms, be sub-optimal.

The remedy to this form of democratic distemper rests, it is argued, in limiting the capacity for opportunistic policymaking on the part of elected policymakers (politicians). And because any capacity for discretionary policymaking risks being compromised by the siren attractions of electoral opportunism, the solution rests in

removing, or significantly constraining, the capacity of politicians to exercise that discretion. Central bank independence constitutes an effective remedy. However, in seeking to remove or limit the capacity for discretionary policymaking the objective is to restore a measure of credibility to the development and implementation of monetary policy. And credibility is seen as being prosecuted by transparency and accountability in policymaking and implementation. In effect, leaving aside the fact that changes to institutional arrangements within the fabric of the state are, in liberal democracies, prosecuted through the political process, notions of policy credibility in and of themselves imply a relationship between the central bank and private economic interests. In other words, 'political' relationships are endogenous to models of central bank independence predicated on the achievement and maintenance of policy credibility. In this sense, the economics of central bank independence is conceptually tied to the politics of central bank independence.

In some accounts of the rationale for central bank independence the narrative would stop at this point. However, it is also acknowledged - although again, the matter is not un-contested - that rules-based regimes in which central banks are operationally independent of politicians, may risk a deflationary bias. Prima facie, the theoretical possibility does exist that an independent central bank (or banker) could elevate the price stability objective to a point where the capacity of monetary policy to make a contribution to other macroeconomic objectives, such as macroeconomic stabilisation, is constrained, or where the trade-off as between price stability and stabilisation/variability of output is unacceptable. And in a situation in which there is much greater transparency attached to the conduct of monetary policy, any failings in policy will be sheeted back to the central bank.

Chapter 2 reviewed the rational economic literature on central banks and the conduct of monetary policy, focusing on the normative thrust of much of that literature which would have it that central bank independence - by which typically is meant a measure of goal dependence and complete operational independence - constitutes the optimal institutional remedy to the economically debilitating consequences of discretionary policy making. Empirical studies have shown, on balance, that central bank independence is associated with lower inflation. Some studies confirm the natural rate hypothesis that there is no discernible impact on output - that monetary policy is neutral or benign in its effects on the real economy - but others are more cautious or contrary at low levels of inflation. Moreover, as we foreshadowed in the preceding chapter, much of the rational economics literature, in failing to admit of any other objective for central banks other than price stability, renders political conflict over

alternative or complementary objectives exogenous.¹ We concluded the preceding chapter by identifying points of interface between the economic and the political - applying the assumption of rational utility maximisation to the conduct of politics, the role of the legislature in codifying into statute the normative prescriptions of rational economics, and the political as a site through which accountability for compliance with contracted policy targets is assessed.

The case for central bank independence is clearly predicated on the endogeneity of the political, in the sense that the assumption of a rational utility maximising calculus on the part of politicians is the root cause of the democratic distemper which institutional independence seeks to remedy. However, therein rests a contradiction inasmuch as because the institutions of central banking are creatures of statute, logically it requires some suspension of the Downsian calculus in order for there to be any statutory surrender of policy discretion. In short, institutional design, however informed by the tenets of rational economics, requires political codification. In most variants of that prescription, compliance within a contractual regime requires transparency of process, both as between central banks and governments, and central banks and financial actors. In short, institutional accountability implies a political dynamic, and particular political forms. Moreover, if, as we have suggested above, there is a requirement to balance the need for stable prices with other macroeconomic considerations, such balance may be best prosecuted through political 'checks' within the accountability regime. Finally, in the absence of an appropriate set of incentives and constraints for policymakers, it is entirely possible that policy and policy outcomes will fail to build 'credibility' with non-financial actors, a form of credibility which, we will argue is best conceptualised as institutional legitimacy. In the event of a legitimacy deficit accruing, it is entirely possible that societal interests will seek to prosecute changes to institutional arrangements by means of the political process. In this sense we would argue that the endogeneity of the political implies much more than the assumption of a rational self maximising calculus on the part of politicians - in short it requires the elaboration of a political-economy framework through which to illuminate the causes and consequences of particular institutional regimes. In this chapter we develop a political-economy model of central banking, and advance a set of propositions which

¹ Strumpel and Scholz have observed that:

"Economic doctrines guiding macroeconomic management have traditionally been unequivocal, acultural, and technical. They have combined simple techniques of diagnosis with highly technical policy advice ... Notwithstanding their at times considerable political influence in some countries, these doctrines pretend to be valid in all cultural, political and institutional settings. Except for cryptic references to the existence of a 'market economy' as a boundary condition, the doctrines claim general validity without specifying the premises for their applicability. Yet their emergence, influence and problem-solving potential are clearly both limited to specific cultures and institutions, and bounded by time and space" (1987: 282).

inform the discussion in subsequent chapters. We review the literature on the political science and political economy of central banking, locate that literature in the context of the 'new institutionalism', review two seams in the contemporary political economy of central banking, and propose a model and a set of propositions which serve to integrate the analysis of the research findings and the development of the argument in succeeding chapters.

The dimensions of the model: interests, institutions and the state

Assuming that the state enjoys a measure of autonomy, the state has the capacity to remake itself, and as an institution of the state, the central bank is both a policy outcome in its own right, and at the same time responsible, in part at the very least, for policy outputs and outcomes, specifically macroeconomic policy outputs and outcomes. The latter dimension - central banks as institutional drivers of macroeconomic policy outcomes - provides the backdrop to the thesis developed in this volume, but is not the central focus of that thesis. Clearly the literature reviewed in the preceding chapter - and the institutional prescriptions in particular - is informed by the fact that particular institutional configurations will produce different macroeconomic outcomes. Our concern is less with those outcomes, than it is with explaining differences in institutional form and in trajectories of institutional reshaping. In essence the analysis that follows casts the central bank as the dependent, not the independent variable. We have already foreshadowed that to fully explain and account for institutional difference requires a political-economy approach.

The dimensions of that approach are suggested by literatures which variously seek to account for policy responses and outcomes, and which view politics and policy - including specific institutional forms - as a function of the organisation of the state and society (Katzenstein, 1978; Gourevitch, 1986; Hall, 1986). We import from these contributions a number of assumptions about the nature of politics and policy. The first assumption may be characterised as a pluralist assumption, and it posits that policy will reflect the particular configuration of interests within the political system. By 'pluralist' we evoke a measure of contestability between interests, and a capacity for interests to coalesce around issues of common ground. However we do not subscribe to the 'classical' pluralist view that such interests are equal, nor do we accept that access to political power is independent of economic power and structural location. Nor do we assume that the state is neutral either in terms of its structural relationship with economic interests, or in terms of the contestable process by means of

which policy is generated. We assume a degree of autonomy on the part of the state, and a capacity for the state to be an important actor in its own right.

For the purposes of the political economy approach we also assume that there is a materialist foundation to the articulation of economic interests within the political system, that such interests will seek to prosecute public policies, including particular institutional forms, that protect and advance those interests. In part this assumption imports elements of a modified Downsian (Downs, 1957) or a public choice approach inasmuch as it posits that interests will be informed by a rational self-maximising calculus. However assuming that there is a materialist and rational maximising foundation to interests does not extend to the acceptance of myopia on the part of voters, or a denial that interest group preferences may be mediated by negotiation or compromise within the political system.

Both of these assumptions resonate with the 'families of argument' articulated by Gourevitch²:

"In an interpretation of policy making centred on interest groups, economic actors, whose preferences are shaped by their economic situation apply pressures on governments. Desirous of a particular policy outcome, these actors form coalitions, involving bargains and tradeoffs, to mobilise the consent needed to prevail. Politicians act as the brokers of such coalitions, thereby having some impact on the shaping of the outcome ...

When questions of public policy arise, the people affected by the decision to be made surely ask of any alternative, *Qui bono?* - Who benefits, and how will it affect my own situation? The answer to that question has a powerful effect on the policies that people prefer. What people want depends on where they sit, as theorists have argued since long before the time of Bentley and Marx" (1986: 56).

Policy choices are explained by the configuration of interests (or in Gourevitch's terms, the 'production profile'), and policy convergence or difference by the specific nature of interests and coalitions: "When countries converge (or diverge) on economic policy, they are likely to do so because of the similarity (or difference) in the pattern of preferences among societal actors" (1986: 59).³

² There are also resonances with the 'institutionalist' model advanced by Hall:

"... we can construct an institutionalist analysis of politics that is capable of explaining historical continuities and cross-national variations in policy. It emphasises the institutional relationships, both formal and conventional, that bind the components of the state together and structure its relations with society. While those relationships are subject to incremental change, and more radical change at critical conjunctures, they provide the context in which most normal politics is conducted" (1986: 19)

³ Katzenstein casts the discussion in terms of 'policy networks' (1978: 308).

And the structure of the 'intermediate associations' through which interests are articulated, and of the state itself also influence policy outcomes, as does the prevailing economic ideology or political culture:

"Countries have varying traditions of economic analysis, not only among specialised elites but more broadly in the population. Some have traditions of active government involvement to promote economic development; others emphasise laissez-faire. In some countries traditions of free trade are strong, unemployment is feared, and social services are accepted. Other countries are protectionist, fear inflation more than unemployment, and dislike social service systems" (1986: 63).

Finally there is the influence of the international system within which interests, coalitions, associations, states and ideologies are situated:

"The issue ... is not whether the international system shapes domestic politics, but how and through what mechanisms. Unless the international situation is completely coercive ... countries do have choices. The selection they make from among those choices depends on domestic politics, on the distribution of power within countries and the various factors that influence it - societal forces, intermediate institutions, state structure, ideology" (1986: 65).⁴

For Hall, situating politics within a broader framework of state-society relations suggests an 'institutionalist model', in which

"... we can see policy as more than the sum of the countervailing pressure from social groups. That pressure is mediated by an organisational dynamic that imprints its own image on the outcome. Because policy-making in the modern state is always a collective process, the configuration of the institutions that aggregate the opinions of individual contributors into a set of policies can have its own effect on policy outputs" (1986: 19).

Recasting this approach in terms of a political-economy of central banking, and positing that a particular institutional arrangement constitutes a policy choice, the issue becomes one of establishing a nexus between particular elements of institutional form, and the interests, coalitions, intermediate associations, state structures, ideology, and international context. Moreover, whatever the nexus between institutional form and these various elements of the state-society interface - whether alone or in combination - policy choices need to be located within the specific historical

⁴ Gourevitch counsels against an over-determination, noting that:

"... ultimately all of the arguments presented here are underdetermining. The historical reality of each case is too open, too uncertain, too plastic to sustain the reductionism involved in tracing outcomes back to one feature or even combination of features of the system ... [j]ust how the

conjunctures out of which they emerge. Not only will the accumulated policy experience shape the choices facing policymakers at any given point in time, but so too will more immediate circumstances and contingencies. As Gourevitch has argued:

"The moments of greatest freedom are crisis points ... Choices are more constrained in stable times, but stability makes analysis easier by producing stable systems. In moments of flux, on the other hand, choices widen, but analysis becomes more complicated because relationships change" (1986: 240).

Institutionalist accounts - the 'new institutionalism' and political economy

This research reported in this thesis is a contribution to comparative political economy, which may be viewed as a sub-set or sub-literature of one of schools of the 'new institutionalism', specifically historical institutionalism (Hall and Taylor, 1996: 938; see also Atkinson and Coleman, 1989, Steinmo et al, 1992; Pontusson, 1995; Scharpf, 1997, Hay and Wincott, 1998; Hall and Taylor, 1999; Thelen, 1999).

The 'old' institutionalism is identified with an earlier tradition of comparative politics, a tradition which involved detailed studies of different legal, administrative and political structures:

"This work was often deeply normative, and the little comparative 'analysis' then existing largely entailed juxtaposing descriptions of different institutional configurations in different countries, comparing and contrasting. This approach did not encourage the development of intermediate-level categories and concepts that would facilitate truly comparative research and advance explanatory theory"(Thelen and Steinmo, 1992: 3).

The 'new' institutionalism arises out of a behavioural renaissance which seeks to explain actual behaviour and outcomes, and to introduce medium range theory focusing on the intermediate level of institutions. The focus of this new institutionalism is,

"...the whole range of state and societal institutions that shape how political actors define their interests and that structure their relations of power to other groups" (Thelen and Steinmo, 1992: 2)⁵

Early contributions to this 'new institutionalism' are found in theoretical and empirical contributions that sought to 'bring the state back in' (Skocpol, 1979, Evans et al, 1985).

elements that shape policy choices actually combine in a given historical situation turns on conjunctural variables - leadership, entrepreneurship, circumstance" (1986: 67).

⁵ For a detailed discussion of the points of difference between the 'old' and 'new' institutionalisms see Thelen and Steinmo, (1992: 3-7).

In a relatively early discussion of the defining features of the new institutionalism Atkinson and Coleman suggest that it is defined by a capacity to combine macro and micro levels of analysis, an analysis that is located in both state and society, and one that seeks to illuminate the nature of relationships between state and societal organisations, and specifically the role of policy networks, or 'negotiated orders' as vehicles within which these interests articulate (Atkinson and Coleman, 1989: 7). For Thelen and Steinmo, the new institutionalism suggests an,

" .. emphasis on intermediate institutions that shape political strategies, the way institutions structure relations of power among contending groups in society, and especially the focus on the process of politics and policy-making within given institutional parameters" (1992: 7)

Within political science three 'new institutionalisms' have been identified - historical institutionalism, rational choice institutionalism, and sociological institutionalism (Hall and Taylor, 1996: 936).⁶ Our focus for the purposes of this discussion is on the first two variants. Rational choice institutionalism views institutions as,

"features of a strategic context, imposing constraints on self-interested behaviour ... Thus political and economic institutions are important for rational choice scholars interested in real-world politics because institutions define (or at least constrain) the strategies that political actors adopt in the pursuit of their interests" (Thelen and Steinmo, 1992: 7).

For Hall and Taylor,

" [O]ne of the great contributions of rational choice institutionalism has been to emphasise the role of strategic interaction in the determination of political outcomes. That is to say, they postulate, first, that an actor's behaviour is likely to be driven, not by impersonal historical forces, but by a strategic calculus, and, second, that this calculus will be deeply affected by the actor's expectations about how others are likely to behave as well ... Institutions structure such interactions, by affecting the range and sequence of alternatives on the choice-agenda or by providing information and enforcement mechanisms that reduce uncertainty about the corresponding behaviour of others and all 'gains from exchange', thereby leading actors toward particular calculations and potentially better social outcomes" (1996: 945).

The resonances with our examination of the rational economics literature, and the normative import of much of that literature are clear - independent central banks are an appropriate institutional remedy for the kind of democratic distemper that will see politicians (informed by the Downsian, rational-choice calculus) seeking to exploit monetary policy to secure short term electoral advantage, which at the same time conspires to produce a collectively sub-optimal outcome. However the limitations of

⁶ Hall and Taylor also identify a fourth variant - the 'new institutionalism' in economics, but suggest that it overlaps quite considerably with rational choice institutionalism (1996: 936).

the rational economics literature are equally relevant to rational choice institutionalism - preference formation is treated as exogenous, and the explanation of cross national variations in institutional forms (or the trajectories of institutional reshaping) is secondary to positing the conditions for institutional equilibrium, given a universally applicable set of preferences.⁷

Historical institutionalism seeks to remedy the limitations of the rational choice variant. There are a number of key differences between this variant of the new institutionalism and the rational-choice school. Historical institutionalism is less deterministic, more inductive in the approach taken to hypothesis building, and, because it takes as problematic the emergence of the equilibrium condition and relatedly takes as a point of departure the fact of institutional difference, the focus tends to be on illuminating the dynamics of institutional development, evolution and change - a focus that is clearly apposite to the 'puzzle' that the present research seeks to address.⁸ Hall and Taylor suggest that historical institutionalism has four defining features - a tendency to conceptualise the relationship between institutions and individual behaviour in relatively broad terms; an emphasis on the asymmetries of power associated with the operation and development of institutions; an approach to institutional development that emphasises path dependence and unintended consequences; and a concern to integrate institutional analysis with the contribution that other factors, such as ideas, can make to political outcomes (1996: 938-942).

⁷ Although variants of the rational-choice institutionalism do entertain the possibility of multiple 'equilibria' emerging:

"Institutional development is path dependent in the sense that where you end up is strongly influenced by where you started from. Moreover, as economic historians have pointed out, mutual adaptation may 'lock in' any one of multiple equilibria, some of which may be Pareto-inefficient ...

Institutionalised rules, even if they are completely effective, will rarely prescribe one and only one course of action. Instead, by prescribing some and permitting other actions, they will define repertoires of more or less acceptable courses of action that will leave considerable scope for the strategic choices of purposeful actors" (Scharpf, 1997: 41-42).

The critique is accordingly less one of rational-choice accounts being too deterministic than it is of them insufficiently illuminating the determinants and consequences of 'multiple equilibria'.

⁸ The distinction between the rational-choice and historical variants of the new institutionalism risks the appearance of a polarity when in fact the issue is much more one of degree (and, to anticipate the discussion that follows, an increasing tendency to 'border crossing' between schools). 'Actor-centred institutionalism' serves to illustrate that an acceptance of some of 'rational-choice' as rational utility maximisation by actors need not imply the assumption that the political is exogenous. As Scharpf has argued,

"Policy ... is intentional action by actors who are most interested in achieving specific outcomes. Thus, unlike in some types of sociological theory, we cannot assume that they will merely follow cultural norms or institutional rules. We also cannot assume, however, as is done in neoclassical economics or in the neorealist theory of international relations, that the goal pursued or the interests defended are invariant across actors and across time" (1997: 36).

However the key difference - and again the point of difference as between the rational economics literature and a political economy approach is apposite - is that whereas preference formation is treated as exogenous in rational-choice institutionalism, historical institutionalism accepts the endogeneity of preference formation, and seeks to account for it. As Thelen and Steinmo suggest:

"... historical institutionalists would not have trouble with the rational choice idea that political actors are acting strategically to achieve their ends. But clearly it is not very useful to leave it at that. We need a historically based analysis to tell us what they are trying to maximise and why they emphasise certain goals over others" (1992: 9, emphasis added).

There is however, particularly in a project that takes as its point of departure the contrast between institutional stability (in a formal sense at least) and significant institutional change, a challenge in explaining both within a single conceptual framework. Rational choice institutionalism is seen as possessing an advantage in accounting for the emergence and maintenance of an equilibrium condition, historical institutionalism in accounting for differences across jurisdictions, and institutional discontinuities within particular national jurisdictions. As Thelen has observed, rational choice's emphasis is on the coordinating functions of institutions, and in the generation and maintenance of an equilibrium condition in particular, whereas historical institutionalism places an emphasis on how institutions emerge from, and are embedded in concrete temporal processes (Thelen, 1999: 371). For Thelen the problem is a lack of any interface or articulation between an approach which focuses on institutional stability on the one hand (rational choice), and an alternative that focuses on institutional change on the other (historical institutionalism) (1999: 371). The remedy, Thelen argues, rests in a measure of 'border crossing' if not a synthesis of the two approaches.

The rational choice account of institutional development sees the institution as the product of a rational set of calculations on the part of actors concerned to maximise the gains from cooperation:

"Typically, they begin by using deduction to arrive at a stylised specification of the functions that an institution performs. They then explain the existence of the institution by reference to the value those functions have for the actors affected by the institution. This formulation assumes that the actors create the institution in order to realise this value, which is most often conceptualised ... in terms of gains from cooperation. Thus, the process of institutional creation usually revolves around voluntary agreement by the relevant actors; and, if the institution is subject to a process of competitive selection, it survives primarily

because it provides more benefits to the relevant actors than alternative institutional forms" (Hall and Taylor 1996: 945).

To the extent that the rational choice variant explains regime shifts, it tends to do so by reference to the notion of a 'punctuated equilibrium', in which change is driven by an institutional breakdown of some kind. Punctuated equilibrium posits that,

"... institutions are characterised by long periods of stability, periodically 'punctuated' by crises that bring about relatively abrupt institutional change, after which institutional stasis again sets in ... institutional crises usually emanate from changes in the external environment. Such crises can cause the breakdown of the old institutions, and this breakdown precipitates intense political conflict over the shape of the new institutional arrangements" (Thelen and Steinmo, 1992: 15).

The notion of 'punctuated equilibrium' or of 'critical junctures' is contrasted with a conception of institutional change which views institutions as more fluid and dynamic entities, and subject to an ongoing 'institutional dynamism' (Thelen and Steinmo, 1992: 17). This approach emphasises that institutional breakdown is not the only source of institutional change and that a given set of institutional arrangements may provide a measure of 'stretch' allowing for the institutional parameters within which interactions occur to be modified by the actors involved. For Thelen and Steinmo,

"[g]roups and individuals are not merely spectators as conditions change to favour or penalise them in the balance of power, but rather strategic actors capable of acting on 'openings' provided by such shifting contextual conditions in order to defend or enhance their own positions" (1992: 17).

This focus on institutional dynamism admits of both continuity and change, and of different trajectories of institutional reshaping at different historical junctures for a given institution, and across different institutions over a common time-frame. For Thelen a synthesis of elements of the rational choice and historical variants of the new institutionalism holds out the prospect of a focus which admits of both institutional continuities or regularities, and of structured change (1999: 384-399).⁹ This 'synthesis' or 'border crossing' of or between these two schools of the new institutionalism involves an engagement between the critical junctures literature, and a body of work that focuses on developmental pathways in which particular institutional forms are sustained more dynamically over time:

⁹ For Thelen the 'critical junctures' and 'policy feedbacks' approaches are both captured within the notion of 'path dependency':

"The first involves arguments about crucial founding moments of institutional formation that send countries along broadly different developmental paths; the second suggests that institutions continue to evolve in response to changing environmental conditions and ongoing political manoeuvring but in ways that are constrained by past trajectories" (1999: 387).

"The great strength of the critical junctures literature lies in the way in which scholars have incorporated issues of sequencing and timing into the analysis, looking specifically at the different patterns of interaction between ongoing political processes and at the effect of these interactions on institutional and other outcomes. Where this literature has generally been weaker is in specifying the mechanisms that translate critical junctures into lasting political legacies. Here the policy feedback literature, which has provided many insights into the mechanisms that account for continuity over time, is useful. However, in this second literature, strong tools for understanding continuity are not matched by equally sophisticated tools for understanding political and institutional change" (1999: 388).

Two types of feedback mechanism are particularly relevant to an examination of the conditions for institutional continuity. One type, emphasising incentive structure or coordination effects is suggestive of a rational-choice variant (Thelen, 1999: 392-394). The other focuses on institutions as drivers of particular configurations of power:

"The idea is that institutions are not neutral coordinating mechanisms but in fact reflect, and also reproduce and magnify, particular patterns of power distribution in politics ... This body of work emphasises that political arrangements and policy feedbacks actively facilitate the organisation and empowerment of certain groups while actively disarticulating and marginalising others. The distributional biases in particular institutions or policies 'feedback' so that, 'over time, some avenues or of policy become increasingly blocked, if not entirely cut off' as 'decisions at one point in time restrict future possibilities by sending policy off onto particular tracks'" (Weir, 1992, cited in Thelen, 1999: 394).

We suggested above that comparative political economy may be viewed as a subset of the new institutionalism, and a focus on the distributional consequences of particular institutional forms, and conversely of the consequences for institutional stability and continuity of particular distributional outcomes suggests a causality which allows the institution to be both an independent and dependent variable. The new institutionalism informs the propositions detailed at the close of this chapter and which serve to integrate the discussion and analysis in subsequent chapters.

The import of the new institutionalism is four-fold. Firstly, there are very clear resonances between the rational economics literature surveyed in the preceding chapter, and the rational choice variant of the new institutionalism. Each has the virtue of directing attention towards the coordinating function of institutions, specifically central banks, and each is suggestive of the conditions under which an equilibrium institutional condition might emerge. Equally, each is limited in confronting the puzzle - the appearance of institutional diversity, and of markedly different trajectories of institutional reshaping - on which this inquiry rests.

Secondly, historical institutionalism provides a remedy to the rational-choice (rational economics) assumption that preferences are exogenously given - indeed, consistent

with the argument developed in the concluding part of the last chapter, historical institutionalism admits of the endogeneity of the political within particular configurations of economic and political interest.

Thirdly, historical institutionalism admits of a more inductive approach to theorising about the nature of institutional production and reproduction because it encourages the fact of institutional difference (including differences in the nature and trajectory of institutional dynamism) to be the point of departure.

Fourthly, a creative approach to the rational choice and historical variants of the new institutionalism - the 'border crossing' referred to above - admits of an analysis of both continuities and change. It is entirely possible to conceive of particular institutional arrangements (and configurations of interest sustained by and sustaining of those arrangements) engendering an equilibrium condition, of significant realignments in interests being reflected in institutional breakdown and renewal, and of processes of change which manifest themselves within the parameters of a given institutional set.

Rational economics, (and rational-choice institutionalism) make out a strong normative case for a particular institutional model - the central bank possessed of operational independence to deliver price stability. However in treating issues of institutional design, evolution, production and/or reproduction as exogenous, these literatures provide few insights into the determinants and consequences of institutional difference, whether manifest in particular forms, or trajectories of institutional reshaping. The institutionalist framework is, as Sharpf has so persuasively argued, one that lends itself to a most similar systems research strategy (1997:23). Historical institutionalism suggests that an analysis of the determinants and consequences of difference is best grounded in the concrete temporal circumstances out of which the particular emerge. But an institutionalist perspective - and in particular one that draws on both the rational-choice and the historical variants of the new institutionalism - provides a basis for scholarship which makes a contribution to what Sharpf defines as 'policy research':

"In policy research, we are dealing mainly with collective and corporate actors, such as political parties, labour unions, government ministries, central banks, or international organisations, rather than with individuals acting on their own account. These composite actors are institutionally constituted - meaning trivially that they were created according to preexisting rules and that they depend on rules for their continuing existence and operation ...

An institutionalist framework ... provides a halfway position between a theoretical system that, like neoclassical economics, substitutes universal and

standardised assumptions, for empirical information on the one hand, and purely descriptive studies of individual cases on the other" (1997: 41).

A political-economy of central banking

The preceding chapter opened by positing a distinction between technical/economic, and 'political economy' approaches to central banking. Notwithstanding this distinction, we have argued that a simple disciplinary bifurcation between economic and political-economy approaches is limiting. We have already noted that applying the assumptions and postulates of economics to the political allowed 'government' to become endogenous to the models reviewed. However the conception of government in those models is typically limited and confined either to government's role as a conduit in the policy process, or 'government failure' evidenced in electorally informed and/or partisan interventions of a dynamically inconsistent kind (and which are economically sub-optimal over the long-run). As Posen suggests:

"Although many economists consider the integration of institutional factors - such as CB [central bank] independence - into their models to be already giving this devil his due, they are actually approaching democratic polities with a partial equilibrium mindset. The 'new political economy', which attempts to explain choices in the market for policy on the basis of institutional incentives, ignores the ongoing market in the power and prospects of the institutions themselves - and therefore ignore that democratic politics is by nature an ongoing process, interacting with, not settled by, institutions" (1993: 46).

Understanding the 'politics' of institutional design and action, and of the context in which central banks are located, admits of an analysis which is both dynamic and historical, and which conceives of central banks (and bankers) as political actors in their own right. Clearly at one level, to the extent that particular institutional arrangements are codified in statute, 'government' has a role to play in the development or modification of institutional arrangements. And quite obviously, therein lies a stark contradiction - and one that will be further explored in this chapter - if 'porous' institutional arrangements provide opportunities for manipulation, why would a rational maximising politician be party to a legislative/institutional change that would in any way reduce the prospect for discretionary intervention?

Moreover the technical/economic conception of central bank independence purports to be not just value-free, but free from the 'predations' of interest based politics and policy making. While over the long-run an optimal institutional frame-work will produce a positive sum game, less than optimal institutional arrangements (dependent central banks, or inappropriate targets) will not, and nor necessarily will optimal

institutional arrangements over the short-run. At some point, even with optimal institutional arrangements, the game will be of a zero-sum kind, with costs and benefits accruing to groups commanding different locations within the political topography. Government, or the contribution of institutions to 'good' or 'sound' government (in a qualitative sense) is not an explicit consideration, but, we have argued, is a factor for those concerned to ensure that the institutions of macroeconomic management are consistent with the values placed on accountability and responsiveness in liberal-democratic polities.

The political economy approach situates the institution at the centre of the inquiry, and posits that institutional design and institutional choices are both a function of, and at the same time serve to shape and influence, the political economic environment within which such institutions are located (see North, 1990; March and Olsen, 1984, 1989).¹⁰ The central bank is an instrument of the state, and as March and Olsen have so persuasively argued, "[t]he state is not only affected by society, but also affects it" (1989: 17). For our purposes we might recast this observation in terms of the central bank possessing a measure of coherence and independence such that, in a formal sense, its specific organisational and administrative form is given by 'society' (or more correctly the predominant societal coalition(s)), but, at one and the same time, the central bank is an actor in its own right in seeking to influence the political environment in which it is situated. The adoption of a political economy model provides a means of overcoming the 'situational determinism' of rational economics - the "autonomy of economics-decision-making and equilibrium processes in market exchange" (Lindberg, Scharpf and Engelhardt, 1987: 348). In short, the political economy model enables us to more effectively pose the first order questions of comparative public policy, why, and why not?¹¹

¹⁰ Woolley suggests that, in the search for 'appropriate democratic institutions' March and Olsen identify two concerns that are echoed in the debates about central bank institutions:

"One is a concern for aggregative institutions that aid in discovery and expression of the voice of 'the people' ... Democratic accountability is obviously central to the effective expression of popular sovereignty. A second concern ... is with integration - a concern for developing good citizens and a good society through processes of reasoned deliberation about appropriate policy. This concern for creating a realm for expertise buffered from conventional politics is also apparent in the concerns of reformers who wish to restrict discretion and to impose a long-run view in monetary policy" (1994: 60).

¹¹ Busch observes that;

"The approach of mainstream economics can generally be criticised for tracing only the sources, but not explaining the underlying socio-political causes of economic phenomena. In the words of Mancur Olson (1982: 4): '[T]hey trace the water in the river to the streams and lakes from which it comes, but they do not explain the rain.' Or, as Paul Whiteley (1986, 84-5) puts it with respect to inflation: 'For example, theory might demonstrate a stable relationship between excessive increases in money supply beyond those warranted by the growth of productive potential and inflation. But this is a rather inadequate theory of inflation, since it does not explain why some governments choose to print money in this way, when others do not. [...] A

The issues that this research seeks to illuminate go to the question as to why it is that institutional regimes differ across nations, or, "which factors ultimately determine the degree of central-bank independence" (Eijffinger and De Haan, 1996: 41). Research that has sought to identify the ultimate causes of differences in economic outcomes, has, been very strongly suggestive of the determinants of institutional difference.¹² So far as the political economy of central banking and monetary policy within specific national jurisdictions is concerned, while there is a significant and growing literature on the US Federal Reserve (see, for example, Epstein, 1982; Woolley, 1984, 1994; Kettl, 1986; Mayer 1990),¹³ there is however a paucity of literature - both theoretical and empirical - on the political economy of central banking in Australia and in New Zealand.¹⁴ In the Australian context, as Bell has observed, the operations of the Reserve Bank of Australia have been all but neglected by political scientists (Bell, 1997b), however Eichbaum (1993) and Bell (1997b), represent initial attempts to remedy this deficiency. Similarly, in the New Zealand context, political scientists have, again, with very few exceptions, ignored the institution of the Reserve Bank (the notable exceptions being Dalziel, 1993; Kelsey, 1995, 1998; and Gregory, 1996).¹⁵

truly general theory would deal in fundamental causes, which are rooted in the social structure and political organisation of society. The economics paradigm very often chooses to ignore these.' This critique can be summarised as follows: economic theories alone can explain how growth or inflation comes about, but they alone cannot explain why'(Hirsch, 1978, 263)" (Busch, 1993: 42-3).

We might further distil the logic of the argument by observing that while economic theories may inform an institutional prescription designed to militate against the evils of politically informed discretionary policymaking, they do not explain why certain institutional configurations are preferred in particular national contexts.

¹² The notion of a 'distributional coalition' and of institutions as the embodiment of interest group preferences (Olson, 1982, Katzenstein, 1978, 1985) indicate a nexus between interests, institutions, and economic outcomes, and there is a growing body of research which seeks to account for differences in economic outcomes as reflecting institutional imperatives. One stream of research examines the influence of corporatist institutional arrangements (Cameron, 1984). Strumpel and Scholz cite a number of studies which follow an institutional economics or neo-corporatist approach to the explanation of cross-national differences in economic performance (1987: 264-347). And the relative influence as between central bank independence and corporatist arrangements has also been examined (Havrilesky and Granato, 1993; Hall, 1994). The contributions of Lindberg and Maier (1985) advance a political/institutionalist account of macroeconomic outcomes. More recently Busch reviews the economic and 'public policy literature' literature on inflation, and concludes that,

"... a combination of economic and political science approaches to the explanation of inflation (understood as a form of distributive struggle) seems particularly promising. What is necessary is to build on economic knowledge about the process of inflation and complement that knowledge with the explanatory power which seems to be offered by tracing the origin of that process in political and social institutions" (1993: 43).

¹³ See the review of the literature on the US Federal Reserve in Woolley, (1984: 271-274; and 1994).

¹⁴ And in other English speaking nations. Coleman comments that, "Canadian political scientists have not reflected on the peculiarities of the institutional arrangements for monetary policy in Canada" (1991: 712).

¹⁵ It is noteworthy that while these three authors have made important contributions to the 'political-economy of central banking', broadly defined, only Gregory is a political scientist as such, Dalziel coming to the topic as a macroeconomist, and Kelsey as legal scholar. Dalziel has located the 1989 New Zealand legislation in the context of revolutions or paradigm shifts in economic thought and views the 1989 Act

Models of the political-economy of central banking

The design of particular institutional structures will reflect a multiplicity of factors - history, culture, and ideology, as well, as economic theory and empirical evidence. The import of much of the rational economic literature reviewed in the previous chapter is that issues of institutional design in and of themselves, raise issues of political economy. At the technical/economic level, issues of central bank accountability are attendant upon the institutional prescriptions suggested by optimal performance contracts. For those concerned to mitigate the deleterious consequences of goal independent and 'conservative' central bankers, accountability provides a check on the over-zealous. Moreover in the context of liberal-democratic political systems, institutional prescriptions that encourage a 'democratic deficit' may need to accommodate requirements that go to the legitimacy of particular institutions. To be both 'independent and accountable' a central bank, and the conduct of monetary policy more generally, will need to be both 'credible', and 'legitimate'.

Central bank accountability suggests a role for 'government' - at the technical level as part of an accountability regime that assesses agents' compliance within an optimal performance contracting regime (including the use of performance contracts and/or override provisions to counter the potential excesses associated with 'conservative central banker' models); but also in remedying any 'democratic deficit' associated with

as being consistent with the tenets of new classical economics, and in particular assumptions about the neutrality of monetary policy, and notions of a 'natural' rate of unemployment (1993). Kelsey (1998) reviews the conduct of monetary policy in a critique of the 'New Zealand model' of structural adjustment, examines the conduct of policy, over the period from 1984 -1995, and, drawing on Dalziel (1993) the genesis and consequences of the Reserve Bank of New Zealand Act 1989. While Kelsey's analysis locates the conduct of monetary policy and of institutional change in a narrative - which, with some justification, locates both within a wider neo-liberal political project - the analysis is somewhat deterministic, and functionalist. Thus, for Kelsey,

"[t]he stated aim of the Reserve Bank [of New Zealand] Act [1989] was to provide relative stability for those prices which were important to investment and free enterprise. In the process, monetary policy caused havoc with employment, interest rates, exchange rates and economic growth. This obsession with one economic indicator forced the economy into an abstract theoretical model which existed nowhere else, appealed to a norm of zero inflation which had never existed in the country's recent economic life, and benefited the rich, in particular finance capital, at the expense of wage labour, families and the poor" (1995: 172).

Bob Gregory has advanced a critique of the Reserve Bank of New Zealand Act 1989 which focuses on the issue of the democratic deficit, and which views this legislation as part of a more general anti-democratic process of technocratisation informed by public choice styled assumptions about the dangers of discretionary policy making (Gregory, 1996). The Gregory paper challenges an argument advanced by Ralph Bryant, in the course of which the latter defends the 'democratic accountability' of the New Zealand arrangements, informed as they are by the distinction between goal and instrument independence. Bryant argues that, " ... the Reserve Bank does not have latitude to depart from society-wide goals as determined by the electoral and parliamentary process" (1996: 7). The essence of the Gregory critique is that the formal institutional arrangements mask the profoundly undemocratic qualities of the conduct of policy and the exercise of choice on the part of delegated 'agents'.

institutions that operate 'independently' of elected governments. A 'political-economy approach',

" ... examines the relationship between the various politico-economic forces and interests which act to constitute and maintain institutions ... [It] stresses that the evolution of the status of the central bank is not ordained by natural factors, nor can it be explained in terms of simplistic imputations about the behaviour of governments, but is rather the outcome of more complex and dynamic political processes" (Bowles and White, 1994: 241).¹⁶

Political variables in this approach fall into two categories:

" ... economic forces and movements which are 'political' in the sense that they apply pressure on governments in certain directions and condition the range of feasible policy options available to governments [and] political pressures in the conventional sense of the operation of the political/state system ... These are 'economic' in the sense that they reflect economic forces in society at large and beyond, they influence economic processes through their impact on policy and they embody economic power through their control over resources" (Bowles and White, 1994: 244).

Bowles and White suggest that the two 'traditions' are more complementary than discrete, with the first highlighting the structural parameters within which political actions may be taken, and the second providing, "a more precise and nuanced insight into the institutional and conjunctural variability of political processes" (1994: 244).¹⁷ The focus of the analysis reported in this work falls largely into the second of the two traditions, while admitting of the 'structural' variables that influence the mix of opportunities and constraints presented to members of policy communities within national policy domains.

¹⁶ In substance there is little to differentiate the political-economy approach advanced by Bowles and White from the more traditional realm of the 'politics of monetary policy'. This approach, referred to as 'monetary politics',

" ... can be understood in large part by examining the objectives and resources of groups and organisations that contend with one another to try to define what policy should be. The Federal Reserve has two kinds of overarching objectives. The first is to achieve stable growth while guaranteeing financial stability; this involves the System inescapably in favoring certain societal interests over others. The second objective is to protect the System's long-run capacity for making an autonomous contribution to macro-economic policy making. These two objectives are frequently inconsistent, and both draw the Federal Reserve into controversy. The result is monetary politics, the interaction of actors with partially conflicting objectives and unequal political resources ..." (Woolley, 1984: 2, emphasis added).

¹⁷ Bowles and White suggest that three broad sites of contestation illuminate the political-economy dynamic - domestic socio-economic forces (the variable patterns of relationship between finance, industry, and labour in society); domestic actors and processes operating within the institutional sphere of the state and in the wider political system; and international political and economic pressures and processes (Bowles and White, 1994: 244-5).

Interests and Networks - political economy models of central banking

For the purposes of the discussion in this and subsequent chapters, after Bell we differentiate between two models of the political economy of central banking - the 'conflict and politicisation' model and the 'policy network' model (Bell, 1997b).¹⁸ The first posits that, " ... central banks operate in an environment involving conflict between governments and central banks, all set within a wider context of sectoral conflict between expansionists and restrictionists over how fast the economy should grow and how much inflation is acceptable" (Bell, 1997b:3). This model shares a number of the assumptions underpinning the 'dynamic inconsistency' problematic we discussed in the preceding chapter. Three central assumptions inform the conflict and politicisation model:

- compared to central bankers, politicians are substantially softer on inflation
- this leads to a pattern of government meddling in monetary policy and Bank politicisation, and
- expansionary interests (particularly industrial interests according to the literature) are important to the political economy of central banking and may challenge financial interests and deflationary policies, leading to a wider conflictual monetary policy environment (Bell, 1997b:5).

However, based on a review of the conduct of monetary policy in Australia post financial deregulation, Bell suggests that,

¹⁸ An alternative basis of reviewing the literature is provided by Maxfield who suggests that the political economy literature seeks to address two questions - when and why do government politicians give discretion to central banks; and under what circumstances do they honour and protect decisions to cede authority to central banks. The answers, Maxfield suggests, focus on:

- (1) the political strength of different sectoral groups with varying preferences for employment and price stability
- (2) the nature of political institutions and party systems, and
- (3) the financial needs of government
- (4) the influence of leadership within central banks, and the weight of economic ideology (Maxfield, 1997: 19, 31).

Maxfield suggests that, "[s]ectoral arguments essentially posit that central banks are an epiphenomenon of sectoral forces and assume that politicians bear no cost in changing central bank discretion and authority ... institutionalist studies focus on how the extent of political competition shapes the cost of change" (1997: 25), and that government financial needs as a driver of central bank independence is evidenced in the use of an independent central bank as a device to lower interest charges on government debt (1997: 29). Given these schema, what we have categorised, after Bell, as the 'conflict and politicisation' and 'policy network' models are conflated into the first (sectoral determinants and effects) category advanced by Maxfield. Moreover these models capture more fully the interactive and dynamic relations as between the state and societal interests and organisations (within policy networks), and the influence of the wider institutional framework in mediating those relations. Maxfield's conception of 'sectoral groups as political constituencies' not only fails to capture the dynamic engagement between sectoral groups and the state, but also - by assuming that institutional change involves no cost for 'politicians' makes the politics of central bank independence (as an element of public policy) somewhat exogenous.

"[t]here are good reasons ... to question the conflict and politicisation model ... It exaggerates the supposed political softness of politicians on inflation, it fails to recognise market constraints on partisan intervention and assume politicians have more freedom to manipulate policy than they actually do. The model is also ahistorical in that it fails to recognise how the context of monetary policy has changed radically in the last decade. In particular, it fails to appreciate important technical changes to the operation of monetary policy, the significance of financial deregulation and the general policy firming on the goals of low inflation and Bank independence" (1997b:14).

We endorse this assessment, and the analysis contained in subsequent chapters would tend to confirm it. However, to anticipate that discussion, the issue is much less one as between the conflict and politicisation model, on the one hand, and the policy networks model on the other, than on the capacity of policy networks to ensure a measure of institutional equilibrium, thus obviating the need for either state or societal interests to have recourse to the formal political/legislative process.

In large part the weaknesses of the conflict and politicisation model are suggested by the absence of any empirical evidence of conflict, either as between interest groups and the central bank and/or between the central bank and the government. In the absence of any overt 'politicisation', or 'regime' changes in institutional arrangements, the suggestion is that conflict and politicisation offers little explanatory power. In essence the argument is that the model has little to offer in understanding the dynamics under conditions of relative political and institutional equilibrium. The counter argument might be that the model may possess a greater utility either where the institutional arrangements or other environmental factors conspire to produce politically 'porous' relations as between a government and a central bank, or under circumstances of significant institutional change, whether that change involves changes to the formal statutory arrangements or informal change within the existing statutory parameters.

The 'policy network' model, it is argued possesses greater explanatory utility. In this model,

"... monetary policy is formulated in a 'state directed' policy network in which 'state actors retain for themselves all decision making competence for the definition of monetary policy'. This implies, especially compared to more openly contested arenas, such as fiscal policy, a relatively closed decision making process in which the key dynamic is not open conflict but a more technocratic management of policy tensions. Hence compared to the conflict and politicisation model ... this implies a more ordered policy environment managed within the state, where politicisation is tantamount to mismanagement or policy failure" (Bell, 1997b:15).¹⁹

¹⁹ More generally the notion of policy networks provide a basis on which to illuminate systems of relationships between state and societal organisations, within an institutional analysis (see Katzenstein, 1978; Coleman, 1996; Atkinson and Coleman, 1989, 1996; Coleman and Skogstad 1995). Coleman

In essence the 'policy network' model more readily entertains the emergence and management of an equilibrium condition, and allows trajectories of institutional reshaping to be viewed as either management within a 'network' or, in the case of significant institutional change (a 'critical juncture' or 'punctuated equilibrium') corresponding changes in the composition of a network over time. Whether a policy network is supporting the institutional status quo (which may involve an evolutionary measure of 'dynamic institutionalism') or prosecuting the case for a qualitative institutional change, the contribution of ideas, and specifically of a shared Weltanschauung, is pivotal. In an analysis of the determinants and consequences of trajectories of agricultural policy change in Canada and Australia, Coleman and Skogstad identify the importance of a shared set of principles tied to a specific policy prescription, within policy networks:

"Where liberal principles have historically been part of the policy debate they are more likely to serve as catalysts to policy change. Such a catalytic role becomes more likely when a neo-liberal world view is promoted by expert, policy entrepreneurs than constitute an epistemic community" (1995: 243, emphasis added).²⁰

The extent to which a policy network, whether existing or emerging constitutes an epistemic community is an important threshold determinant of the capacity for institutional reshaping, and the particular trajectory of change.

The distinction, we will argue, between the 'conflict and politicisation' and the 'policy network' models is one of degree rather than kind, and for the purposes of the discussion that follows in this and in subsequent chapters, both models will be directed to explaining both continuity and change in the institutional arrangements within which central banks, governments, and societal interests interact.

suggests that policy networks are manifest in relationships between private and state actors within policy communities - a policy community defined, "to include all actors or potential actors with a direct or indirect interests in a policy area or function who share a common policy focus" (1996: 11). Atkinson and Coleman define 'policy network' as referring to "dependency relationships that emerge between both organisations and individuals who are in frequent contact with one another in particular policy areas" (1996: 196), with networks described as, "corporatist, state-directed, collaborative, or pluralist not simply on the basis of who participates, but also on the basis of the distribution of organisational resources within the network" (1996: 200).

²⁰ Coleman and Skogstad suggest that the different trajectories of agricultural policy in Canada and Australia over the 1980s and 1990s are attributable to different domestic political-institutional arrangements, "including federalism, bureaucratic arrangements, the presence or absence of a neo-liberal epistemic community, and the structure of the interest intermediation systems" (1995: 242), and conclude, in part, that, "[c]hanges in policy communities and policy networks appear to be an essential condition for policy innovation and change" (1995: 260).

Conflict and Politicisation? - explaining institutional continuity and change

In examining the politics of central banking in Western Europe - specifically the central banks of Italy France and Germany - John Goodman has argued that the origins of central bank independence, and of economic policy choices more generally, are to be found in the nature of the societal coalitions whose preferences serve to set the policy agenda at any one point in time (Goodman, 1991: 331) ²¹.

In summary, Goodman's argument is as follows:

- politicians and central bankers have different policy preferences - compared to politicians, central bankers will be more concerned with the risks of inflation
- politicians tend to be more unwilling to subordinate goals such as economic growth and employment to that of achieving and maintaining price stability
- conflict between politicians and central bankers is likely over the substantive goals or outcomes to which monetary policy should be directed, and over the specifics of monetary policy settings at a given juncture
- central banks are categorised as falling within one of the two ideal types - dependent central banks largely conform to their government's agendas, in turn influenced by the parties in power, and the strength of domestic interest groups; independent central banks are able to pursue policies which differ from those preferred by the government of the day
- and,(consistent with the empirical findings reviewed in Chapter 2), Goodman suggests that because central banks tend to be more concerned with price stability (restrictive monetary policies) than do governments, countries with independent central banks tend to have lower rates of inflation than do countries with dependent central banks (Goodman, 1991:329)

This leads Goodman to pose two questions:

- why do governments allow central banks to become independent in the first place? and
- once independent, how do central banks retain their independence given the incentives of politicians to reassert control over monetary policy ?

In seeking to answer these questions Goodman suggests that the important variables are less economic than they are political, that a country's economic choices are determined by societal coalitions, and secondly, that a country's institutional choices are governed by the expectations of political leaders regarding tenure in office:

²¹ See also Clark (1993, 1994), Franzese (1995), and the review by Maxfield (1997: 23-25).

"Political leaders who expect that their party will be in office for a long period of time will want to maintain a high degree of freedom. As a result, they will have an incentive to increase (or at least maintain) political control, over the policy making process. By contrast, political leaders who expect to be in office for only a short period of time (and return to a long period of opposition) may be willing to bind even their own hands in order to bind the hands of their successors. These leaders may be willing to reduce political control by establishing rules like the balanced budget amendment or by creating independent regulatory agencies" (1991:333)

Under conditions of economic stability, and where the dominant societal coalition represents other interests - for example farmers, manufacturers and workers - it is argued that the individual and collective preferences of such groups will tend to favour greater monetary expansion (Goodman, 1991: 333). Independent central banks emerge, it is argued, where two conditions are satisfied -

- under conditions where the dominant societal coalitions are those in which financial interests dominate, because, it is argued, those financial interests tend to be more supportive of policies of monetary restriction, and
- where the incumbent government expects to be in office for only a short period of time and seeks to effectively institutionalise policy constraints on future governments (Goodman, 1991: 332).

Accepting that the interests of monetary and political authorities will at times diverge, it is argued that central banks maintain their independence by building support among key societal actors, and that the financial community serves as the "first line of that support" (Goodman, 1991: 335). These ties serve both to establish an enduring coalition capable of maintaining the institutional bases to central bank independence, and of sustaining a conservative central banking ethos:

"Banks are highly averse to both unexpected inflation and market instability; their long-term interests depend upon the central bank's ability to control inflation and maintain stability in the financial system. Thus, central banks can be seen (and see themselves) as providers of a collective benefit which banks are themselves unable to supply" (Goodman, 1991: 329)

Maintaining institutional equilibrium - State directed policy networks

If the assumption is made that institutional actors will be concerned to maximise the standing and viability of an institution, and if such standing and viability is a function of the kind and quality of political resources than can be mobilised by civil society actors, then there is a direct functional relationship between institutions and interests:

"... if policymakers are assumed to assess whether exercise of their freedom against any given moment's constellation of interests in a society could be institutional suicide, such hesitation is comprehensible.

As a result it can generally be predicted that a public institution's actions must always have the support of a politically powerful interest coalition ... Therefore the changing relative strength of interests in society, not the institution's structure, is the source of policy decisions - and this strength is a function of the oft overlooked and always changing political background" (Posen, 1993: 46).

We noted in the previous chapter that the prevailing orthodoxy is one that rests on the (not uncontested) assumption of the neutrality of monetary policy over the long-run. That assumption of neutrality of impact on real economic activity, is mirrored in the assumption that the particular institutional framework suggested by that orthodoxy is, in terms of the distributional consequence, benign in its distributional impact. This second assumption is contested by the political economy literature. Posen observes that:

"Restating the general framework in the context of monetary policy begins with three observations: the existence and independence of CB [central bank] institutions are subject to democratic control; inflation has significant redistributive effects; financial intermediaries as a group are harmed by inflation. Thus, while CB decision-makers form their policies in part in response to statutory constraints, they also simultaneously respond to the risks that anti-inflationary policies could lead to alterations in the autonomy and powers of the CB itself. And financial intermediaries reduce the risk through political activities in order to gain from lowering the inflation level " (1993: 47).

The literature reviewed in Chapter 2 is strongly suggestive of contingent patterns of relationship between central banks and particular socio-economic forces or interests. The need to maintain a high level of credibility (or reputation) with financial actors suggests that central banks will develop a special relationship with the finance sector. This relationship can be recast as a 'political alignment' between central banks and the financial sector:

"...in general central banks have a particular political character stemming from their special relationship with the financial sector. Given this political alignment, one might reasonably expect that the distributive consequences of their actions should favour that sector over others in society. Moreover one would expect their view of what constitutes 'sound' policy - and indeed 'sound' politics - to coincide to a large degree with those of the financial community, particularly the larger and longer established banks which dominate oligarchical financial systems" (Bowles and White, 1994: 247).

And yet there is also the acknowledgment that a central bank, in order to maintain its independence from government, "must pay some attention to gaining the support, or at least the acquiescence, of other interests in society" (Bowles and White, 1994: 247).

Consistent with the logic of this argument Posen proposes a 'model of interests' in which central bank independence and policies are a function of financial sector opposition to inflation:

"[S]ince CB independence is always at risk from proponents of inflation, and that risk both determines the policies pursued and is determined by the political strength of opposition to inflation, there is no reason to expect that CB credibility or revealed policy preferences will have a fixed relationship with statutory independence; instead they will vary with developments in the ongoing political struggle over inflation" (1993: 47, emphasis added).

The import of this is very much at odds with the conceptual frameworks discussed in the previous chapter. Inflation, it is argued, is the product of a distributional struggle, not of the opportunistic manipulation of monetary policy for either electoral advantage or to generate revenue (Posen, 1993: 47). Posen reports research which purports to demonstrate a causal link between more effective finance sector opposition to inflation on the one hand, and higher central bank independence and lower inflation rates on the other (1993: 50), and on the basis of this evidence advances a distinction between interests and institutional models of inflation. The institutional account would have it that central bank independence will result from a situation in which a right-leaning government thinks itself at risk of losing office to the left. Accordingly, government instability or turnover becomes an important predictor of central bank independence. While the involvement of financial actors may be influential at the time of the design of the institutional arrangements, the interests of financial actors (and in particular, financial sector opposition to inflation) becomes less of a factor once the formal changes have been effected. The 'interests' explanation denies the importance of government instability altogether (since the purpose of central bank independence is not to bind the hands of the government but to fight off other inflationary advances championed by other interests). Moreover, because the 'interests' explanation admits of the possibility that the degree of central bank independence will be variable over time (i.e. the parameters of central bank independence are not fixed by statutory arrangements), the extent of central bank independence will be a function of the relative power and influence of financial interests within the political economy (see Posen, 1993: 50-51).

However we would contend that there are two principal limitations to the model advanced by Posen. Firstly the argument assumes a classical pluralist political system which allows for a range preferences to be articulated and codified into policy from time to time; no interest group is privileged in terms of its access to political resources, nor in terms of its mobility - 'voice' and 'exit' in the classic Hirschmann formulation (Hirschmann, 1970). Secondly it assumes that institutional arrangements can be

modified to accommodate shifts in the relative influence of different interests over time, and that the mix of institutional arrangements used to place a central bank on an independent footing will not include sanctions where that independence is challenged, diminished, or subject to an override. Moreover, and most importantly, the argument risks both a simplistic and an arbitrary bifurcation as between institutions and interests, and a decidedly ahistorical approach. Arguably the dynamic interplay between interests and institutions is somewhat more complex than the distinction implies.

These limitations notwithstanding, the model does suggest that institutional design, establishment, and maintenance is part of a political process in which the mobilisation of interests plays an important role. It also suggests that the utility or integrity of a particular set of institutional arrangements will be variable over time, and that, as a consequence, an institutional framework that provides for a measure of flexibility or discretion will be better placed to withstand shifts in interest group influence (represented in changes as between left and right party governments) over time. Moreover the model also suggests that central banks may be active in the process of shaping opinions, and by implication preferences and policies, within the electorate. That in turn suggests that an independent central bank may be able to generate additional bases of support within society, and that institutional arrangements may be somewhat more durable than the 'interests' model suggests:

"[T]here is no institutional 'fix' for the redistributive struggle over monetary policy ... CBs designed with similar degrees of statutory independence will offer significantly differing degrees of protection from inflation over time as the political situation alters" (Posen, 1993: 53).

Whereas Goodman is concerned to explore the conditions under which, in a formal sense, central banks may be made more independent of governments, the alternative approach seeks to examine the conditions under which overt conflict and politicisation (and regime changes in institutions) are not present. Posen suggests in effect that, because formal elements of the institutional regime are underpinned by societal interests, a focus on formal regime shifts may militate against an appreciation of the importance of variation in finance sector opposition to inflation, which is causally more significant, and independent of the formal institutional status of the central bank. There is a clear affinity between this line of argument, and the notion of a state directed network.

Examining the institutional arrangements underpinning the conduct of monetary policy in Canada, Coleman, (1991) suggests that monetary policy in Canada is formulated in

a state directed policy network. The term network suggests that there are structured linkages among various state agencies and between those state agencies and societal interests and organisations. Coleman posits that, "two sets of political conditions must be met if a state directed network with responsibilities over economic policy is to be sustained in an advanced capitalist society with liberal democratic institutions" (1991: 713) - political arrangements within the network must ensure that political authorities remain accountable for their decisions and that their actions are perceived as legitimate; and because the intervention often involves the state in activities that impinge on the activities of the business community, special efforts must be taken to ensure that this community understands and accepts the intervention. Legitimacy, in this context, is defined as "the extent to which decisions and actions of political authorities are perceived as right and proper by members of the political community" (1991: 728), whereas the concept of credibility, "refers to the necessity of support for state actors from a sector of the business community " (1991: 719). And as Coleman suggests,

"[m]eeting these two sets of political conditions is not always simple because they are potentially contradictory. If too much emphasis is given to reassuring the business community, the network might suffer problems in accountability and legitimacy. In contrast, if sensitive economic decisions are placed directly in the hands of politicians, the business community will quickly become concerned that political criteria might displace economic criteria in the decision making process...

... The business community normally demands a special degree of autonomy for the central bank in the hope that its decisions will be market-oriented rather than political in nature. Yet this autonomy, if not properly defined, might work against the central bank's legitimacy and make it appear to weakly accountable in the democratic context" (1991:713-714).

Moreover, within the business community, specific interests or fractions constitute discrete communities of interests in their own right, Coleman suggesting that, "the direct clearers and domestic and foreign financial market actors constitute a community with in an interest in ... 'sound finance'" (1991: 717). Clearly the notion of the 'business community' is, albeit somewhat implicitly in the Coleman schema, somewhat blunt, and to posit a distinction between 'the business community' and 'the community at large' risks a failure to differentiate between those interests within the business community supportive of an expansionary stance for monetary policy and others, typically financial sector actors, more disposed towards a restrictionist policy stance.

In evaluating the development and implementation of monetary policy within a state directed network, Coleman suggests that, what he characterises as a political science perspective, is advanced by,

"an analysis of the structural properties of the policy network, reflecting on the balance between accountability and legitimacy on the one side, and responsiveness to economic needs on the other. This kind of study must complement any assessment of policy carried out by monetary economists ... In proceeding then to evaluate the policy network from this political science perspective, questions arise under two broad headings: political accountability and legitimacy" (1991: 724).²²

A synthesis: accounting for institutional continuity and change:

For the purposes of the discussion in the balance of this chapter, and those that follow, we advance a model which draws on both the two streams of political-economy reviewed above, and which seeks to incorporate elements of the rational economics literature reviewed in the preceding chapter. After Coleman, we posit a distinction between credibility on the one hand, and a broader conception of legitimacy on the other. In terms of the former, credibility - whether of institutions, policy or personnel - is seen as the necessary requirement where monetary policy has been contaminated by the siren attractions of the short-term benefits that accrue from opportunistic political interventions (ie. the problem of dynamic inconsistency). Moreover in terms of the attendant political or relational consequences, the notion of credibility generally suggests some kind of nexus between a central bank and financial actors within the business community. The fact of this relationship is suggested by an accountability regime which, by means of transparency of process and of contract subjects policy objectives and implementation to scrutiny by markets, and by the fact that the practical conduct of monetary policy requires, "a close working relationship between the Bank and financial market actors. The bank must familiarise itself with, internalise and react to the opinions of these players when formulating policy if this policy is to be perceived to be 'credible'" (Coleman, 1991:728). For the purposes of this model, accountability arrangements that are endogenous to a model of institutional design,

²² Coleman suggests that the relative influence of the central bank and private sector actors differs across the policy development/implementation divide:

"In summary, the Bank of Canada *formulates* monetary policy autonomously from private sector actors - it is not easily lobbied and has formidable expertise in-house for policy analysis. In contrast, the Bank *implements* monetary policy through daily intervention in financial markets amid a network of working relationships with major institutions in those markets, particularly the chartered banks. The need to remain credible with these market players feeds bank in turn into policy formulation, particularly in the definition of ultimate objectives of monetary policy" (1991: 719, emphasis in original).

This implies a 'layered' state directed network within the policy formation process (the 'subgovernment' of the policy community developing policy) dominated by state actors (Coleman, 1991: 720).

including but not limited to those designed to assess the technical 'credibility' of behaviour and policy within an optimal performance contracting regime, will be treated as an aspect of central bank/policy credibility.

In terms of legitimacy, which, we have argued also relates in part to formal accountability arrangements, the issue is one of ensuring that, however credible, institutional arrangements and the conduct of monetary policy accord with wider community sentiment about both policy objectives, process, and policy outcomes. 'Legitimacy' entertains those kind of accountability arrangements that may variously exacerbate or militate against the emergence of a 'democratic deficit' - accountability arrangements which seek to secure institutional arrangements less by reference to their technical effectiveness or efficiency, than to their 'appropriateness' within the polity and society at large. However legitimacy also goes to the appropriateness of policy objectives, and as such is suggested not just by the political-economy of central banking, but by those contributions within the rational economics literature that caution against institutional arrangements which may militate against an appropriate balance between price stability and other elements of macroeconomic stabilisation (specifically the fact that the short-run Phillips Curve is not vertical, with adjustment costs accruing over the 'short-run', and the possibility that monetary policy may be not be neutral in its real economy effects over the 'long-run'.)

Moreover a synthesis of the 'conflict and politicisation' and 'state network' models suggests that particular societal interests may view the institutional arrangements underpinning central bank/government relations as variously credible and/or legitimate. What is suggested is the possibility of various institutional arrangements informed by differential weightings given by those responsible for policy and institutional design to credibility, on the one hand, and legitimacy on the other. If we conceive of these possibilities as informed by a simple 2 x 2 tabulation, four possible outcomes are suggested, and represented in Figure 3.1:

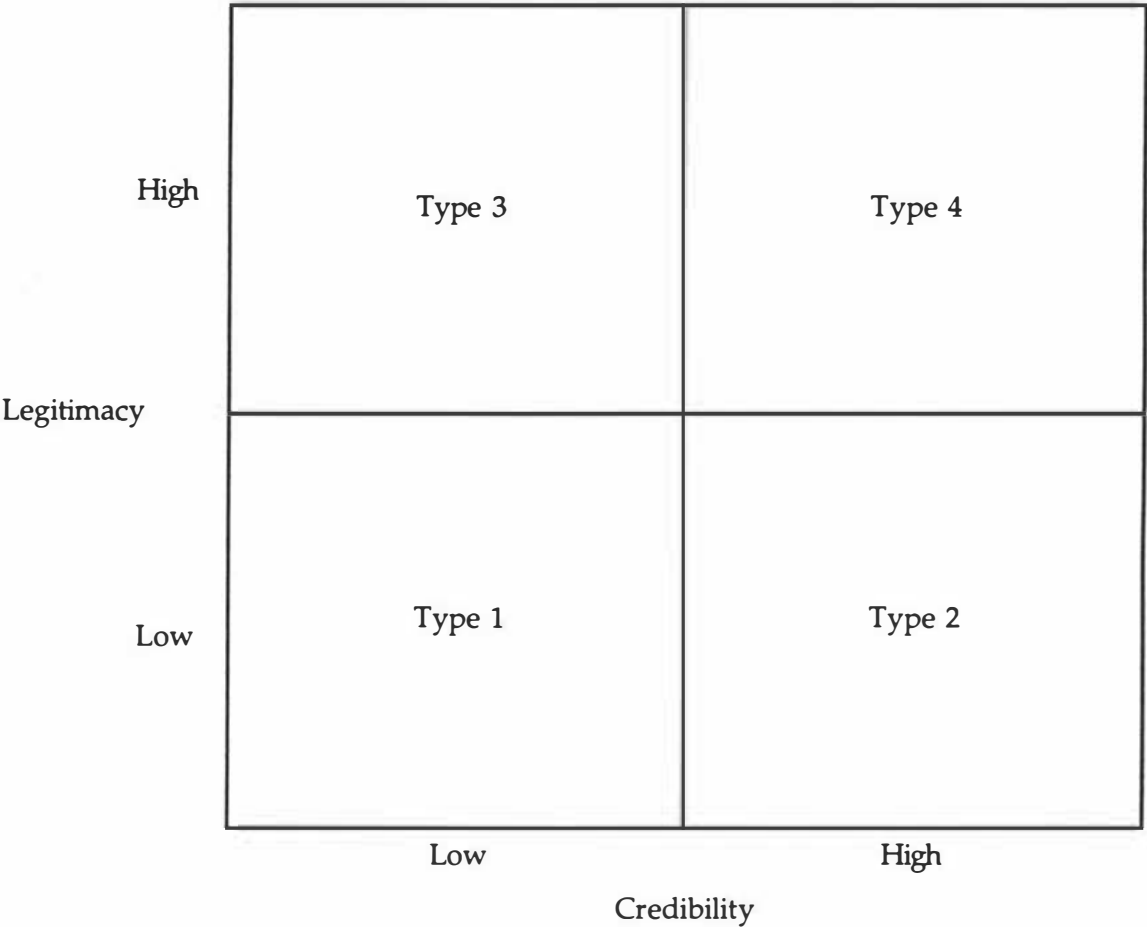


Figure 3.1 A typology of institutional arrangements 'regulating' central bank/government relations

The model offers a means of exploring both the formal (statutory) elements of institutional arrangements, and actual behaviour, within a more dynamic and historical framework than that suggested by the ahistorical statute reading approach. Clearly the model admits of a greater range of institutional possibilities than the simple 'two by two' schema would suggest (and in the concluding Chapter we foreshadow the possibility of adapting the model to enable trajectories of institutional reshaping to be mapped, over time, in 'credibility/legitimacy' space). However the use of this tabulation does suggest a typology within which particular institutional arrangements - existing or desired - might be located. Accepting for the purposes of this discussion that it is conceptually possible to optimise both, then the 'optimal' institutional arrangement/outcome is one which has a high ranking on both.

However the discussion in the preceding chapter entertained the possibility of theoretically informed institutional remedies producing technically credible, but socially (and politically) sub-optimal outcomes. One can envisage an institutional remedy

which, while entirely 'credible' in terms of the conduct of policy and market perceptions, may nonetheless be found wanting in terms of a wider test of legitimacy - for example a central bank that maintains price stability, but at the expense of stability in output. Such an institutional set might conceivably score high on credibility and low on legitimacy. Conversely, one can conceive of a situation in which a central bank/banker is perceived as legitimate by non-financial actors, but where the ambiguity of the institutional arrangements generates a credibility deficit within the finance sector. And finally it is entirely possible that a central bank/central banker may be perceived as neither credible nor legitimate. That possibility is suggested by a policy target which is assessed by the market as 'too hard', and/or by the failure of a central bank to realise its contracted target(s), and where policy is such as to engender economically sub-optimal outcomes which in turn contribute to a loss of 'popular' legitimacy. The model accepts that within a particular institutional configuration it is entirely possible for the status of the central bank to move in 'credibility/legitimacy' space. The over zealous pursuit of an inflation target may result in a diminution in institutional legitimacy; conversely the failure of a central bank to realise a contracted target may have result in a credibility deficit. Clearly the model acknowledges that central bank behaviour, and the status of particular institutional configurations are historically contingent.

Clearly Type 4 represents the optimal model, with the remaining three variously limited by low rankings on either or both credibility and legitimacy. In terms of the distinction between the equilibrium and disequilibrium condition, Type 4 represents the equilibrium condition, with the other three possibilities presenting degrees of disequilibrium.

The model, and the four-fold typology suggested by it, not only provides a framework for comparative research but a basis for work of a more normative kind when it comes to issues of institutional design. If one accepts the dual imperatives of legitimacy and credibility, the issue for institutional design and policy practice becomes one of maximising returns from each. Moreover this model may also help to illuminate the imperatives behind changes, or complete regime or paradigm shifts in the formal institutional arrangements and state-directed networks within which central banks operate, and within which relations between central banks and civil society actors are conducted and mediated.

The model overcomes the limitation suggested by the distinction between the 'conflict and politicisation' and 'state directed networks' models, a limitation that is all the more marked when the object is one of seeking to explain institutional difference and

different trajectories of institutional reshaping within a comparative framework. As such the model lend itself to a deductive inquiry, whereas, in part at least, the two streams on which it is based appear to have been generated inductively out of single case studies. In essence the model imports the 'pluralist' and 'materialist' assumptions common to the political-economy literature. We posit that policy outputs will be a function of the interaction between the state and societal organisations, and that at any given point in time policy - in the case the formal elements of the relationship between the central bank and the government - will reflect the relative ascendancy of societal interests and coalitions, and of actors within the state apparatus. That dynamic will be situated within a broader political-economy context which admits of the accumulated policy experience of actors and states, and the influence of economic and political ideology, and of the international context within which state-society relations are conducted.

It might be argued that credibility and legitimacy are less qualities of institutional arrangements, or imperatives driving trajectories of institutional reshaping, than they are consequences of particular institutional arrangements, differentially regarded by different interest coalitions. Such an interpretation would however deny the logic of historical institutionalism, and indeed the endogeneity of 'central bank independence'. Legitimacy and credibility may well enjoy a differential weighting within the political economy - but they simply cannot be reduced to the status of preferences or prejudices on the part of actors within the political economy. As the discussion in the chapters that follow will demonstrate, these institutional attributes or endowments are manifest in particular, and verifiable qualities of institutional form - policy objectives and modes of governance in particular. Moreover, because the conduct of monetary policy (and trajectories of institutional reshaping) occurs within a dynamic and a relational context, in a very real and substantive sense, the effectiveness of policy and the viability of institutional forms is very much a function of credibility and legitimacy. In the absence of 'credibility' there may be no remedy to the dynamic inconsistency constraint discussed in Chapter 2. In the absence of a mandate or charter that requires a central bank to factor short-run adjustment effects into the policy calculus, policy and institution may fail the test of legitimacy, calling into question the political viability of a given set of institutional arrangements. To view credibility and legitimacy as simply the consequence of a given set of institutional arrangements is to risk a replication of a major weakness of the rational economics literature - the assumption that central bank independence (or more generally the genesis of any particular institutional configuration) is exogenous.

The research reported in this thesis takes as its point of departure the fact of significant difference in the institutional frameworks within which monetary policy is developed and implemented within the two Australasian nations. Using a most similar systems research strategy we seek to account for institutional difference. The model elaborated in this chapter constitutes a synthesis of a number of strands in the existing literatures on the determinants and consequences of central banking. At one level, a political economy model admits of an interface between the rational economics literature (which treats the institutional as exogenous) and a political science perspective which is episodic and reactive (Woolley, 1984: 182). At a second level, the model admits of elements of both a rational-choice and an historical institutionalism - it does not deny the materialist basis to the articulation of interests within the political economy (the assumption of rationality), and it does posit the existence of an equilibrium condition. However it seeks to illuminate the imperatives contributing variously to institutional equilibrium and disequilibrium within an historical framework, allowing for path dependency and feed-back, and entertaining the possibility of both evolutionary (dynamic institutionalism) and revolutionary (punctuated equilibrium) trajectories of institutional change. Thirdly, the model admits of a synthesis between the conflict and politicisation, and policy network models. Whereas the latter possesses a comparative advantage in explaining institutional equilibrium, it is our contention that it fails to sufficiently illuminate the conditions under which state networks themselves are made and unmade, and the conditions under which the locus of institutional reshaping moves from the policy network to the contested terrain of partisan politics and legislative change.

It is one of the characteristics of historical institutionalism that it seeks to bring historical and micro-level accounts to bear on the study of institutions - to focus on the specific contextual conditions out of which particular institutional forms emerge and which they are, in turn sustained by - in preference to the deductive logic of rational choice institutionalism (Thelen, 1999). A rapprochement, or some border-crossing between the two institutionalisms does however suggest that elements of the deductive and inductive method might be fruitfully combined. The model elaborated above suggests a number of testable hypotheses - hypotheses that lend themselves to testing on the basis of micro-level and historical evidence.

On the basis of the evidence of institutional difference that constitutes the point of departure for this thesis, reflecting the literatures surveyed in this and the preceding Chapter, and the model elaborated above, we postulate that any given set of institutional institutions will be a function of the political economy in which they are situated. Moreover we would contend that the conduct of monetary policy - in

relational terms - and the determinants and consequences of particular institutional forms, can only be fully illuminated within a political economy framework. Two imperatives determine the extent to which a particular institutional configuration will satisfy the tests for the equilibrium condition, and will be sustainable within the political economy - they are the imperatives of credibility, and legitimacy. The equilibrium condition assumes that endowments of both credibility and legitimacy have been optimised. A disequilibrium condition implies a deficit in one or both of credibility and legitimacy. Such a deficit may be remedied either through incremental adaptation within an existing institutional set (dynamic institutionalism), or through comprehensive change, possibly involving the remaking of the institutional arrangements (punctuated (dis) equilibrium). Management of incremental adaptation may be undertaken within a state directed policy network, or, where the nature of the network or the scale of the institutional deficit does not allow for an adaptive trajectory of change, it may be prosecuted through a more comprehensive process of legislative reform, and entertain the possibility of a complete regime shift.

The fact of institutional continuity - manifested in the unchanged nature of the formal statutory arrangements - suggests that, within the Australian context, an equilibrium condition has obtained. However this does not imply that in other respects the 'institution' of central banking has remained static, merely that the logic of institutional reshaping has been such as to preclude the mobilisation of societal interests and political elites in a legislative project. The equilibrium condition implies that institutional reshaping can be achieved without recourse to formal legislative change. By contrast, the fact of a significant regime shift in New Zealand by means of statutory change suggests a state of disequilibrium in which the locus of power shifts as between economic interests and coalitions, and where the de jure form of the institution is required to be recast in a manner consistent with the locus of power within the political-economy. Both 'conditions' imply contrasting configurations of state-society relationships, and, in the case of New Zealand, a shift in the relative power and influence of interests and societal coalitions.

We hypothesise that:

- interests within the political-economy will exhibit differential preferences regarding the institutional weighting placed on credibility and legitimacy. In essence, while these 'endowments' are neither discrete nor exclusive, financial actors will place a greater weighting on credibility, and non-financial actors on legitimacy

- considerations of institutional (and policy) credibility and legitimacy are reflected (codified) in particular elements of the formal institutional design of central banks (including the institutional framework within which they are situated) - specifically in the nature of central bank charters and governance arrangements
- a condition of relative institutional equilibrium will be satisfied where endowments of both credibility and legitimacy are optimised. The fact that such a condition obtains may be reflected in the absence of demands for institutional change surfacing either within a state directed policy network, or in the wider political environment
- a deficit in one or both of the endowments of credibility and legitimacy will precipitate a condition of institutional disequilibrium - a credibility deficit is more likely to be prosecuted by financial actors, whereas a legitimacy deficit is more likely to be prosecuted by non-financial actors
- a condition of institutional disequilibrium may be remedied by an adaptive response, managed within a state directed policy network, or by a formal revisiting of the formal elements of the institutional scheme (and the possible remaking of a policy network) by political authorities

All these hypotheses are suggested by the model elaborated above. In addition the New Zealand case provides an opportunity to further test the proposition advanced by Goodman, namely that a government will be more likely to legislate for central bank independence where it faces imminent electoral defeat and wishes to tie the hands of its successor. In Chapter 5 we take the opportunity to test this hypothesis, although it is secondary to, and not directly suggested by, the model we have advanced.

The following chapter provides a capsule history of central banking in Australasia over the period from the establishment of central banks, through to the currency floats and financial liberalisation of the 1980s. Assuming that these particular institutional configurations have distributional consequences, that societal actors will typically gravitate to political parties that advance the particular interests of groups within the political economy, and that institutional reshaping will from time to time be prosecuted by political authorities, one would expect to see evidence of 'partisan effects' in the prosecution of changes to the formal statutory arrangements over time.

Chapter 4

A Capsule History of Central Banking in Australasia

Introduction:

In the preceding chapter we proposed a political-economy model of central banking, and argued that this model has the potential to illuminate what we have referred to as an equilibrium condition - a stable state-directed network - and a disequilibrium condition in which, for reasons of a loss of credibility and/or legitimacy, the institutional framework comes under pressure, and may be subject to change. Moreover we have suggested that a formal regime change may be precipitated by particular economic interests or coalitions of interest seeking to prosecute changes through the political process, and that, to the extent that interests and coalitions of interest may coalesce around partisan organisations, institutional regime changes may reflect the partisan complexion of governing parties, and of the interests supporting such parties. In effect we are assuming both a materialist foundation and a pluralist logic to policy formation - both of which are consistent with the 'rational-choice' variant of the new institutionalism. If the imperatives driving institutional design are both economic and political, and if underpinning these imperatives there are distinctive communities of interest, or societal coalitions, one might expect to detect changes in institutional arrangements over time reflecting relative shifts in economic and political power, and in the complexion and orientation of the state. In effect a review of the historical trajectory, across nations, permits some preliminary examination of the determinants of institutional difference.

This chapter is informed by two objectives. The first is suggested by the theoretical framework and propositions advanced in the preceding chapter, and in particular, the proposition that institutional disequilibrium may 'spill-over' into the political domain and be evidenced in partisan orientations to institutional forms. The second objective has already been foreshadowed in the introductory chapter and that goes to the need to locate existing institutional arrangements within an historical context. Notions of institutional 'path-dependency' suggest that at any given point in time institutional arrangements will codify the accumulated policy experience of particular nations, and, moreover, be reflective of the values and preferences that both reflect, and are shaped by, that historical experience. As we noted in the preceding chapter, notions of path dependency and institutional feedback are central to an examination of the dimensions and the determinants of institutional change and difference.

The chapter examines the development of the institutions of central banking in New Zealand and Australia, and in particular the formal institutional arrangements within which bank and government relations have been managed and mediated. Scholars of central banking in Australasia are particularly well served by a number of seminal institutional histories (Giblin, 1951, Schedvin, 1970, 1992; Hawke, 1973), which locate the two central banks within the wider canvas of political and economic change. In this chapter, using the existing institutional histories as a foundation, the focus is on the prosecution - successful and otherwise - of changes to statutory arrangements, and we complement existing historical accounts with material gleaned from First and Second reading debates as recorded in the Hansard reports of the two Parliaments.

The intention is not to unpack the political economy of legislative and institutional reform over the period up to the early 1980s - such an analysis would require a much more detailed examination of the nature of economic and political interests, the distributional consequences of particular institutional forms and policies, and the resultant pattern of interest articulation through the state. The objectives for this chapter are more modest, but no less important. In order to assess the extent to which the trajectory of institutional reshaping over the 1980s and 1990s has been informed by a measure of path dependency (or feedback) we first need to examine the institutional foundations on which successive frameworks have been built (or re-built). As we noted in the concluding section of the preceding chapter, the logic of the institutionalist inquiry is, in part at least, an inductive one. Differences as between the Australasian institutions of central banking provide the initial point of departure. Accounting for those differences - and a different trajectory of institutional reshaping over time - requires a framework that admits of the political economy. If we are correct in suggesting that the durability of particular institutional forms (ie an equilibrium condition) reflects a capacity on the part of central banks to accommodate a range of interests, and that the equilibrium condition is such as to obviate the need for the formal revisiting of institutional arrangements through the political process, instances of institutional disequilibrium will be made manifest through legislative change. Moreover, to the extent that the historical trajectory suggests a partisan pattern of reform, this will support the argument that institutional form reflects distributional interests within the political economy.

The Niemeyer legacy, and the evolution of the institutions of central banking in New Zealand

In 1933 the New Zealand Parliament passed the Reserve Bank of New Zealand Act, bringing into existence New Zealand's central bank. Prior to the passage of the 1933 legislation each of six independent trading banks had issued its own distinctive bank notes. Four of these were primarily Australian institutions, one a British bank, and the sixth the privately owned Bank of New Zealand. While from the 1920s the New Zealand Labour Party (formed in 1916) had argued for a State Bank, Governments of the day declined to take any steps towards the development of such an institution, or to intervene in the management of the Bank of New Zealand (Hawke, 1973:14).¹ However the case for a bank of reserve, and more generally for a greater measure of State activism and control in matters of credit and currency was advanced by the actions of the private trading banks during the Depression.²

The Reserve Bank of New Zealand Bill was introduced to the Parliament in October 1933 and received the Royal Assent on the 27 November that year. The genesis of this first statute can be traced to a recommendation to the New Zealand Cabinet on the 20 June 1930 by the Secretary of the Treasury, A D Park, that one Sir Otto Niemeyer be invited to visit, "for the purpose of advising the Government on exchange and currency" (Hawke, 1973:26). Niemeyer was to have a significant influence on the institutions of central banking in both New Zealand and Australia, although for markedly different reasons. An Officer of the Bank of England, formerly of the British Treasury, and described by Park as, "a recognised expert on finance and banking", Niemeyer visited New Zealand in August and September 1930, and his report was tabled in Parliament in 1930.(Hawke, 1973:26).³ The Niemeyer Report, "Banking and Currency in New Zealand" recommended,

¹ Hawke quotes leading Labour politician Walter Nash on the case for a State Bank - "The case for a State bank is that the whole credit of the Dominion must be used to prevent the bank's failure, and this being so, then the benefit from this programme should automatically come to the whole of the people, and not be used for the benefit of a few shareholders" (in Hawke, 1973:14).

² Hawke suggest that there were various acts on the part of the banks during the depression that attracted criticism, including from the Government (Hawke, 1973, 23-24):

"Modern economic reasoning would imply some criticism of the actions of the banks during the Depression. The advances of the trading banks fell in a period when increased credit would have been beneficial. The banks may have had difficulty in the 1930s in finding projects to finance, but the modern (sic) criticism would be that they made no such attempt. On the contrary their lending policy, governed by fear of losses, became more conservative" (1973:23).

³ Cabinet approved the proposal from Park, "subject to expense not being too great" (Hawke, 1973:26). Hawke suggests that Park was invited to visit for at least two related reasons - "since 1914 New Zealand's currency had been governed by proclamation rather than by statute and Treasury wanted advice on how a more permanent basis should be arranged; secondly, the United Kingdom - New Zealand exchange rate was

" ... the establishment ... of a Reserve Bank of a size appropriate to New Zealand's conditions. Such a bank would necessarily be charged with the duty of managing the note-issue, accepting the responsibility for the ultimate stability of the exchange, holding reserve balances of the trading banks, and carrying the Government account " (Niemeyer, 1931).

Significantly, Niemeyer made his recommendation to establish a Reserve Bank subject to what he referred to as "Two fundamental conditions":

"...the bank must be entirely free from both the actual fact and the fear of political interference. If that cannot be secured, its existence will do more harm than good, for, while a Central Bank must serve the community, it cannot carry out its difficult technical functions and cannot hope to form a connecting link with the other Central Banks of the world if it is subject to political pressure or to influences other than economic. Experience has shown that the best method of safeguarding the independence of a Central Bank is to constitute the Central Bank as a private corporation with a capital subscribed by the general public and an independent Board of Directors elected by the shareholders..." (1931:4).

The second of these two fundamental conditions went to the requirement that the bank should hold both the banking balances of the Government and the reserve balances of the trading banks. And lest there be any doubt or confusion about the import and implications of his recommendations, Niemeyer provided a full and detailed draft of a Bill. If the genesis of New Zealand's central bank is to be found in the Niemeyer recommendations, then so too are the issues that would underpin debate over the institutional arrangements within which central bank and government relations would be conducted.

At the outset, Niemeyer's concern was to establish the bank as an 'independent' institution, free from the 'fact and fear of political interference'. This 'independence' was to be provided by establishing the bank as a 'private corporation'. The bank was to be insulated not just from political pressures, but from 'influences other than economic'. Governance of the bank was to be invested in an 'independent Board of Directors'. The bank was enjoined to 'form a connecting-link with the other Central Banks of the world'. The bank's independence would enable the bank to carry out its 'difficult technical functions'. And finally the charter, or the 'motto' of the bank, as embodied in the draft Niemeyer statute, provided that, "the primary duty of the bank shall be to ensure that the value of its notes remain stable" (1931: 7).⁴

diverging from par in 1930 and Treasury wanted advice on what steps should be taken in reaction to this" (1973:27).

⁴ Hawke suggests that Niemeyer took the wording of this draft clause from the statutes of the Bank of Estonia - "He regarded this provision as fundamental The concept of 'stability' was often loosely used in the 1930s, but Niemeyer was obviously thinking of a stable exchange rate rather than a stable internal price level" (Hawke, 1973:32).

The Reserve Bank of New Zealand Bill received its second reading on the 24 October 1933. Opening the second reading debate Minister of Finance Coates emphasised the importance to the Government of placing the new institution on an independent footing:

"I want to emphasise that, in order that the bank may function properly, the management must be free of the suspicion of being influenced other than by the general economic and financial condition of our country. Even suspicion must be removed...

It is definitely essential that the bank should have the complete confidence of the trading or commercial banks, because they can help materially in keeping credit control flexible. Indeed the proposed reserve bank will be a bankers' bank, and will, therefore, be called upon to carry out many transactions at present carried out by the trading banks" (NZPD, 1933: 624)

The objective, Coates suggested, was to provide for what he referred to as the, "unified and disinterested control of currency and credit by New Zealand directors, for the benefit of New Zealand" (NZPD, 1933:633). However the level of 'disinterest' was somewhat more circumscribed than Niemeyer had entertained in the draft statute that had accompanied his original report. Whereas Niemeyer had recommended a charter requiring the bank to ensure stability in the value of its notes, the Bill now required the Bank,

"to exercise control, within the limits of the powers conferred on it by this section, over monetary circulation and credit in New Zealand, to the end that the economic welfare of the Dominion may be promoted and maintained" (Statutes, 1933, No 11, section 12).

And whereas Niemeyer had recommended that the Governor and Deputy Governor, and members of the Board of Directors be elected by the shareholders at a general meeting, the Bill provided that the Governor and the Deputy Governor would be appointed by the Government, that four of the seven directors of the bank would be elected by shareholders, and three, to be known as "State directors", would be appointed by the Government, and a further director - the Secretary to the Treasury - would also be appointed as a director ex officio, to "represent on the Board the point of view of the Treasury, and, no doubt, of the Government" (NZPD, 1933:633). Moreover the Bill proposed that of the four shareholders directors, two would be drawn from representatives of primary industry, two would be drawn from industry or commerce, and of the latter, not more than one was to be a director of a trading bank. While Coates argued that the bank was to be a bankers bank, governance of the new institution was to admit of a greater range of interests than the original architect had perhaps envisaged.

A number of explanations have been advanced for these changes. Dalziel suggests that the change to the proposed charter reflected a resiling from the orthodox theory of the day:

"Orthodox economic theory ... argued that the gold standard was the best mechanism available for promoting economic welfare ... However at the beginning of the 1930s there was a growing disenchantment with this theory, which began with the experience of Britain bank on the gold standard after 1925. Contrary to Hume's law domestic prices and incomes were very slow to move downwards, so that the recession intensified as the critics of the policy had predicted. Eventually it became clear to financial markets that the British pound would have to be devalued. This instigated a run on the currency, and Britain was finally off the gold standard again on 19 September 1931 ... If Britain, with all its resources and international contacts, could not make the gold standard work, how could a small country such as New Zealand?" (Dalziel, 1993:79).

Hawke suggests that the changes made to the Niemeyer recommendations were a function both of the disruption to exchange rates in the world economy, and the need to satisfy several political points of view (1973:33):

"The Labour Party wanted a State Bank, and within the Coalition Government there was opposition to private shareholding. For example it was argued that farmers would not support a bank dominated by urban commercial and financial interests. The official explanation of the change in legislation was that it was intended to emphasise the "national character" of the bank, but Park described it more prosaically as a compromise with forces in Parliament" (Hawke, 1973:39).

The Labour Party Opposition remained unconvinced, continued to advocate the establishment of a State bank, and represented the establishment of a reserve bank as a function of pressure from Great Britain, the Bank of England in particular, and private interests more generally.⁵ Leader of the Opposition Savage suggested that the primary issue was that of the control of the banking system:

"The Right Hon. the Minister appeared to contradict himself slightly when he said that the measure contained machinery to give effect to the Government's policy and immediately afterwards said that the bank must be free from political control. If that is not a contradiction it is very nearly so, for I cannot imagine how a banking policy can be carried into effect on the lines of the Government's wishes, unless there is some sort of political influence or control. I am not saying, however, that the Government should not have that control. I am one who believes that Parliament can be trusted, and that the mess the world is in today is not due to Parliaments" (NZPD, 1933: 637).

⁵ Mention is made in the Parliamentary debates of the risk of the new institution adopting a 'deflationary' stance to the conduct of monetary policy (see the speech by Carr, NZPD, 1933:674).

Issues of governance and management were to the fore in the Labour Opposition's criticism of the Bill. One Labour Member of Parliament suggested that,

"whether the reserve bank will render any real service to the Dominion, or a dis-service, is entirely dependent, not upon the fact of the establishment of the reserve bank, but upon its constitution, and upon its management. If it is rightly constituted, and exists for the purpose of really serving the people, untainted, uncorrupted by private interests, then it can serve the people..." (Sullivan, NZPD, 1933:651).

Savage noted however that the formal constitutional relationship between Government and the bank should of necessity provide the latter with some operational independence:

"No Government could control a banking system, but some Governments would be capable of outlining a policy, and they would also be capable of insisting upon the banking system of the nation making the credit and currency available for the carrying-out of that policy. That is the policy of Labour, and we would not be administering the thing from the Cabinet room. We would have somebody doing the job who would know what he was doing. We would be laying down the policy which he would be expected to operate, and if he could not do so we would get some one who would. However we use words or phrases, Parliament must be master" (NZPD, 1933: 641).⁶

Insofar as the changes to the charter originally proposed by Niemeyer were concerned, and specifically reference to the need to promote and maintain the economic welfare of the Dominion, Labour appeared to be unconvinced. One Labour Member of Parliament suggested that the change was largely cosmetic:

"How splendid, how altogether desirable and commendable are the sentiments there expressed. But it reminds me of the term used by our American cousins. In referring to the screed on the dust cover of a book - the screed printed there by the publishers to make the book sell - our American friends call it a "blurb". I suggest that this clause is a "blurb". It is part of the pretence, of the attempt on the part of the Government to sell the Bill. It is a specious indication of what is really not there..." (Carr, NZPD, 1933: 673).

The Labour Party would have its own opportunity to revisit bank governance and management within two years. In the intervening period however the Board of the Bank itself would develop its own definition of the roles of Government and Bank. Labour Party misgivings about the 'independence' of New Zealand's central bank from the Bank of England were not without foundation. Hawke notes that Bank of England Governor Montague Norman offered to make one of his officers available as the Bank's first Governor, and suggested one Leslie Lefeaux. Lefeaux was appointed Governor for

⁶ With the benefit of hindsight it is perhaps noteworthy that Savage refers to a relationship that is almost contractual in nature, and between the Government and Governor, not the Government and the Board.

a seven year term from 1 January 1934. The whole of the bank staff were recruited in New Zealand however, and the Bank began operations on the 1 August 1934 (Hawke, 1973: 54-55).

In June 1934 the board adopted as a definition of the roles of Government and bank, the following six points:

- "1. The ultimate decision as to national monetary policy must always rest with the Government.
2. The Reserve Bank should act as advisers to the Government on monetary matters, and should be responsible for carrying out the monetary policy decided upon by the Government.
3. The Reserve bank should be kept closely informed as to the Government's monetary policy.
4. Pronouncements as to monetary policy should not, in the ordinary course, be made on behalf of the Government without prior consultation with the Reserve Bank.
5. The Reserve Bank should never make any pronouncement on major questions of monetary policy, e.g., the exchange rate, without the authority of the Government to do so.
6. The Reserve bank should be free to take whatever steps they consider necessary to carry out the monetary policy adopted by the Government" (Hawke, 1973:64).

This policy was informed by a distinction between policy formation and operating decisions (consistent with the contemporary distinction between goal and instrument independence, or 'political' and 'economic' independence). The distinction was shared by the Government of the day, and accepted formally in a Cabinet minute (Hawke, 1973:64). Late in 1935 the First Labour Government took office, and while Hawke suggests that the policy-administration distinction was generally accepted,

"... having used suspicion of the monetary system to good political effect since 1933, and especially in the 1935 campaign, the party was committed to legislative assertion of supremacy over the Reserve Bank" (Hawke, 1973: 65).

The first legislative act of the Labour Government involved an amendment to the 1933 legislation. Speaking in the second reading debate Labour Minister of Finance Walter Nash affirmed that,

"... the first imperative step to effect co-ordination between idle labour and unused materials has to be made inside the credit, currency and monetary

system; and that is why we claim this step must be taken before anything of a worthwhile nature can be achieved" (NZPD, 1936:140).

On the issue of central bank independence Nash quoted, as an authority, an Officer of the British Treasury, one Mr Hawtrey, who had suggested that,

"[t]he chief grounds for preferring an independent central bank to one under Government control as an instrument of currency administration, appears to be its comparative freedom of criticism and pressure ... The central bank is free to follow the precept 'never explain; never regret; never apologise'. It need make no statement of policy. It is remarkable in a democratic age that this exemption from criticism should be viewed as an advantage. Technical questions in other spheres, naval, military, or fiscal, are by no means excluded from criticism. The public interest in the broadest sense is profoundly affected by currency administration" (NZPD, 1936:142).

Originally established as a 'private corporation' the bank was effectively 'nationalised', and the directors of the bank made subject to the control of the Government. The charter of the bank was amended to reflect this change on control, in a section of the Bill referred to by Nash as the most profound of the Bill. The amended section now read:

"It shall be the general function of the Reserve Bank, within the limits of its powers, to give effect as far as may be to the monetary policy of the Government, as communicated to it from time to time by the Minister of Finance. For this purpose, and to the end that the economic and social welfare of New Zealand may be promoted and maintained, the Bank shall regulate and control credit and currency in New Zealand, the transfer of moneys to or from New Zealand, and the disposal of moneys that are derived from the sale of any New Zealand products and for the time being are held overseas" (NZPD, 1936:145).

This change, Nash observed, gave the Government, "complete and absolute control" (NZPD, 1936:145). The sponsors of the 1933 legislation opposed the amendments on the basis that the institutional arrangements provided for in the original statute had provided a check on the expansionist proclivities of Government. Coates suggested that under the original constitution,

"the Reserve Bank has played a very important part in acting as a check on, shall I say, quick activities, conceived perhaps with the best of good intentions, and we may live to regret the change" (NZPD, 1936: 152),

and raised the spectre of inflation borne of the manipulation of monetary policy for short term or expedient political reasons:

"It is easy to recall that in every country where anything of the kind has been attempted the result has been disastrous. There has been no control, and

inflation must inevitably follow where the Government desires to use the financial machine for the purpose of remaining in office" (NZPD, 1936: 152).

In reply Prime Minister Savage reaffirmed the commitment of the Government to the policy/administration distinction:

"... we have no more intention of running the banking system from the Cabinet room than we have of going up to Wellington Hospital to perform surgical operations on the patients. Operating is the work for surgeons, not for Ministers of the Crown. Banking is the business of bankers. However, this Bill decides who shall be masters - whether it shall be a handful of individuals representing private shareholders in private hands, in this case the Reserve Bank of New Zealand, or whether the representatives of the people shall be the masters after all, just as they will be masters of any other public service" (NZPD, 1936:159).

This defence clearly failed to satisfy the Opposition, with the Leader of the Opposition, Forbes, presaging a loss of confidence, and the prospect of hyper-inflation:

"... we are to have the political banker... We have the confidence of the people shaken on account of this Bill. We have this confidence shaken by the fact that instead of being run on ordinary banking lines, giving security to the people, the institution is going to be run by a political head, who, as a politician, will look to the matter of political expediency first...

We should always remember what happened to a certain country that set out on the path of inflation. When a policy of inflation was adopted in Germany that authorities did not believe that it would get out of hand. They thought that they would be able to control it, and I daresay that their Minister of Finance made a similar statement to that that was made by our Minister in his speech last night - that the utmost caution would be used and that nothing untoward would happen" (NZPD, 1936: 171-172).

Armed with a sizeable majority, and a considerable popular mandate the First Labour Government proceeded to place the Reserve Bank of New Zealand under public ownership, and Government control. And as Dalziel observes, these institutional changes were underpinned by the emergence of a new economic orthodoxy. In the same year that Keynes was to publish the General Theory the First Labour Government was to seek the control necessary to manage key economic aggregates. Minister of Finance Walter Nash quotes Keynes approvingly in the Parliamentary debate:

"Keynes said what is embodied in this Bill - that there must be some state intervention ... the solution which he favours lies in the securing of full employment by means of increasing the volume of capital and lowering interest rates" (NZPD, 1936:221).

But while the 1936 amendment was seen as providing for full control by the Government of the Reserve Bank, Governor Leslie Lefaux and the Board of the Bank

continued to be guided by the 1934 policy, and to resist the policy embrace of the First Labour Government. Hawke suggests that from 1936 to 1939 Lefeaux, "struggled to influence Government policy" (1973:66):

"He (Lefeaux) disagreed with the Government's inflationary financing schemes, with its policy of low interest rates, and especially in 1938, with the imposition of exchange control ... Although as early as 1936 he had suggested to Nash that the English system in which the Governor of the Bank of England was the mouthpiece of the chancellor to the city, and of the city to the chancellor should be the model for their contact he and Nash were never able to reach such an agreement. Lefeaux does not seem to have appreciated that there was no "city" in Wellington nor that Nash was subjected to great pressure from the left wing of the Labour Party caucus" (1973:66).

On October 6 1939 the Reserve Bank of New Zealand Amendment Bill was introduced into the House under urgency. Minister of Finance Walter Nash advised the House that the Bill would have been introduced had there been no war, and justified the legislation on the grounds that the 1936 legislation had failed to clarify the respective roles of Government and Bank:

".. the Government is of opinion that it is not sufficient that the policy of the bank and its controlling agency should be run on broad lines in accord with Government policy. At the moment the feeling of the Government is that if it is to take responsibility for guiding and controlling the productive life of the Dominion, it must have control of the central feature of its economic life, and control in its fullness, and not merely on broad lines...

The question of determining policy and actions where there is a difference of opinion between what the Board of the Reserve Bank may consider should be done and what the Government considers should be done must rest with someone. I think that it is entirely contrary to the ideas of government, in the accepted term of the word, for any one outside of the Government to have the last word in determining what the Government wants done" (NZPD, 1939:732).

The 1936 amendment had required the Bank to give effect to the monetary policy of the Government, as communicated to it from time to time by the Minister of Finance. The 1939 legislation codified the relationship in a far more prescriptive fashion:

"In the exercise of their functions and powers under the principal Act the Governor and the Directors shall have regard to any representations that may be made by the Minister of Finance in respect of any functions or business of the Reserve Bank, and shall give effect to any decision of the Government in relation thereto conveyed to the Governor in writing by the Minister of Finance" (NZPD, 1939: 734).

Finance Minister Walter Nash described this provision as, "the most important clause in the Bill" (1939: 734). For their part, Opposition members raised the spectre of inflation, the Leader of the Opposition, Hamilton, suggesting that,

"[t]here are no other countries in the world, except Germany and Russia that have the kind of control over their reserve banks that this government is taking" (NZPD, 1939:742).

Opposition focused on the balance of control passing from the bank to the Government, with the attendant risk of politicised policy making:

"I am not saying that he will do it, but I do say that he should not put himself in the position where one set of industries can have his favour and progress, while others can be allowed to die, because he has the complete say in the handling of the finance... it leave room for political log rolling" (Coates, NZPD, 1939:782).

Other Opposition speakers reinforced the danger of the country becoming the subject of electorally informed political business cycles:

"Inevitably there must be a tendency, no matter how careful Cabinet may be to guard against it, in election year, for example, to make things a little easier for the people, to use the powers of inflation that are given to the government to bring about a little more prosperity" (Macdonald, NZPD, 1939: 824).

So far as the justification for the 1939 amendment is concerned, Hawke details a series of disputes between Governor Lefeaux and the First Labour Government, and suggests that the conflict between the Bank and the Government,

"latent in discussions of the Government's use of Reserve Bank credit, of exchange control, and of the Government's policy of maintaining low interest rates, became open only on the last issue (Hawke, 1973: 68).

Commenting on his relationship with Lefeaux, Minister of Finance Nash advised the House that there had only been two disputes worthwhile noting:

"One was in connection with interest rates. I received an opinion, on behalf of the Government, that we had the right to determine interest rates. It was thought by the Governor of the Reserve bank that the bank had the right to determine the interest rates, that being an administrative matter associated with policy. The other matter had reference to the changing of the discount rate from 2 per cent to 4 per cent. I was not consulted, and I felt I ought to have been. But the reasoning behind the Governor's action was that, if he had consulted me, the responsibility for the change would have been with me. He felt that I ought not to be consulted, because the responsibility was entirely with him and the bank" (NZPD, 1939: 825).⁷

For the Government the issue was one of control:

⁷ Subsequently in 1950 speaking as an Opposition member Nash confirmed that the advice of the Crown Law Office had been sought on the respective roles and authority of the Government and the bank, and that the Office had supported the interpretation placed on the 1936 legislation by Lefeaux and the board.

"...the issue we are faced with today, and the issue that the Government is facing in this measure, is simply this: that either the bank rules the Government or the Government rules the bank ...

No Board appointed by the Government can be allowed to dictate to that Government as to what its policy should be. If a Board has any reason for its existence at all, it ought to have the right to indicate to the Government the probable effect of any particular line of action. It should have the right, and must exercise the right, to indicate from its expert knowledge what things are likely to happen if other things take place; but always, the Government must be supreme; and, I think, members opposite will themselves admit that it is an intolerable position that a Governor of a bank, or a Board of a bank, can dictate to the Government as to what the policy of the bank is to be...

... no longer will we have the ridiculous position of the Governor or Board of the Reserve Bank dictating to the Government as to what the policy of the bank is to be " (Nordmeyer, NZPD, 1939: 769).⁸

The Opposition, referring back to the fundamental concerns raised in the Niemeyer Report, represented the 1939 amendment as a departure from the principles and practice of 'sound finance':

"[t]his morning New Zealand has apparently come to the cross-roads in her political career, and a choice has to be made whether it is to be sound finance or unsound finance it is worth noting that New Zealand is the first British dominion to depart from sound finance" (Gordon, NZPD, 1939: 829).⁹

The next change to the statutory arrangements underpinning Government and bank relations was to occur in 1950. The Labour Party was defeated in the 1949 election, and the National Party came into office under the Leadership of Prime Minister Holland. National's 1949 manifesto had emphasised the threat posed by high inflation, and had foreshadowed a desire to separate responsibility for monetary policy and the maintenance of a stable internal price level from political control and ministerial dictation. Accordingly the National Party would seek to repeal the provision giving the Minister of Finance the power to direct the Reserve bank, and provide in the Act that

⁸ Opposition members appear to have been attracted to the kinds of arrangements advanced by the Chair of the Australian Royal Commission on Banking and Monetary Reform, Justice Napier, who is approvingly cited as recommending that, " [s]hould at any time there be a difference of opinion between the Commonwealth Government and the Commonwealth Bank Board as to its policy, a free and frank exchange will take place on the matter. Should their views be irreconcilable the Government shall tell the bank that they take responsibility and shall instruct them what to do" (NZPD, 1939: 813).

⁹ Hawke notes that Lefeaux,

"... presented his board with a letter protesting against the Bill and giving notice of his resignation. He allowed himself to be persuaded that the war made it necessary for him to remain as Governor and he amended the letter accordingly. He wrote to Nash that the imposition of exchange control in 1938 and the removal of the bank's discretionary authority in the 1939 Amendment had fundamentally altered the conditions on which he had accepted appointment, and he served the remainder of his term as unpaid war service" (Hawke, 1973:69).

any difference between the Government and the bank be determined by Parliament. The Bill introduced by the new Government changed the charter of the Bank in adding to the functions of the Reserve Bank,

" ... by requiring it to maintain as far as lies within monetary power, a stable internal price level" (NZPD, 1950: 1271).

The charter required the bank, in addition, to promote the highest level of production, or trade, and of employment.

Speaking in the second reading debate, and referring to his Party's policy Prime Minister Holland noted that:

"In the very forefront of the National Party's, now the Government's policy, was provision for a plank that provided for a system of sound finance ... In this Bill, which it is my privilege to introduce tonight, we have taken one of a series of orderly steps designed to bring about this end ...

We say that the inflation is due to the former Government's policy of unsound finance, and we also say, and we have advanced arguments in support of it, that it is largely due to the dictatorial powers possessed by the previous Minister of Finance" (NZPD, 1950: 1266- 1268).

In support of the legislation the Government referred to the support of a significant extra-parliamentary policy community:

"It is important to say, and it is worth recording and being listened to by every honourable member, that this legislation has been recommended, endorsed, and approved by both the Reserve Bank and the Treasury. That takes it out of the field of party politics ...

We do not bring Government officers into our Bills very much, but in a case like this, where a technical measure is being placed on the statute book, it is of some advantage to members to know that the Bill has the support of our leading financial authorities..." (NZPD, 1950: 1273).

Contributing to the debate, the former Minister of Finance Walter Nash referred to the circumstances that had given rise to the 1939 amendments, and defended the right of the Government of the day to instruct the Reserve Bank:

"I still think that a power of this type is a power that should always be held and exercised by a Government. I do not think than any Governor or Board of Directors, however competent and whatever their integrity, that are away from the body politics, are competent to be the determining voice in connection with monetary and credit matters in a country such as ours..." (NZPD, 1950: 1279).

While the charter would be changed with each change of Government between 1950 and 1975, the concerns of the Labour Party at this point were confined to the formal aspects of the relationship between the Government and the Bank. While the new charter arguably elevated price stability to a status that it had not previously enjoyed relative to output and employment objectives, the Labour Party interpreted the change to the charter as being consistent with, "the original instruction, phrased perhaps a slightly different way" (NZPD, 1950: 1280). While Nash suggested that, "the clause taking away from the Government the power to determine policy is wrong and retrograde", on the question of the amended charter he was somewhat more sanguine - "if the stabilised internal price level can be achieved, then let us have it" (NZPD, 1950:1281).

Relations between the Bank and the Government came under public scrutiny in the mid 1950s. Following the 1954 election, and partly in response to the level of support for the Social Credit Political League, a Royal Commission was established to inquire into the monetary, banking and credit systems. The Report of the Royal Commission traversed familiar ground, with a section of the Report directed to the "Statutory Definition of the Relationship Between the Government and the Reserve Bank". The Royal Commission recommended against the 1950 amendments, suggesting that the Minister should be given the power to issue written directions to the bank on any question of policy and on the detailed measures to be used to give effect to policy (Hawke, 1973: 73). As Hawke observes, while the Royal Commission's recommendations were unwelcome to the National party Government, they were more consistent with the Labour Party's stance on bank-government relations. In 1957 the Second Labour Government was elected, and the Royal Commission's recommendations incorporated into an Amendment Act in 1960. Speaking in the second reading debate Minister of Finance Nordmeyer indicated that the Bill followed the recommendations of the Royal Commission, quoting from paragraphs 897 and 898 of the Commission's Report:

"We suggest that the Reserve Bank of New Zealand Act be revised to make clear and explicit the respective functions of the Government and of the bank in relation to monetary policy. In our view, the Government must accept full and final responsibility for all decision of policy in this field. We consider therefore that there should be no provision requiring a resolution of the House of Representatives to enable the Government to give directions to the Reserve Bank. In our view any such provision merely detracts in the public mind from the full and final responsibility of the Government in matters of monetary policy.

We recommend legislation to make it clear and explicit that: (a) It is the function of the Reserve bank to give effect to the monetary policy of the

Government as communicated to it by the Minister of Finance. (b) The bank is to advise the Government on matters relating to monetary policy, banking, and foreign exchange. (c) The bank is to keep the Government fully informed about the measures it is adopting or proposes to give effect to the monetary policy of the Government. (d) If there is any difference of opinion between the bank and the Government as to the measure adopted or proposed to be adopted under (c) above, the bank is to give effect to a decision of the Government conveyed to it in writing by the Minister of Finance. (e) The Government is to decide such important questions as exchange rate policy. The Government and not the bank, is to have the final authority to determine the London-New Zealand exchange rate. (At present the legal right to fix the exchange rate rests with the bank by virtue of section 16(3) of the 1933 Act). (f) The Government is to have the power to initiate and direct a change in the reserve ratio..." (NZPD, 1960: 3299).

The Bank for its part was opposed to the Royal Commission's recommendations. Hawke notes that in his submission to the Royal Commission then Governor Fussell had argued that, while policy was clearly the responsibility of the Government, if the Bank disagreed with any specific Government decision it could force the issue to be voted on by the House of Representatives (1973: 73). This was a state of affairs that the National Party Government was prepared to accede to and support, given that it placed the Reserve Bank outside of the control of politics. In an interesting justification Nordmeyer linked the power to direct to the existence of multiple objectives in the Bank's charter:

"There is therefore under existing legislation no clear order of priority and no overriding duty. The bank is required on the one hand to give effect to Government policy, and on the other to do all such things as it considers necessary. It is given objectives which may be irreconcilable - maintaining a stable internal price level on the one hand, and, on the other hand, doing all things necessary for promoting the highest degree of production, trade and employment, one a prescription for stability, while the other could involve inflationary expansion" (NZPD, 1960: 3301).

The Opposition for their part suggested that it was inappropriate to provide the Government with the power to direct when the actions of the Government of the day - principally by means of the operation of fiscal policy - could well compromise the ability of the Reserve Bank to meet its charter objectives:

"To place these duties on the Reserve bank is useless when by other economic, financial, and taxation policies the Government makes it impossible for the Reserve Bank to achieve those objectives. What is the point of asking the Reserve Bank to maintain a stable internal price level, as this provision does ... when the Minister gave away a whole lot of taxation revenue bringing inflation to the economy..." (Watts, NZPD, 1960: 3305).

And while the Act has been viewed as simply providing an opportunity to codify the recommendations of the Royal Commission into statute, debate on the provisions of

the Bill reflected underlying differences in the approach of the two principal political parties to the conduct of monetary policy, and foreshadowed further changes. Speaking in the debate Labour Party member of Parliament, and future Prime Minister Norman Kirk cast the issues in a more ideological light:

"It is accepted everywhere in every civilised and organised country that it is the prime function of Government to follow such economic and social policies as will bring about the maintenance of stable and balanced conditions in the country, to ensure that full employment is maintained, and to pursue such policies as will confer upon the people the highest standard of living consistent with the level of productivity. It is the State's responsibility to create those conditions; it is not the responsibility of the private trading banks, who answer to their shareholders. It is the responsibility of Government, and for that purpose this Bill asserts the sovereign right of the Crown, and in saying, "the sovereign right of the Crown" it means the sovereign right of the people. That fact is well worth writing into our laws...." (NZPD, 1960: 3310).

By 1964 the Government had changed and a National Party administration was in power. On the 16 October 1964 the Government introduced a Bill to consolidate and amend the Reserve Bank of New Zealand Act.¹⁰ The Bill introduced into the House provided rights for both Government and the Parliament. The Minister of Finance noted that:

"The Bill not only retains the existing primary function of the bank of giving effect to the monetary policy of the Government conveyed to it in writing, but in addition introduces a requirement similar to that which was in effect from 1950 to 1960 - that the bank is to give effect to any resolution of Parliament in relation to that monetary policy. I can thus assure the House that adequate safeguards are provided for the direction of monetary policy by Parliament, by the Government, or by the Minister. The provision regarding a resolution of Parliament will provide a procedure whereby, on an important issue, this House can reinforce and give its approval to the monetary policy of the Government as conveyed to the bank" (Lake, NZPD, 1964: 3617).

The National Party MP for Tamaki, Robert Muldoon explained that the Bill differed from the 1960 legislation in that while it retained the power of the Minister of Finance to tell the Bank what policy it should be carrying out, the Government would not be interfering in the day to day business of the Bank. For the Labour Opposition, enhanced central bank independence represented an abrogation of the responsibilities of Government. Labour Member of Parliament Bob Tizard claimed that,

¹⁰ Hawke notes that in 1962 the Bank itself had prepared a draft Bill which would have required the bank to give effect to a resolution of Parliament or to written Ministerial direction on matters of monetary policy (1973: 75). However that draft was not proceeded with. Subsequently, in discussions between Treasury and the Reserve bank a compromise position was reached between the bank's desire for independence on matters other than policy, and Treasury's desire to retain a Ministerial right of intervention in the bank's functions or business in general (Hawke, 1973: 75).

"The way in which the Government influences the bank is to be altered and substantially weakened ... the previous requirement was that the bank was to give effect to Government policy now we find that it is only to have regard to Government policy. Concern on this side of the House is expressed mainly around this point of the relationship between the Government, which must have primarily the responsibility of directing the country's economy, and the bank, which through this Bill and existing legislation is the main means whereby that policy is carried into effect ...

Other provisions indicate that the bank may well be made more independent. If this is Government policy we would like to know just what it intends to do and what it hopes to achieve by it, because we believe that the Government has a primary responsibility for managing the country's economy, and we believe that many of the provisions in the Bill weaken the means by which the Government can make that control effective. We have already seen this Government, by deliberate acts of policy, reduce its opportunity for managing the economy ... here we find, as a corollary to Government policy, a Bill which weakens the way in which the Government may indicate its wishes and have them carried into effect by the Reserve Bank" (NZPD, 1964: 3670-3672).

The Third Labour Government was elected to Office in 1972. In July 1973 the Government introduced a Bill to amend the 1964 legislation. Minister of Finance Bill Rowling advised the House that,

"... the Bill reaffirms the sovereign right of the crown to control currency and credit for the purpose of maintaining a stable value for money ... The implementation of the provisions of the Bill will increase the ability of the Government, through the Reserve Bank, to pursue its social and economic objectives and ensure the continuing full employment of labour and other resources..." (NZPD, 1973: 2473).

The new charter for the bank elevated the importance of the employment objective by requiring the Bank to pursue full employment. The charter and the Act was now to read:

"the maintenance and promotion of economic and social welfare in New Zealand, having regard to the desirability of promoting the highest level of production and trade and full employment and of maintaining a stable internal price level" (cited in Dalziel, 1993: 84, emphasis added).

But the Government made a number of additional changes impacting on the governance and management of the Bank. The Act was amended to provide that one or more of the directors of the Bank was to have commercial or industrial experience, and also to enlarge the executive committee of the Bank board. Whereas the 1964 Act provided that the executive committee would comprise the Governor, Deputy Governor and not less than one director chosen by the Board, the amendment increased the committee by the addition of the Secretary of the Treasury, and one other director to be designated by the Bank. However the Act was also to provide that if any one director of the

Reserve Bank was at the same time a director of the Bank of New Zealand, that person would be automatically appointed to the executive committee.

This last change was justified on the grounds that a concurrent appointment to both boards would ensure that the Minister was in a position to co-ordinate advice from the two most important financial institutions in the country. It was this change that attracted the most attention from Opposition members, and in particular from the Opposition's Finance Spokesman, Robert Muldoon. And yet concerns raised at the supposed dangers attendant upon the appointment of a "Minister's man" to the boards of the Reserve Bank and the BNZ, were not a reflection of any desire on the part of the National Party that the Bank become more independent of Government.

Speaking in the debate National Party Finance spokesman and former Minister of Finance appeared to suggest that, if anything, the Bank was to become more, not less independent as a result of the passage of the 1973 legislation:

"I see in the Bill that the Reserve Bank is being given the right to fix certain interest rates, principally those on the trading banks, and I want the Minister to tell the House and the country when he replies whether in fact that will be so or whether it will do it on the direction of the Government, as is the case at present. This is a very important matter because I know the Reserve Bank's views on interest rate policy. Its views are different from mine, and they were different throughout the whole of the time I was Minister of Finance. The Reserve Bank wanted to use the interest rate as an economic weapon, but when I was Minister of Finance, and during the whole of the time of the National Government, we refused to allow it to do so because we believed in a low interest rate policy - not a high interest rate policy which puts up interest rates to inhibit economic activity. If the Minister genuinely and sincerely wishes to step out of this responsibility and allow the Reserve Bank to fix interest rates and to use them as an economic corrective, we will then have the high interest rates which obtain in other parts of world. During the last 6 or 7 years interest rates in New Zealand have been 3 percent, 4 percent, and even 5 percent below the equivalent rate of other countries. Is this what the Bill does?

... Is the new Labour Government handing this over to the Reserve Bank in accordance with its policy or will it break its election promise and keep control at Government level, as I believe it should?" (NZPD, 1973: 2479).

In 1989 the Fourth Labour Government was to pass the Reserve Bank Act. But Muldoon's contribution to the 1973 debate suggests that the adoption of policies somewhat antithetical to the orthodox prescriptions of left and of right party governments had occurred well in advance of the election of the Fourth Labour Government - indeed, in part, the rationale for the 1989 legislation may be found in the tendency to 'regulatory excess' on the part of Prime Minister Muldoon and the National Party governments over the period from 1975 to 1984. While in his contribution to the

1964 debate Muldoon justified the National Party Government's amendments on the grounds that they would prevent the government of the day from meddling in the operational affairs of the Bank, by 1973 his criticism of amendments prosecuted by the Labour Government is clearly contradictory - on the one hand the Labour Government is criticised for seeking to effect a degree of coordination to the activities of the Bank of New Zealand (at that time in public ownership) and the Reserve Bank, and yet on the other for acceding to a loss of control on the part of government by allowing the Bank some independence in determining the 'interest rate policy'.

Public control and nationalism - Labour's legacy to Australian central banking

The genesis of Australia's central bank, now the Reserve Bank of Australia, can be traced to the establishment of the Commonwealth Bank of Australia in 1911. Schedvin suggests that from the 1890s most of the Australian discussion was about the transformation of the banking system to achieve broad public control - "the debate was politicised from the outset, and remained so for half a century" (1992:45).¹¹ Providing for this public control was seen to reside less in the imposition of regulatory and prudential measures by a central bank than in the establishment of a publicly owned bank to compete against, and limit the money power of the private banks:

"The idea was to establish a public bank that would compete against the private banks, keep the government accounts and provide other financial services to the government, act as custodian of the savings of the people, and avoid the presumed hazards of profit seeking private banking" (Schedvin, 1992: 47).¹²

Reform was driven from within the labour movement, and by the emerging Labor Party. It was the Labor Party that would sponsor the establishment of the Commonwealth

¹¹ Schedvin attributes this politicisation to a number of factors

- pressure emanating from within the Australian labour movement as part of a broader strategy to achieve greater social equality and to minimise the disruptions attendant upon the business cycle
- banks were seen as exercising a disproportionate amount of economic power, and extracting rents by way of high interest rates
- banks were thought to be operating in a pro-cyclical manner
- a series of bank failures in the early 1890s indicated an inadequate level of self-supervision on the part of the banking industry (Schedvin, 1992: 45)

¹² Schedvin attributes the largely non-technical nature of the Australian debate to the absence of bankers:

"In the United States and to some extent in Europe, bankers and economists were at the centre of the reform movement. Consequently the main issues were of a technical character: reserve requirements, rediscount policy, capital adequacy, portfolio regulation and the role of a central bank. In Australia the issue was not internal reform, but the transformation of the system to a different standard of behaviour. Understandably in these circumstances dialogue between bankers and reformers was minimal" (1992:47).

Bank of Australia in 1911, although the Bank's role was seen as providing a check on the money power of the banks by way of direct competition in 'retail banking'. However in 1920 the Commonwealth Bank assumed responsibility for the note issue, the first stage in the formalisation of its role as a central bank:

" A separate Note Issue Department was established within the Bank under the control of a Board comprising the Governor as chairman, the Secretary to the Treasury, and two other members, This introduced the principles of policy determination by a Board as against the original notion of concentration of authority in the office of Governor. This was an issue that was to cause deep disagreement in the future" (Schedvin, 1993:49).

Currency difficulties over the period from 1920-1924 - in particular a period of currency contraction - produced an amendment to the Commonwealth Bank Act in 1924. Labor's appointee as Governor of the Bank, Denison Miller, had managed the bank, "in autocratic but effective style" until his death in 1923 (McMullin, 1991: 154), but following Miller's death, and with the passage of the 1924 amendment, the management of the Bank passed from a single Governor to Board of Directors, and responsibility for the note issue was transferred to the whole Board. Speaking in the debate in the House of Representatives the Treasurer, Earl Page justified the extension of powers to a board of directors:

"There is now a consensus of opinion that one-man control is inadvisable for an institution whose policy may affect production, employment, and prices ... it is now widely recognised that the government of a central banking institution should include all the varied experience and mature judgement can supply. It is too much to expect that all the necessary qualifications can be found in one man" (AHRH, 1924: 1289).

The Board was to include two officials, the Governor and the Secretary to the Treasury. In respect of the appointment of the latter Page referred to the precedent of the Secretary of the US Treasury also being the Chairman of the Federal Reserve Board, and the fact that of the fifteen regents or directors of the Bank of France, three were required to be officials of the Government Treasury Department. On the matter of the qualifications of the other directors, Page advised the House that,

" ... the Government has been impressed by the fact that in the two most recently created central banking systems, those of the United States of America and South Africa, particular care was taken to have commerce agriculture and industry represented on the governing boards. It has been decided that four of the Directors of the Commonwealth Bank shall be persons who have been associated with manufacture, agriculture, pastoral pursuits, other primary industries, or commerce" (AHRH, 1924: 1289).

Moreover the Bill also provided that ,

"[i]n order that the requirements of every part of the Commonwealth shall be kept in view in the management of the bank, a clause has been inserted in the Bill requiring that fair representation of the geographical divisions of the Commonwealth shall, as far as possible, be arranged in the making of appointments to the Board of Directors" (AHRH, 1924: 1289).

Directors or officers of any corporation in the banking industry other than the Commonwealth Bank, were precluded from being members of the Board - a provision that continues in force to the present day. Notwithstanding the Government's stated intention of bringing into existence a 'truly national bank' of deposit, issue, discount, and reserve - an intention which it was argued that original legislation had failed to realise - the Leader of the Opposition, Matt Charlton highlighted changes in the governance and management of the Bank, suggesting that:

"... the real object of the Government in introducing this Bill is to place the management of the Bank under a board of directors...

[t]he big pastoral interests have played a very important part in the government of Australia during the last two years - altogether too large a part in fact ... The Bill is nothing less than an attempt to kill the Bank. How can the institution be made more of a national bank than it is when it is proposed to appoint as directors persons who, generally speaking, are entirely opposed to the nationalisation of banking, or of anything else? The board of directors, with the exception of the two public servants, and possibly the two special currency officers, will, if the Bill is passed, be composed of men who are altogether out of sympathy with the objects of a real national bank operating in competition with the existing private banks" (AHRH, 1924: 1506).

Charlton went on to suggest that in investing the board of directors of the Bank with the powers of governance the Government was abrogating its own responsibilities:

"The time has come when Ministers should retain full responsibility for the administration of affairs. We should get back to responsible government, and the work involved in the acceptance of Cabinet portfolios should be done by Ministers, who should be directly answerable to Parliament ... If Parliament agrees to the appointment of a Board of Directors for the Commonwealth bank, and it is found, subsequently, that the affairs of that institution are not being conducted satisfactorily - that, in short, the Bank is becoming a bankers bank instead of a national bank - the Government will doubtless say "The Board is to blame"" (AHRH, 1923:1507).

Charlton proceeded to raise objections to the length of the terms of office of directors, suggesting that the terms of appointment reflected a desire on the part of the Government to "tie the hands of ... new Ministers" (1923: 1507). But the concern of the Labor Party was less that the Bank would impose policies of financial austerity in the name of sound finance than that the failure of the Bill to provide for private banks to place reserve funds with the Commonwealth Bank was a recipe for inflation:

"The Treasurer proposes to cure financial stringency by inflation ... Those who control the Bank will control the notes. Therefore it will be a simple thing for them to cure monetary stringency by inflating the currency. One evil is to be checked by developing another" (AHRH, 1924: 1507).

At the core of the Labor Party's concerns lay the issues of governance and management, and these concerns were reflected in the amendment moved by the Leader of the Opposition in closing his contribution to the second reading debate in the House of Representatives:

" I move -

That ... in order to preserve the Commonwealth bank as a national institution, and to extend its operations for the purpose of controlling credit and exchange, it is desirable that financial experts to be fully employed in the service of the Bank should be appointed to its management, the proposal of the Government to appoint persons representing squatting and commercial interests, who are diametrically opposed to national banking, being designed more in the interests of private financial institutions than of the people's Bank" (AHRH, 1924: 1513).

Schedvin reports that the Board, comprised of businessmen and officials, was keen to learn more about central banking in order to allow it to discharge its new responsibilities. Advice was sought from the Bank of England, and in 1927 Sir Ernest Harvey, the Bank of England's comptroller visited Australia for the purposes of advising on the basic principles that might guide the central bank.

"They included the desirability of a central bank being privately owned and managed at arm's length from government, that it should not compete with commercial banks, that it should exercise general supervision over banks .., that it should act as the government's banker, and that it should hold the ultimate reserve of the banking system" (Schedvin, 1992: 50)

The actions, or perceived lack of action, of the Board over the period of the Great Depression were to provide further justification for banking reform, particularly within the ranks of the Australian labour movement. In 1930 the Scullin Government attempted, unsuccessfully, to change the institutional topography by way of the establishment of a Central Reserve Bank. The Central Reserve Bank Bill received its second reading in the Representatives on May Day 1930.¹³ The Treasurer, Mr

¹³ Passage of the legislation was frustrated by the Senate:

"The rejection of the Wheat Marketing Bill was quickly followed by obstruction of the Central Reserve Bank Bill, which represented another moderate reform in line with good sense, Labor's platform and recognised banking practice in Australia and overseas. Conservative interests opposed the bill because it weakened the stranglehold they enjoyed over the Scullin Government's financial policy via the Commonwealth Bank Board" (McMullin, 1991: 159).

Theodore, speaking in the second reading debate suggested that the Commonwealth Bank had not succeeded in fulfilling the functions of a central reserve bank, and that the Commonwealth Bank could not readily assume these functions while it was in competition with the private banks. The Bill provided that the central reserve bank would be controlled by a board of directors, with a governor and two deputy governors. The board of directors was to consist of a governor, two deputy governors, the Secretary to the Treasury, and five other directors representative of the commercial, banking, and other interests. The governor was to be the chairman of the board of directors, the principal executive, and the principal controlling officer of the bank.¹⁴ The Governor of the bank was to be appointed by the Governor General on the advice of his Ministers. Referring to critics of the Bill, Theodore quoted a communication from the President of the Sydney Chamber of Commerce, which, at a special meeting of its council had expressed its concern that a central bank may come under pressure to depart from 'sound policy'¹⁵:

" .. a federal reserve bank such as is proposed in the Bill ... has also dangerous possibilities if subject to pressure from varying and variable political interests" (AHRH, 1930:1345).¹⁶

Two days after the Scullin Cabinet was sworn in, the New York Stock Exchange collapsed. Commonwealth Bank Board Chairman Gibson was instrumental in bringing

¹⁴ The Treasurer also foreshadowed a desire to appoint a representative of 'labour' to the board of the new institution:

"A number of central reserve banks on the Continent have a sufficient number of directors to give separate representation to different interests, such as commercial, manufacturing, and banking interests, and in many cases special representation is given to labour, not in a political sense, but as a factor of life in the community. The Labour representative is not a political nominee. He represents the wage earning community as distinct from the commercial and manufacturing interests" (1930: 1342).

¹⁵ Dyster and Meredith suggest that, while the proposed institution was to be tasked with the powers of a central bank, it "would be an instrument of cabinet policy, particularly (Theodore intended) in credit creation during the current crisis. The trading banks campaigned against its establishment, Gibson was invited by the Senate to damn the bill, and the Senate voted it out" (1990: 144; see also Schedvin, 1970).

¹⁶ Referring to the collapse of central banking systems on the continent the Council resolution noted that the circumstances behind these failures, "revealed that their failure in time of crisis was largely due to the fact that political pressure was put upon the central banks to abandon the fundamental principles of sound central banking and to subordinate financial prudence to political expediency" (1930: 1345). Commenting on these, and other issues raised by the Chamber of Commerce Theodore suggested that the Bill would not,

" ... create disturbance in banking circles, nor lead to any confusion in our credit system. The bill has been widely reviewed in Australia and abroad ... most of the overseas criticism was of a favourable nature. In most quarters it was admitted that central reserve bank would be advantageous to Australia in the present state of our trade and national development" (1930: 1347).

the severity of the economic situation to the attention of the Scullin Ministry.¹⁷ At an early meeting of the Scullin Cabinet,

"Gibson 'piled on the horrors and notified us that unless the government indicated the methods by which it would reduce expenditure the bank could not finance the government beyond the end of November - five weeks. He made it clear that as chairman of the Bank Board he considered himself loftily independent of the elected government, which he despised" (McMullin, 1991: 155).

Largely it would appear at Gibson's urging - in turn reflecting pressure from the Bank of England, acting on behalf of creditors (Dyster and Meredith, 1990: 135) - Scullin issued an invitation to Sir Otto Niemeyer to visit Australia.¹⁸

"Gibson applauded Niemeyer's harsh medicine when it was unveiled at a conference of federal and state ministers in Melbourne on the 18 August... It was not so much his analysis of the economic position that caused sparks to fly, but his blunt criticism of Australian characteristics like their unhelpful 'natural optimism', faith in 'sheltered trades' protected by high tariffs, and unwillingness to cut 'costs' (which was, as the labour movement recognised, a euphemism for wages)" (McMullin, 1991:163).^{19 20}

¹⁷ Gibson was one of the bank's inaugural directors. He was, McMullin suggests,

"... steeped in conservatism: he possessed indomitable rectitude and blinkered views on finance. A gaunt sad looking man approaching his 66th birthday when Scullin became Prime Minister, Gibson loathed indulgence in any form. He became the bank's dominant figure when his fellow directors elected him as chairman of the board in 1926, the same year a newspaper listing the most influential men behind the scenes in the Nationalist party named Gibson among the powerbrokers right at the top" (McMullin, 1991: 154).

¹⁸ The 'invitation' to Niemeyer was followed by the re-appointment by Scullin of Gibson to the Commonwealth Bank Board. McMullin suggests that this was against the wishes of some in the Scullin Cabinet and in Caucus, and without their prior knowledge and consent. Scullin reasoned that not to do so would put at risk negotiations with British financiers. McMullin also suggests that Scullin was of the view that given the chairman of the Bank Board was now appointed by his fellow directors, and since nearly all of them were Bruce's appointees, their choice would inevitably be someone with views like Scullin. However Scullin did proceed to appoint one M D Duffy, a Victorian Labor identity, THC Secretary and financial specialist to a vacant position on the Board.

¹⁹ Manning-Clark reports the reactions of those present in Melbourne on 21 August 1930 when Niemeyer addressed a conference of the Prime Minister, the Premiers and Treasurers:

"Those present were penitent. They had sinned against the laws of political economy through their 'own most grievous fault'. They swore to try, with Sir Otto's help, and the help of the Bank of England, not to sin again. They would balance their budgets. The Loan Council would raise no more loans overseas until after the short-run indebtedness had been completely dealt with. They would not give approval to the undertaking of new public works which were not capable of paying for themselves" (1998: 528).

²⁰ McMullin offers an alternative view on the decision to invite Niemeyer, and on Niemeyer's attitude to his hosts:

"Scullin 'invited' Niemeyer to make the visit, which was in fact instigated, with Gibson's full support, by the Bank of England. Its senior bankers were appalled by the prospect of Australia defaulting, but before authorising the provision of emergency assistance they wished to obtain

Niemeyer's analysis placed much of the blame on the absence of budget and exchange equilibrium, and was embraced by Gibson. This advice was to result in the Melbourne Agreement in which,

" ... all state governments concurred with the Scullin Government on the desirability of strict economies and balanced budgets as stipulated by Niemeyer and Gibson ... 'Niemeyerism' entered the political vocabulary as a scornful label for deflationary reductions"(McMullin, 1991:163).²¹

At the core of policy differences between the Commonwealth Bank and the Government was the financing of the public deficit. Niemeyerism placed a premium on fiscal balance, and early in 1931 the Bank, on behalf of the system as a whole, placed a limit on the amount of deficit finance,

" ... insisting that governments adopt a collective plan to achieve budget balance within a defined period. Within the Labor government this was seen as an attack on democratic principles, and in particular on the right of an elected government to determine its own budgetary policy. The Board won this contest: the mildly expansionary programme proposed by the government could not be financed" (Schedvin, 1992: 53).²²

first-hand detailed information about Australia' financial position... His (Niemeyer's) discreet affability and the government's reticence about the purpose of the visit did not prevent uneasiness spreading through the labour movement. In an unguarded moment Niemeyer revealed the wisdom these suspicions when he met Labor's Speaker in the Representatives, Makin, Ever polite Makin said he hoped Niemeyer was finding his visit satisfactory. 'That depends on whether you do as you're told, the banker barked back" (McMullin, 1991: 162).

Compare this with the following contribution from the Labour Party member for Timaru, the Rev Carr in the second reading debate on the Labour Government's 1939 legislation. Referring to the visit of Sir Otto, Carr reports that,

"I was in the social room of these buildings when Sir Otto Niemeyer was entertained. Members of both Houses were present. The Speakers of both Houses were present. A welcome was extended to the visiting banker, and in reply he said, " Mr Speaker, and honourable gentlemen - I have been very glad to come here at your invitation. I have been very grateful to partake of your hospitality. I have been very pleased to come here as your guest. I hope the time will not come when I shall have to be sent here" (NZPD, 1939: 807).

²¹ Schedvin suggests that the impact of the Niemeyer visit was to colour the approach of the Labor Party for some time, with the ALP concerned:

" ... to avoid a repetition of the humiliation of the early 1930s when the Bank of England appeared to be sending in a bailiff in the form of Sir Otto Niemeyer ... " (Schedvin, 1992: 28).

²² In June 1931 the Commonwealth and, with the exception of New South Wales, the States agreed on a Premiers' Plan, which proposed,

"The reduction of government expenditure by 20 per cent of the level of 1929-30 (except for old-age pensions which were to come down by only 12.5 per cent) ..

Increases in federal income and sales taxes, in primage duties, and in some state income taxes ...

Schedvin suggests that the events of 1931, and in particular the contest between restrictionists and expansionists were to influence the future conduct of relationships between Bank and government for a considerable period - "for many years after World War II central banking was conducted in the long shadow of 1931" (1992: 53).

Following the 1934 Federal election campaign, during which banking reform had been to the fore, the Government, under Prime Minister Lyons moved to establish a Royal Commission into the financial system. The Royal Commission, chaired by Mr Justice Napier of the Supreme Court of South Australia, commenced its investigations in January 1936, and reported in July 1937.²³ Schedvin observes that on the issue of relations between the government and the central bank the Royal Commission adopted a clear position on how to avoid the policy disagreements of 1931:

"The solution was a middle course: if a policy disagreement arises, the first task should be 'full and frank discussion'. Most differences are likely to be resolved in this manner. If they are irreconcilable, the government should give the Bank an assurance that it accepts full responsibility for the proposed policy, and is in a position to take, and will take any action necessary to implement it. It is then the duty of the Bank to accept this assurance and to carry out the policy of the government" (Schedvin, 1992:57).

Schedvin records that consultations with the private banks delayed the preparation of legislation embodying the Royal Commission's recommendations, the main issues being minimum deposits with the Commonwealth Bank, and Bank access to the sterling funds of the trading banks (1992:59). While legislation was introduced it was not taken beyond the second reading stage and matters were overtaken by the onset of war. Regulations necessitated by the economic and political exigencies the Second World War saw the Commonwealth Bank conferred with all the powers of a central bank, exceeding in some respects the recommendations advanced by the Royal Commission. The Government assumed full control over foreign exchange, regulations provided for the sterilisation of the effects of monetary expansion, and regulations also empowered the Bank to set interest rates - "[t]he main recommendations of the royal commission were implemented, and much more besides. The degree of control was such as to gladden the heart of the staunchest opponent of the private banks" (Schedvin, 1992:61).

A cut in the interest paid on existing government loans to Australians (but not to foreigners) of 22.5 per cent; state parliaments to pass laws that would bring down mortgage rates similarly, and the banks to be persuaded that bank interest should move in the same direction" (Dyster and Meredith, 1990: 137).

²³ See also Coombs' account of the Royal Commission (Coombs, 1981: 108-9).

The Curtin Government introduced two pieces of banking legislation in March 1945. The first of these, the Commonwealth Bank Bill, tasked the Bank, by way of its charter, to pursue a monetary and banking policy directed to the greatest advantage of the people of Australia, and to exercise its powers so as to best contribute to:

- "(a) the stability of the currency of Australia;
- (b) the maintenance of full employment in Australia; and
- (c) the economic prosperity and welfare of the people of Australia" (in Schedvin, 1992: 63).

What Schedvin describes as a 'bold declaration of responsibility' represented the adoption of an agenda which, "embraced broad macroeconomic objectives because of the perceived interconnections between private banking policy and economic fluctuations" (1992:63)²⁴. Moving the second reading of the Bill Treasurer Chifley advised the House that,

"[t]he legislation that I am proposing to-day is based on the conviction that the Government must accept responsibility for the economic condition of the nation. The problems of the post-war period - of employment, development and trade, are of such magnitude, and involve such serious consequences, that no other attitude could be maintained. Accordingly the Government has decided to assume the powers which are necessary over banking policy to assist it in maintaining additional economic health and prosperity" (AHRH, 1945: 547).

The 'political' rationale was provided in large part by the perceived failures of the banking system, and of the Commonwealth Bank in particular at the height of the Great Depression. The banking legislation was positioned as insurance against a return to the doctrine of Niemeyerism:

"In 1931, in the depths of the depression, the Commonwealth bank and the private banks refused to assist the rehabilitation plan of the Commonwealth and State Governments designed to relieve acute unemployment and to restore industry. The present Government is determined to ensure, so far as lies within its power, that this will not be repeated" (Chifley, AHRH, 1945:547).

²⁴ Coombs recalls that:

"From the Keynesian stronghold of the Ministry of Post-War Reconstruction, I and my colleagues were urging that the Bank legislation should record the commitment of the objective of full employment. Treasury and the Bank argues that the concern of the Bank was essentially financial and that its primary objectives should be the stability of the value of the currency in both its domestic and international contexts. In the event it was finally agreed that there was no profit to be gained from exploring legislatively the compatibility of these objectives or the nature of the trade-offs between them which might be required. Accordingly, with varying degrees and styles of reluctance, we all accepted a 'Charter' for the Bank which committed it to both, balanced by a third which was so imprecise that it could be welcomed equally by those who saw the Bank as the instrument of the populist vision of 'The People's Bank', correcting the inherent inequalities of the capitalist system, and those who saw the interest of all being best served by the separate pursuit of their individual interests" (1981: 111-2).

The 'disputes resolution' procedure recommended by the Royal Commission was written into the Bill. Chifley advised that House that,

"[t]his procedure is to be invoked only in matters of policy affecting the interests of Australia and there can be no interference in the relationship of the bank with its customers, or in matters of day to day administration" (AHRH, 1945: 549).

While this change was represented by private banking interests as a diminution in the independence of the bank and criticised as such, for its part the Bank accepted the formulation, viewing policy making, subject to the provision of frank advice from Bank to Government as may be required, as the province of the government of the day, and the implementation of that policy as the responsibility of the Bank. Schedvin notes the annual report for the 1944/45 year stated the Bank's position:

"... it is no new departure from central banking practice to expect the central financial institution of a country to follow the broad lines of policy which are laid down by the Government and for which the Government naturally must take final responsibility. Finance is, however, a highly technical business and it is possible for genuine differences of opinion to arise over policy and procedure. It is the Central Bank's duty from its experience and specialised role to tender to the Government without fear of favour the best possible advice as occasion rises. In questions of day to day internal administration, it should, however, be free from interference" (1992: 64).

The Bill provided that the Board of Directors would be abolished and replaced with an Advisory Council composed entirely of officials.²⁵ The Council comprised the Secretary to the Treasury, one other Treasury Official, the Deputy Governor, and two other bank officials:

"The point of this structure was that the emphasis was on advice; the authority of the Governor was in no sense diminished" (Schedvin, 1992: 66).

Chifley represented the change as insulating the management of the Bank from potential conflicts of private interest:

²⁵ This was against the advice of Coombs, who recalls that he wrote to Chifley recommending the retention of a Board:

"My experience as an employee of the Bank suggests that there is a real need for a Board ... Banking is a limited field of experience and bankers are notoriously narrow in their outlook and inclined to rule of thumb methods. The existence of a Board to whom executive decisions have to be submitted forces them (the Executive) to consider the reasons for the action they recommend and to justify their recommendations. This is an essential protection against routine thinking" (1981: 112).

"The selection of persons who have the qualifications and experience to manage a central bank, but at the same time no other business interests in the community is obviously a difficult if not an impossible task. Most persons with suitable qualifications have other interests which might at times conflict with their duties as members of the board. It may be that these interests can be completely submerged when affairs of the State are under consideration. Nevertheless, the Government feels that an institution of this character should be under management which is entirely divorced from private interests" (AHRH, 1945: 551).

The second piece of legislation introduced by the Chifley Government was the Banking Bill. The Bill provided the Commonwealth Bank with powers of prudential supervision and management, but also empowered the Bank to regulate the lending policies of trading banks by way of special accounts, and controls on credit and lending policies, including control of interest rates. Significantly the Bill also proposed that all government and public bodies would be required to conduct their business with a publicly-owned bank.²⁶

For their part the Opposition parties in the Parliament foreshadowed a different approach to the institutions of central banking and the conduct of monetary policy. Menzies suggested a prioritising of objectives which elevated 'sound money' above other considerations:

"The chief function as I understand it is the regulation of the volume of credit, including currency. That regulation is designed to achieve, among other things, three results. The first is the stabilisation of the internal or domestic value of the currency, which is not merely a matter of stabilising things as items in accounts, but stabilising the purchasing power of the people's savings, the people's future money. It is therefore a task of the first magnitude. The second result is the stabilisation of the external value of money, naturally through the exchanges. The third result is the reduction or elimination of sharp variations in the general level of employment or trade activity... To achieve those results the central bank must be in a position ... of real strength and real authority. The central bank is not to be simply the servant of some passing movement" (AHRH, 1945:747).

On the question of the abolition of the Bank Board, Menzies defended the superiority of the post 1924 arrangements:

"The great advantages of a board are the bringing together of a diversity of experience, the added judgement produced by frank discussion by competent men, the added strength involved in joint responsibility, and the publicity which a board of directors can secure for that view in the event of a great conflict of opinion on a central banking problem" (AHRH, 1945: 753).

²⁶ McMullin records that this provision was inserted against Chifley's wishes, who no longer saw nationalisation as necessary, was advocated by Calwell and approved by Evatt who attested to its constitutional validity (1991: 232).

Menzies also objected to the provision in the Bill requiring the bank to give effect to government policy - "... it is quite clear that the clause provides for complete political control" (AHRH, 1945: 754), - suggesting that the status and composition of the Advisory Council was window dressing to make it appear that there was some check on the powers of the Governor:

"The royal commission recommended that there should be a method of reconciling differences, not between the Government and the Governor, but between the Government and a board of directors. There we have an essential difference. After all, one man, himself dependent for appointment on the government of the day, is not in a strong position to resist or argue about the instruction of a Treasurer or a government; but a board of directors, consisting of people who are in every other respect independent of the Government, is in a far better position to say, 'We think this is wrong. We object to it. We are prepared to argue about it, and if necessary to tell the people and Parliament about it'. There is a vital distinction between the recommendation of the royal commission and what appears in the bill... It is high time that the authority of Parliament was restored. If there is any major conflict between the central bank and the Government, then Parliament should be invited by appropriate means to deal with the matter" (AHRH, 1945: 754-755).

Menzies concluded by committing his party, and his coalition colleagues to the restoration of board control of the bank, free from political interference, and the restoration of parliamentary authority. The banks mounted a campaign of opposition, but with the Labour Party enjoying a majority in both Houses the Bills were passed and proclaimed in the 2 August 1945. In the aftermath of the High Court and Privy Council decisions on bank nationalisation, the subject at issue, namely central banking, received little further attention, notwithstanding that aspects of the 1945 legislation other than those challenged before the Courts were now open to some question:

"There were aspects of the 1945 legislation that the banks would continue to contest, but they did so outside the courts - at the political level and in conference with the Commonwealth Bank. The change of government might have been a factor in the banks' attitude, but one suspects that the reason lies deeper. It appears that the basic principles of central banking as developed in Australia in the 1930s and 1940s had been accepted, or at least tolerated" (Schedvin, 1992:89).

Australian central banking, it is suggested, was built on two foundations, described by Schedvin as both unusual and inauspicious:

" ... central banking had become enmeshed in politics and would continue to be highly political for at least another decade. Partly as a consequence, central banking had been tightly incorporated in the apparatus of the state; only gradually was the Bank able to achieve a degree of operational independence. Second, the central bank had been elevated ... to become the central agency of economic control. It was assumed that monetary instability was at the heart of

macroeconomic instability, and it was therefore incumbent on the central bank to steer the ship of capitalism through stormy seas" (1992: 89).²⁷

The intentions of the Liberal-Country Party Opposition had been made clear in the Parliamentary debates over the 1945 legislation. The Curtin Government was defeated in the election held on the 10 December 1949, but retained a majority in the Senate. The incoming Government proceeded to draft legislation with a view to making two principal changes in the governance and management of the bank, and in relations between bank and government. A board of directors was to replace the Advisory Board of officials, with the Governor as chairman of the Board, and the disputes procedure was made somewhat transparent inasmuch as any matter formally in dispute between the bank and the government was to be placed before the Parliament, with a decision of Parliament binding on the Board. The Labor Party opposed the changes, and in particular the abolition of the Advisory Board and its replacement with a board of directors. Chifley defended the existing arrangements, suggesting that:

"It is impossible to devise a system under which the Commonwealth Bank, the Treasurer or the Government would be better advised than under that which is now in operation ... We shall oppose all the provisions of the bill that [constitute] a bank board" (quoted in Schedvin, 1992: 144).

In March 1951 the ALP Conference congratulated the Federal Parliamentary Labour Party for blocking the Menzies Government's amendments to Labour's 1945 legislation, and approved an amendment to the ALP platform opposing the reinstatement of the Commonwealth Bank Board. When the ALP senators referred the legislation to a Senate select committee Menzies approached the Governor-General and sought a double dissolution (McMullin, 1991: 260).²⁸ The Menzies Government was returned on the 28 April 1951 with a majority in both houses. The second version of the Bill was introduced in 1951 and duly passed (Schedvin, 1992: 152).

Further legislation in 1953 created the Commonwealth Trading Bank as a separate legal entity, but the Bank as a whole was controlled by a common board of directors, and there was an interchange of staff between departments within the bank as a whole (Schedvin, 1992: 271). The next episode of legislative change occurred in October 1957,

²⁷ Our earlier review of the genesis and development of the central banking statute through the New Zealand Parliament would suggest, however, that the politically contested development of the Australian model is not as unusual as Schedvin suggests. Whether that development, in the Australian case, was also inauspicious depends on the stance one adopts as regards the rational economics prescription for central bank independence.

²⁸ McMullin suggests that Chifley had been advised by Evatt and McKenna that the Governor-General would not be able to interpret reference of legislation to a select committee as satisfying the 'failure to pass' test in the Constitution.

with the separation of the Commonwealth Bank of Australia's trading bank activities from its monetary policy and prudential functions. Four bills were introduced to give effect to this separation and other matters but were defeated in the Senate on the 3 December, and again in the Senate on the 20 March 1958 (Schedvin, 1992: 288). The Liberal-Country Party was returned to power following a general election in December 1958, and with a majority in both houses. The legislation was passed through both Houses and received the Royal Assent on the 23 April 1959. Speaking in the second reading debate on the 26 February 1959 Treasurer Harold Holt advised that the essential purpose of the legislation was,

"to provide for the reconstitution of the non-central-banking components of the present Commonwealth Bank group under a new corporation, to be called the Commonwealth Banking Corporation, which will function as an entirely separate organisation from the Reserve Bank " (AHRH, 1959:378).

The 'Reserve Bank' was to be governed by a board comprising the Governor and Deputy Governor of the Bank, the Secretary to the Treasury, and seven other members appointed by the Governor General. The board of the Bank was vested with determining the policy of the Reserve Bank, and the charter, with its multiple objectives, was retained as was the requirement that the board keep the government of the day informed regarding the banking and monetary policy of the bank, with relations between bank and government subject to the ultimate override as provided for in the enhanced disputes procedures. The ALP Opposition characterised the changes as evidence of the influence of the money power of the private banks over the Liberal-Country Party Government. The Leader of the Opposition, Dr Evatt suggesting that,

"[i]t is clear beyond doubt that the sole inspiration of these changes is the need to placate the Government's financial backers - the private banks - by sacrificing the interests of the Commonwealth Bank of Australia ... Slowly but surely the economic prosperity and welfare of the Australian people are being construed by vested interests as the prosperity and welfare of the big financial interests and it is these interests which have demanded the changes contemplated in this legislation" (AHRH, 1959: 441).

The 1959 legislation continues in force. In terms of the formal institutional arrangements there has been no change to the general scheme of the Act since the passage of the 1959 legislation. Manifestly there have been significant changes in terms of the informal dimensions of the relationship between the Bank and governments, between the Bank and other members of the 'official community', and in the broader domestic and international economy and policy environment within which the Bank is

located, and, in turn, on which it has an influence. We explore these changes in subsequent chapters.

Conclusion: the drivers of institutional change

This chapter was informed by two objectives. The first was to examine whether the historical trajectory of institutional change and reform provides support for the proposition that institutional disequilibrium may 'spill-over' into the political domain and be evidenced in partisan orientations to institutional forms. This review of changes in the formal institutional arrangements suggests a pattern of evolution, and of reform that is driven in large part by partisan imperatives. Both in terms of the policy objectives to which the central bank has been directed, and in terms of the governance and management of the central bank, there are parallels to be drawn between the trajectory of institutional evolution and reform in Australia, and that found in New Zealand. As with the development of the New Zealand arrangements, governments of the left have tended to elevate output and employment objectives, and governments of the right to place a higher priority on the stability of the currency.

And in terms of the governance and management of the Bank, the role of the Board or Advisory Board has been the principal site of contestation. Governments of the left have indicated a clear preference for a more direct relationship between the executive branch and governors of the Bank, whereas right-party governments have tended to support a greater degree of operational independence for the Bank, with relations between Bank and government buttressed by way of an 'independent' Board of Directors. Australian Labor Party governments in the period reviewed have tended to view the board as possessing an advisory, as distinct from a policy making function, and have placed a greater measure of confidence and authority in the office of the Governor, relative to that of the chairman of the Board of Directors. Right party governments have tended to favour a greater measure of operational independence for central banks, based in large part on 'public choice' styled assumptions about the inflationary consequences attendant upon politically porous institutional arrangements.

Indeed one is struck by the fact that the case for central bank independence that emerges out of the rational economics literature is very much in evidence in the discourse of Australian and New Zealand politics from the outset of formalised central banking in both countries. Long before the era of rational economics, politicians of both the left and the right had very clear views on the dangers and pitfalls of subordinating

central bank decisions to political imperatives - typically, for the left, the danger lay in a set of institutional arrangements that provided points of entry and influence for representatives of capital; for the right, the danger lay in arrangements which would permit the conduct of monetary policy to be more responsive to the preferences of governments, and much less to the requirements of 'sound finance'.

The second objective went to the need to locate existing institutional arrangements within an historical context. This capsule history suggests that central banks are important sites of contestation within both the domestic and international political-economy, and both shape, and are shaped by the accumulated policy, and political and economic experiences of particular nations. While the pattern of institutional development suggests a shared partisan code, in a number of other respects there are important differences in the pattern of institutional development in the two Australasian nations. One important difference may be captured in the relative influence of Sir Otto Niemeyer and 'Niemeyerism' in each of the two nations.²⁹

In both cases there is, particularly on the part of the labour movement, the suggestion that Niemeyer was imposed or 'foisted' on the governments of Australia and New Zealand. But whereas in the case of New Zealand central banking originates with the visit to New Zealand in 1930, a central bank was already in existence in Australia at the time of Sir Otto's visit.³⁰ Moreover that Bank was one that had come into existence

²⁹ And Sir Otto Niemeyer continues to surface in contemporary Australian politics. In early February 1997 the Liberal Party Member of the Australian House of Representatives, Mr Hockey, evoked the memory of Niemeyer in support of the Howard Government's introduction of a charter of budget honesty. Mr Hockey suggested that Niemeyer had,

"... fulfilled his mission with conspicuous tact, placing unpleasant facts on record in a manner that left no sting, and then left the abiding impression of a kindly, courteous gentlemen who has rendered conspicuous service to the Commonwealth ...

It is somewhat ironic that, whilst the Australian Labor Party continues to oppose our level of accountability through the charter of budget honesty, their own state government in New South Wales continues to release on a monthly basis something that is known as the Niemeyer Report, which is a regular update for the people of New South Wales on the status of the New South Wales budget" (AHRH, 6 February, 1997).

³⁰ It might be argued that the reasons for Niemeyer's visits to Australia and New Zealand differed somewhat - Hawke notes that the New Zealand Minister of Finance Forbes wrote to Niemeyer in advance of his visit, that it,

"... was particularly requested that in any statement made by you when leaving it should be made quite clear that visit to New Zealand is in connection with [the] banking and currency system only and not for purposes similar to those which have occasioned your visit to Australia" (in Hawke, 1971: 28).

New Zealand was, at the time, believed not to have the same kinds of serious financial problems as faced the Australian Commonwealth and States.

under a Labor administration. The Reserve Bank of Australia was, in an institutional sense, the progeny of the Commonwealth Bank of Australia. By contrast, the Reserve Bank of New Zealand emerges largely out of the recommendations of the Niemeyer Report to the New Zealand Government. And whereas the Reserve Bank of New Zealand was established to be a bankers bank, the Commonwealth Bank of Australia was established to contest the money power of the private banks. In the Australian case the policy 'root stock' was provided by a Labor Government, whereas in New Zealand's case it was provided by an Officer of the Bank of England. One might therefore argue that the prospects for a sense of ownership of the institution might be somewhat greater on the part of Australian Labor than their New Zealand counterparts. And underpinning these partisan preferences are particular configurations of class and economic interest. In both Australia and New Zealand there is evidence of a considerable reluctance on the part of Labo(u)r governments to countenance modes of governance and management that privilege private economic interests.

As the two nations entered the decade of the 1980s they shared central banking statutes that were more similar than different - both central banks were guided by charters that directed them (or more correctly, in the New Zealand case, the government of the day) to pursue multiple objectives, and the governance of both was vested in a board of directors. Both central banks were, to varying degrees, required to consult with the government of the day in the implementation of monetary policy (although both institutional regimes, and the policy environments of the time, were such as to admit of a high level of direct government involvement). However while statutes might have been largely similar, it was the decade of the 1970s that was to see a significant departure in the approach to monetary policy on either side of the Tasman. Under the Fraser Government Australia would be one of the first of the OECD nations to embrace orthodox monetarism. Under Prime Minister and Finance Minister Muldoon, New Zealand would eschew the principles and practice of monetarism in favour of more statist policy prescriptions. Whatever the policy and political excesses of Muldoon there is a sense in which, in seeking to exploit the central bank as an important tool contributing to government-initiated economic development, the Muldoonist policy trajectory represented, albeit in a somewhat extreme and illiberal form, the continuation of the politics of domestic defence. In New Zealand the election of the Fourth Labour Government in July 1984 would see the un-making of that policy paradigm. Policy divergence over the course of the 1970s would end briefly in 1984 when, for a period both central banks practised hybrid forms of monetarism, but thereafter the differences would again become much more marked. Under the ~~emerging~~ New Zealand model, and in a reaction against the statist excesses of 'Think Big', the

role of the central bank would increasingly be confined to providing a stable macro environment for the private sector. Indeed one might suggest that the Fourth Labour Government was required to 'turn right' on central banking because its predecessor had 'turned left' and in a very orthodox and excessively statist manner.

In 1989 differences in the implementation of policy were evidenced very starkly when the New Zealand Parliament, by a unanimous vote, passed the Reserve Bank of New Zealand Act 1989. In the case of the New Zealand arrangements the 1989 statute represents the institutional ascendancy of economics over politics - a state of affairs with which Sir Otto Niemeyer would be quite comfortable.

Chapter 5

The Reserve Bank of New Zealand Act 1989

Introduction

This chapter examines the genesis of the Reserve Bank of New Zealand Act 1989. The passing of this Act provided an important background to subsequent debates in Australia, and so it is interesting in its own right for understanding those debates. But this chapter will also argue, in terms of the model developed in Chapter 3, that reform in New Zealand was necessary because the Muldoon legacy was a monetary policy framework that was low in both credibility and legitimacy. It will be argued that this provided the right environment for an 'institutional regime shift' that was, for the most part, inspired by the rational economics theories surveyed in Chapter 2. Consequently, it will be argued that the reform shifted New Zealand from a position of low credibility and low legitimacy to a position of high credibility but still low legitimacy. The concluding chapter of this thesis will argue that, in contrast to the changes in Australian policy, a failure to include consideration of legitimacy was a major weakness in the 1989 New Zealand reform.

From the election of the Fourth Labour Government in July 1984 New Zealand embarked on a programme of economic reform acknowledged as the most concentrated and comprehensive of any attempted among the OECD nations (see Bollard and Buckle, 1987; Silverstone, Bollard, and Lattimore, 1996).¹ In effect the programme of structural reform constituted the 'unmaking' of the politics and the policies of domestic defence (Castles, 1984). The fact of significant structural reform suggests changes to the make-up and relative power and influence of 'societal coalitions' within the New Zealand political system, and of relations as between actors within state directed policy networks, including the monetary policy network. Capital and finance market liberalisation had been largely completed by 1985, and a more orthodox approach to the conduct of monetary policy was adopted immediately following the July 1984 election, an approach which pre-dated, and anticipated the codification in statute of a new set of institutional arrangements with the Reserve Bank of New Zealand Act 1989.

¹ A chronology of the economic reforms over the 1984-1996 period is provided in Silverstone, Bollard and Lattimore, (1996: 24-8).

The Muldoon legacy - low endowments of credibility and legitimacy

To reduce the rationale for the 1989 Reserve Bank of New Zealand Act down to the personality of one individual is to risk doing a considerable violence to the complexity of New Zealand politics and policymaking over the period from 1970. But if one personality dominates both, and in particular from 1975 to 1984, it is that of Robert Muldoon.² From 1975 until 14 July 1984 Muldoon held the positions of Prime Minister and Minister of Finance. Moreover he held those positions in an institutional and constitutional context that vested considerable power in the executive branch of government, and in the position of Prime Minister and Finance Minister. In the context of the material reviewed in preceding chapters, the personality, politics, and public policies associated with Muldoon and Muldoonism resonate very strongly with the critiques of discretionary, and politically informed policy making which inform the normative prescriptions for central bank independence. That being the case while it is difficult to categorise Muldoon and Muldoonism, in totality, on a standard left-right continuum, the style of policymaking more readily lends itself to analysis when recast in terms of the literature reviewed in Chapter 2. Muldoon was the embodiment of the Downsian politician, ever ready to exploit whatever policy tools and instrument he had at his disposal in pursuit of the retention of power, and, in government and in opposition, possessed of an acute sense of the preferences or prejudices of the median voter. Muldoon's brand of post-war populism was reflected in a concern to minimise unemployment, maximise growth, and minimise the national and sectoral (and electoral) risks attendant upon exposure to the vagaries of the international economy. As an economic project Muldoonism was about economic nationalism, underpinned by a large measure of state regulation and support, and with policies developed and implemented, by design, in a manifestly less than transparent fashion. As an electoral project Muldoonism was about exploiting the political business cycle to the fullest possible extent, operating policy according to a political and electoral calculus, and eschewing a medium term focus in preference for what was, in effect, short term expediency. In short, Muldoonism represented the embodiment of the sins that institutional remedies informed by the rational economics literature sought to remedy.³

² Commentaries on, and analysis of politics and policymaking under Muldoon can be found in Bassett (1998); Gustafson (1986); James (1986). A sympathetic view is presented in Gould (1985).

³ Michael Bassett quotes Gary Hawke on the defining elements of 'Muldoonism':

"Muldoon became what Gary Hawke calls, 'an inveterate meddler, and overconfident, self-proclaimed economic manager with a demagogic streak. He was clever, but undisciplined; he thought of the balance of payments today, the fiscal deficit tomorrow, but never seemed capable of balancing all the relevant factors at the same time. He had the misfortune to be in office at a time when this mattered'" (Bassett, 1998: 352).

Muldoon's legacy to politics and public policy is arguably much more clearly manifest in what was done in the name of 'Muldoon-proofing' the economy in the period following his defeat in July 1984 than it is in the trajectory of politics and policymaking over the course of his leadership. Muldoon-proofing the economy was less about a change in the policy mix, than it was about revisiting the institutional context within which public policy was developed and implemented. And, at the risk of privileging the 1989 Reserve Bank of New Zealand Act, it is this institutional change that most clearly demonstrates the legacy of Muldoonism. As we shall observe, the policy path followed by the Reserve Bank of New Zealand changed immediately as a consequence of the 1984 election. By the time of the passage of the 1989 legislation monetary policy was far more orthodox, and located procedurally in a set of arrangements which anticipated the Act. Muldoon-proofing the economy was less about changing policy than about changing the institutional parameters within which policymakers - elected and non-elected - operated.⁴

Those tasked with responsibility for the implementation of monetary policy under Muldoon recall an environment in which there was sufficient institutional space to allow for a large measure of intellectual freedom and debate within agencies like the Treasury and the Reserve Bank, but in which Muldoon's response to the ideas generated was anything but encouraging. Dr Roderick Deane recalls a,

" ... really special environment within government bodies despite the oppressiveness of people like Muldoon. I mean Muldoon at times actually wrote to the Governor of the Bank trying to suppress people like me, and trying to suppress our publications through the Reserve Bank Bulletin ... you could go back and look at them now and they're all pretty innocuous but ... at that time [they] were regarded by Muldoon as troublesome for him because we pointed to the problems of monetary policy and the problems of foreign debt, the problems of balance payments, etc. ...

And from '81 to '84, of course, we had the most onerous set of controls in the Western world. In fact they were more onerous in some ways than economic controls in the communist countries because we literally froze every price, every wage rate, every exchange rate, every interest rate, every dividend - it was nutty economic policy, bizarre and inevitably it led to blow-outs in the fiscal deficit

⁴ Three important caveats apply to the proposition that the excesses of Muldoonism not only confirmed or were consistent with much of the theoretical and empirical literatures on discretionary policymaking, and provided a ready political justification for the remedy to those excesses. The first is that some of the ex post analyses of Muldoon and Muldoonism have been advanced by individuals with a measure of sympathy with and support for the trajectory of policy in the post 1984 period, including some who were intimately involved in that process; (Bassett, (1998) is illustrative of the latter, James (1992) of the former); the second is that, whatever the failings of policy under Muldoon, this is not to suggest that there was only one institutional remedy available (see Castles, Gerritsen, and Vowles (1996) on the differences in policies as between the Hawke/Keating ALP administrations, and the Fourth Labour Government); and the third, as Robert Gregory has argued, is that a crude juxtaposition of Muldoonism and 'technocratic' solutions risks obscuring issues of democratic accountability, and the fact that particular institutional remedies may risk a democratic deficit (Gregory, 1996).

and the balance payments deficit but Muldoon didn't believe those blow-outs were going to occur and wouldn't take accountability for them when they did.

So what was happening was that within the Bank and the Treasury there was a very vigorous debate about the inadequacies of past policy, the inadequacy of the fortress New Zealand approach to economic policy, the inadequacies about trying to insulate - what we had really done was as the world started to turn against us in terms of our terms of trade moving against us and the EEC issue arising and our slow growth of productivity and slow growth of output, we had substantially for decades tried to insulate ourselves from the rest of the world by a whole stack of tariffs and exchange controls and import licensing mechanisms. But all that did of course was contribute further to our inefficiency relative to the rest of the world and meant that the need for those trade barriers seemed to become even greater in order to protect what we had already constructed. And so we had this artificially high employment rate sitting alongside an internationally uncompetitive economy and then the extreme version of that of course was when we started to ... subsidise in a major way even the most internationally competitive part of the economy - the rural sector ... for a decade or two it had been clear to the younger people in the Bank and the Treasury that there was going to have to be a break out from that at some stage, that reality was going to have to be faced. And so people used to write papers for internal seminars and discussion and to each other and occasionally in very suppressed language for publication So there was this academic freedom of discussion, this recognition of these huge imbalances building up occurring alongside a policy environment that was actually getting even worse in terms of its insularity and its blinkeredness and what was interesting about it was, it was a different age I guess, was the essential loyalty of people that much of that debate was not known until all that material got released in 1984 when Labour came to power and started to release the Reserve Bank and the Treasury papers. But prior to that even when Muldoon was in his darkest moments the media references to it were quite oblique and people didn't realise how serious the problems were because, despite the fact that there was this ferment of ideas within the Bank and the Treasury, it was not ill-disciplined and people recognised the conventions of government. And the leadership of the Bank and the Treasury in my view had huge integrity and people respected those leaders so much that no one was actually prepared to go and try to undermine the institutions by going public in this debate. Now, what was interesting about that of course was that other politicians were realising through the 70s and particularly the early 80s that the Muldoon and National party solutions of the day were really just building up further problems rather than addressing them "(personal interview 1998).⁵

⁵ Deane also recalls Muldoon's acute sensitivity about any Reserve Bank advice reaching the public domain:

"In 1981 Muldoon issued us with an instruction for example, that no Reserve Bank, monetary or exchange rate policy papers were to go to Cabinet in contrast to previous practice where all our important policy papers went first to the Minister of Finance then to the Prime Minister and Cabinet. And Muldoon issued that instruction because he knew that information was power and he knew that if he withheld that information from the others, he couldn't do it with Treasury papers because the Treasury were just so much part of the system, but he knew he could away with it with Reserve Bank papers and he did. And after we had met with him, I can still remember Bill Birch and Jim Bolger appearing in the corridor after the Governor and I would come out of Muldoon's office and they would say come and have a cup of tea and fill us in on what's going on around here and the Governor used to discreetly try to tell them what we'd talked to the Prime Minister about without undermining the Prime Minister in any way ... So, there we have the trends. Muldoon getting increasing paranoid and increasingly trying to keep the information to himself. Everybody else realising that we were living in an unreal world. His National colleagues not having the courage to do anything about it and so they didn't actually

And one of the issues debated within both the Reserve Bank and the Treasury prior to the change of government in 1984 was the need to revisit the 1964 Reserve Bank Act. Rod Deane recalls that it was not a new idea resulting from Labour coming to power:

"It had been raised within the Bank and the Treasury and we'd all been too nervous to raise it with Muldoon for fear that he would actually go in the opposite direction. The Bank Act was really seriously out of date. I mean it had references to things like IMF par values that had been long since abolished and so there were all sorts of historical curiosities in it but no one felt that they could get enough support from Muldoon and we experimented in a number of ways. The most notable experiment was when we said to ourselves, 'lets see whether we can persuade Muldoon to give the Bank more independence in practice and if we can do that maybe we could chance our arm on running a change of legislation past him.' The most notable example that would have been around 1980 when we introduced Government tenders for bonds and we said 'lets use the tender process so Muldoon can say well look, the market's determining these interest rates.' And of course what Muldoon did was just to ... Muldoon agreed to it all and I can remember, I was the principal advocate of this bloody thing. And we were astonished that Muldoon agreed to all these mechanisms, so we thought 'gosh we're going to make progress.' We came up with the first tender, prices come in, applied interest rates all above the controlled interest rates, and Muldoon just writes us a note back saying, 'cut it all off at X' and so we realised that he'd just immediately undone all the work of the preceding year trying to get this thing set up and all he'd do is just override it because it was his idea that he could control the rate and we said 'but you're not going to get the money.' He said 'I'll get it some other way', etc. So I mean basically he stuffed it. So wherever we tried to see whether we could get him to hook onto the idea of having monetary policy to some degree, a bit more independent from the Government, he would let us down. He wasn't prepared to run with it" (personal interview, 1998).

On the 14 July 1984 the Fourth Labour Government was elected, and was immediately faced with a constitutional and currency crisis. Bassett notes that Muldoon,

"refused advice from the Acting Governor of the Reserve Bank, Roderick Deane, to devalue the currency when a run on the New Zealand dollar began in the early stages of the election campaign. While some of the severity of the situation was conveyed by Treasury officials to McLay when he was acting Prime Minister in May 1984, Muldoon kept the rest of his Cabinet in the dark about the advice he was receiving and refused to discuss problems in any detail with his deputy" (1998: 374).⁶

overtly confront him on the issue, and the Reserve Bank and Treasury working up material and that material getting increasingly to a formal stage of actually taking the initial ideas and working them up into formal material that was suitable for presentation to government if there was a government willing to receive the papers" (personal interview, 1998).

⁶ Roderick Deane recalls that the Reserve Bank had predicted the crisis, and had advised Muldoon of the severity of the situation on numerous occasions:

"... the crisis emerged during the election. The things that upset Muldoon about that was that the Reserve Bank had predicted the crisis in writing and that of course was subsequently published by Labour and we had predicted it often in private to the point where Muldoon, he knew I used to go back to the Bank. He used to ring up the Governor and say can I have Deane's file notes because he knew that I was the one who dictated the file notes after the meetings. And

The circumstances of the Labour Party's accession to power, and the trajectory of policy over the two terms of the Fourth Labour Government have been well documented elsewhere (the essays in Easton, 1989 constitute a critical evaluation, those in Walker, 1989 a more sympathetic treatment)⁷. In both substantive and procedural terms the conduct of monetary policy changed with the change of government. Don Brash, who joined the Bank as Governor in 1988, recalls that the incoming Minister of Finance immediately armed the Bank with a large measure of operational independence:

on a couple of occasions he caught me by surprise by saying could he have the copies of the file notes, but they were always properly worded but I mean the warnings we gave him were in the file notes and that's what upset him and he indicated and at one stage he actually said to us you are not to talk about devaluation with me again. Now why did he do that? Because he knew that whenever we raised it with him we would record it in writing the fact that we raised it with him because he said that we weren't to send him any papers on the issue so then we were reduced to oral discussion then file notes, as we were so worried about the risks of the country having huge problems which indeed it did" (personal interview, 1998).

⁷ Roderick Deane contests the popular view that the policy trajectory pursued by the Lange Labour Government resulted from a stratagem developed prior to the 1984 election:

"... in contrast to what some people thought that there was some sort of conspiracy between the Bank and the Treasury and Labour prior to Muldoon's demise. That's totally incorrect. You know, the people within the Treasury and the Bank were absolutely meticulous about the way they dealt with politicians. It was much more old fashioned than now. It wasn't nearly as sort of free and easy, well even now I think civil servants are pretty respectful of politicians and discreet about what they say in public but in those days the conventions were very strict and the consequences of disobeying them were very well understood very old fashioned in a sense that no matter what our views we're here to serve the government and we'll implement their policies regardless of our views in the matter. We'll give them our best advice but once that's done we won't relitigate, we won't keep arguing... and we won't undermine the public. And so that's just the way it was, so Roger Douglas of course, along with two or three of his colleagues was preparing papers, some of them secret, within the Labour Party which had a remarkable coincident of interest with the stuff that was being done in the Bank and the Treasury but without there being any interaction. The only point of interaction really was the fact that the Treasury traditionally for as long as I can remember had an officer seconded to the office of the Leader of the Opposition and that officer in those days was Doug Andrew - and he helped Roger Douglas develop some of those ideas. So he would have been party to some of the material in the Treasury and the Bank, but I've known Doug for 25 years and there is no way that he would have released anything that he shouldn't have released to Labour and Muldoon wouldn't have contemplated it for a moment in any event.

So when Labour came in, what was interesting about the first couple of days after we'd got over the constitutional crisis bit was that ... Lange had us all together - there was two or three of us from the Bank and two or three from Treasury and we were with - it's in the file note, but I think it was Lange and Caygill and Prebble and Douglas and it might have been Palmer - and Lange said 'OK Roger, tell these guys what we're going to do'. And I dictated the file note and I think I headed it 'Agenda for Action' and it was only a couple of pages and it had maybe a dozen points and it had all the things that we did in the first couple of years under Labour were listed there, not in the precise form they ended up being done but I mean all the fundamentals were listed and they were straight out of Douglas' head and many of them of course were not formal Labour Party policy. And they coincided in a truly remarkable way, given that nobody in the Bank or Treasury apart from that linkage with Doug Andrew had worked with them. There was a great coincidence and people thought it was a conspiracy but as I say, that's just a bit of a popular mythology. It makes a nice story but it wasn't the case. So we had actually had papers ready on all most all the subjects that he listed" (personal interview, 1998).

" ... my understanding is ... that pre-July 1984 election the de facto situation was one where the Minister of Finance was very directly involved in all monetary policy decisions and the Reserve Bank wouldn't have dreamt of adjusting monetary policy without getting not just the view of, but the approval of, the Minister of Finance. Now, it's my understanding that when the election took place, Roger Douglas, the new Minister of Finance, quite explicitly said 'I do not want to be involved in the day to day decisions of monetary policy. I want you at the Reserve Bank to get inflation down and I don't want to be bothered with precisely how you do that'. Now, it was shortly after that of course, that the New Zealand dollar was floated and that meant that for the first time in a sense, we had an independent ability to control monetary conditions in New Zealand to a significant extent unaffected by what the inflation rate was elsewhere. So de facto from that change of government, the government said we will tell you what the objective is and the objective is low inflation, but you will run the implementation of policy to deliver that outcome. In a sense, the 1989 Act was simply the legislative embodiment of that de facto situation" (personal interview 1998).

Brash also recalls that early in the term of the Fourth Labour Government Roger Douglas invited the Bank to consider alternative institutional arrangements for the development and implementation of monetary policy:

"Now quite early on in the piece, and I don't know the date, Roger Douglas apparently said to the Bank 'I would like to find some way to Muldoon-proof monetary policy in New Zealand' and I think that was the expression he used and what he meant by that I think, was to try to avoid the risk of some future Minister of Finance manipulating monetary policy for short term political gain. And there began the search for institutional structures which might achieve that. Now I came into that process as I say in September 1988 when thinking was quite well advanced on how that should be achieved and I didn't make any substantial input into the structure" (personal interview, 1998).

Arthur Grimes, who returned to a position as the Senior Adviser in the Economic Department in late 1986, has a similar recollection:

"By that time there was some thinking going on and there some preliminary thinking had been done, not a lot, and my understanding at that stage, because I wasn't here at the time was that was started by Roger Douglas and it really was his initiative. He said 'I want to make monetary policy Muldoon-proof, you go away and work out how to do it.' Full stop. 'Come back to me when you've got a plan'" (personal interview, 1998).

Thinking within the policy community was already well advanced, and this reflected, in part, the institutional culture within the Bank and the Treasury, to which reference has already been made. Roderick Deane, the Reserve Bank's Deputy Governor when he moved to the position as State Service Commissioner in March 1986, had previously been Chief Economist and the Head of the Bank's Economics Section, was on the Board of the International Monetary Fund in Washington DC for a period, had short periods with the Bank of England and the Reserve Bank of Australia, and was

provided with a good deal of exposure to the operations of the US Federal Reserve. Within the Reserve Bank there was, by the time of the 1984 election, a preference for the kinds of institutional arrangements within which 'independent' central banks such as the Bundesbank and the US Federal Reserve operated.

The Reserve Bank's 1984 post-election briefing paper to the Minister of Finance was silent on the issue of institutional change, but did signal a very strong preference for a medium term focus for policy:

"As a general proposition, we are dubious of both the desirability and the effectiveness of selective interventions ... They distort the optimal allocation of resources, thus reducing the overall level of welfare (1984: 25)

The recommended approach, consistent with the intellectual climate of the times, was one informed by orthodox monetarism:

"... while a flexible exchange rate enables much closer control over monetary aggregates than is possible with a fixed exchange rate, it is vital that this ability to operate an 'independent monetary policy' is targeted towards containing the domestic inflation rate. While it is dangerous to be too simplistic in spelling out how this should be done, the Bank's view is that it would be appropriate to aim for a growth rate in the money supply, say, based on the sustainable level of real economic growth plus the desired inflation rate. If such a policy were maintained over a reasonable length of time, and if the public became convinced of the Government's determination to achieve tolerably stable money supply growth, this should contribute usefully to dampening inflationary expectations and in time to the reduction of inflation itself. However this would be a medium term strategy ..." (1984: 30-31, emphasis added).⁸

For its part the Treasury, in their 1984 post-election briefing paper, Economic Management, supported a shift in monetary policy towards a medium term focus as part of a strategy of disinflation. Inflation, the Treasury argued - although without advancing a case for an alternative set of institutional arrangements - was generated largely by political pressures:

"The factors which cause economies to experience persistent inflation are reasonably clear. The pressure on governments to adopt soft options at the expense of future rates of inflation arise in a large number of ways, but the most

⁸ And consistent with much of the advice tendered to the incoming Government at this point in time, the Reserve Bank identified the key contribution of more prudent fiscal management in reducing pressure on interest rates and exercising a restraining influence on expectations:

"Inflation expectations are determined, among other factors, by the stance of monetary policy, also directly affected by the fiscal deficit. Thus, the best way to achieve a permanent reduction in nominal interest rates is to permanently reduce the fiscal deficit and permanently reduce inflation and inflationary expectations, and a firm monetary policy is one essential ingredient of this strategy - although it is not, on its own sufficient" (1984: 28).

common would be a desire to stimulate the economy for short-term output, income and employment gains, knowing that the linkages between monetary expansion and price inflation are not particularly stable or predictable in the short-run; nor are they necessarily fast acting. Once inflation has gathered momentum, it is difficult to stop, both because of concerns about the possibility contractionary effects of tighter monetary and fiscal policies and because inflation diverts attention from causes (overly expansionary monetary and fiscal policies) to symptoms such as the depreciating exchange rate and the fruitless debate as to whether or not wage increases are causing price increases or vice versa" (1984: 139-140).⁹

Evans et al capture the essential thrust of macroeconomic policy under the Fourth Labour Government: "The key theme of the macroeconomic approach of both the monetary and fiscal authorities through the reform period has been to provide stable policies rather than stabilisation policies" (Evans et al, 1996: 10). While the incoming government did seek an understanding with unions and employers on a managed exit from the wage/price freeze, including an agreed ceiling on award rate wage adjustments, as Grimes noted in 1996, the dropping of the wage freeze, "coupled with the exchange rate devaluation of 20 percent in July 1984, saw inflation rise to 16.6 percent in June 1985. From this time onwards, successive governments have been intent not only on controlling inflation, but also in doing so through market-oriented policies" (Grimes, 1996: 252). In March 1985 the New Zealand dollar was floated, a change which provided the Reserve Bank with the technical means with which to conduct an independent monetary policy (see Buckle, 1988; Grimes, 1996: 252).

As the Treasury would note in Government Management, the 1987 post election briefing paper to the incoming government:

⁹ Others were however identifying problems with the 1964 legislative arrangements. The Business Roundtable's submission to the Finance and Expenditure Committee on the Reserve Bank Bill cited a paper by Robert Clower (1984) in which the author was strongly critical of the 1964 legislation and argued that,

"The importance of credibility and predictability in monetary policy can hardly be overemphasised. Though the Government must, of course, be able collectively to alter direction when conditions demand (eg. in time of war or other national emergency), the normal procedure should be to assign meaningful policy objectives to the Reserve Bank and leave it to responsible Reserve Bank officials to carry them out" (Clower, 1984)

Commenting on Clower's paper in their 1989 submission the Business Roundtable observed that:

"In considering what these objectives should be, Clower made the obvious point that saddling the Bank with trying to achieve objectives, such as economic growth or full employment, which are related 'only loosely or in unknown ways to instruments over which they have direct control', will cause its actions to 'necessarily be confused, contradictory and subject to constant change'. He endorsed the goals proposed for the Bank by the Treasury in its 1984 briefing paper Economic Management namely, price stability, efficient financial intermediation and the integrity of the financial system" (1989: 5).

"Starting with the 1984 Budget, macroeconomic policies have been aimed at restraining the growth of nominal demand in the economy in order to reduce inflation to rates similar to those prevailing in New Zealand's main trading partners and, eventually, to deliver price stability over the medium term. These policies have unavoidably entailed some costs in the form of output losses and unemployment as the economy has adjusted only gradually to a monetary environment designed to accommodate only low inflation" (1987: 201).

But notwithstanding the political costs attendant upon rapid disinflation - costs that the Treasury acknowledged had the potential to undermine the entire 'restructuring programme' (1987: 203) - in Government Management the Treasury argued for a more rapid pace of disinflation, couching the argument very much in terms of the requirement for dynamic consistency in policymaking and implementation:

"The principal lesson of the past three years' experience is the importance of ensuring that price stability consistently takes priority over other objectives in the formulation and implementation of monetary policy. While it is desirable to mitigate the costs of adjusting to a low inflation environment, a bias toward excessive ease can easily emerge if doing this displaces price stability as the goal of policy. The effect of allowing this to happen is likely to be perverse, because by weakening the credibility of the Government's commitment to disinflation, high inflation expectations will be reinforced rather than discouraged ... clear evidence that the Government intended to move forcefully and rapidly to complete the disinflation process notwithstanding the costs, would reduce these costs by enhancing the credibility of the commitment to price stability, and favourably affect expectations" (1987: 210).

And while Government Management contains no specific comment, nor recommendations, on changes to the institutional arrangements underpinning the formulation and implementation of monetary policy, Treasury comments that:

"The processes by which policy is formed, both in terms of advice and implementation is important. The stubbornness of inflation, the difficulty of controlling and evaluating expenditure, and a high degree of regulation can all reflect biases built into current institutional arrangements ...

Chapter 1 emphasised the importance of a stable environment for economic decision making in which information costs and uncertainty are minimised. The Government can contribute to creating such an environment by ensuring that its own activities are not a source of uncertainty. In the context of monetary policy this implies:

- (1) that the objective of policy, that is, medium term price stability, should be pursued steadily and consistently; and
- (2) that the implementation of policy should be as transparent as possible" (1987: 217).¹⁰

¹⁰ Treasury then proceeds to rehearse the prevailing orthodoxy:

"It would be desirable to find a monetary aggregate whose growth could be suitably restrained by the Reserve Bank with a reasonably predictable effect on inflation over the medium term" (1987: 217). But

In July 1984 the Reserve Bank adopted a 'monetarist' approach, targeting a narrow monetary aggregate with a view to stabilising movement in broader monetary aggregates, nominal GDP and the price level.¹¹ For a variety of reasons adherence to this approach waned, with reintermediation and other 'more standard' instabilities combining to limit the effectiveness of monetary aggregates as indicators of development in inflation and nominal activity (Grimes, 1996: 264). Orthodox monetarism was followed by the adoption of a 'checklist' approach in which officials factored in, not just changes in monetary aggregates, but also changes in interest rates, exchange rates and other economic variables (Grimes, 1996: 265). However the disciplines which the Treasury foreshadowed in Government Management, and which would increasingly inform the process of institutional change within the New Zealand public service, were predicated on a degree of precision in specifying the policy outputs and/or outcomes for which government agencies would be accountable. And in moving from orthodox monetarism, in which a rate of money supply growth had provided a nominal anchor for monetary policy, the Bank and the Government had embraced an approach - the ubiquitous checklist - which far from providing a measure of certainty and transparency, appeared to represent a movement back to a more discretionary policy regime. While, within New Zealand's official family of policy advisers there was a large measure of common agreement on the limitations of the 1964 Act, and an equal measure of agreement on the fact that monetary policy should be directed to the attainment and maintenance of price stability and operated within a medium-term time-frame, the specific elements of the institutional framework within which these objectives would be realised was to prove far more problematic.

Four dimensions of this process are apposite to the literature reviewed in preceding chapters, and to the discussion that follows. The first is the fact that in searching for an appropriate New Zealand model of central bank independence, the specific circumstances of, and conventions attendant upon New Zealand's constitutional

Treasury goes on to identify a number of problems associated with controlling the level of primary liquidity:

"The result has been that, in practice, discretionary adjustments in policy settings have been required in light of officials' judgement about the appropriateness of a range of economic and financial indicators. Such judgmental adjustments make it difficult for the authorities to avoid some responsibility for the behaviour of financial indicators, however formally market-determined they are. They also generate costs in the form of effort by financial markets to understand the monetary authorities' thinking in some detail because a premium is created on being able to anticipate both the substance and the timing of their actions"(1987: 219).

¹¹ Evans et al note that:

"The 1984 Labour government changed the policy approach. Reflecting the view that monetary policy had a much stronger and more predictable medium-term impact on prices than on output, monetary policy was directed consistently towards containing inflation. This was facilitated by a policy of fully-funding the fiscal deficit by bond tenders at market yields" (1996: 11).

arrangements - in particular relationships between Parliament, the Executive, and the public service, were an important consideration. Arthur Grimes recalls that the quest for institutional independence was predicated on the requirement to observe the constitutional conventions typically found in Westminster democracies:

"So what we did was, we started off by having lots of discussions as we would in those days saying about we'd like and we thought we'd better go around and look at what the rest of the world has done. So fairly early on we had a group of people that looked at different central banks. The ones that we looked at from memory were the RBA, Bank of Canada, Federal Reserve, the Bundesbank ... We knew that the Bundesbank and the Fed were independent, we knew that the Bank of Canada and the Reserve Bank of Australia both had some measure of independence and they were both operating with the Westminster style system and we figured, I'm not sure why but it was always a guiding principle for us that what we had to do was, somehow that there was something different about a Westminster style parliamentary democracy than other kinds. I'm not sure why we thought that. We probably didn't give it much thought but it just became an axiom almost" (personal interview, 1998; emphasis added).

The second dimension is given by the influence of the academic literature on rules versus discretion in policymaking, and the normative implications of that literature for the design of central bank/government relations. The literature on dynamic inconsistency - which we reviewed in Chapter 2 - appears to have been singularly influential. Arthur Grimes recalls that:

"...we were starting to get into the time inconsistency literature in a big way, Prescott and all that sort of stuff. In fact the very paper I presented when I came back from London was demonstrating, given Kydland and Prescott, why two targets were going to cause problems. That was just an internal seminar in economics, and why we should just settle on one target, without knowing exactly what that target should be at that stage. So we were being influenced by all sorts of things. The OECD reports, IMF research, all of this sort of academic research obviously, and so it was a real melting pot, it was great, it was fantastic" (personal interview, 1998).

If the literature on 'time', or 'dynamic inconsistency' provided an effective diagnosis, agency theory and similar literatures suggested a remedy. And these kinds of remedies were consistent with the requirement that any institutional arrangement be consistent with the rights of a sovereign parliament under the Westminster system. If the Bank was to be held accountable for the delivery of a target, the issue was one of determining an appropriate one:

"... we kept on coming up with this saying well exactly which target, you know some people target exchange rates some people were targeting monetary aggregates - we didn't quite like that - some people target interest rates, we didn't like that. So we said well why don't we target inflation. It came out of some of the models we were doing, like the Kydland and Prescott model which

if you have an inflation and a growth target you've got problems and we said why don't we just have an inflation target and be done with it. Leave it up to the technocrats to decide how to control the money supply or the exchange rate or interest rates. In a way we fell on that one purely as a - we said well, what is the ultimate objective - well let's do it. We didn't copy anybody on that because we were the first, but it was because we couldn't work out anything else to do, and it was the ultimate target anyway as we visualised it at the time. So then it came down to how do we go about doing that from an institutional arrangement and that's where we looked at the various models. And so we looked at complete independence which is to set your own target which essentially what the Bundesbank and the Federal Reserve have got, and that's when we decided that in a parliamentary or Westminster style democracy that was not appropriate. We didn't consult any constitutional experts or anything on this but we just considered that was inappropriate and that wouldn't be acceptable in a Westminster system and certainly not in New Zealand - and the ultimate target had to be set by government ...

We were quite explicit about that in our conversations... and with the Ministers. So we decided that, we said it's fair enough for the legislation to set it, or the government to set it from time to time, but we wanted to restrain what future governments could do in the sense of making it difficult for them to change ... and that's where we ... we came up with the idea that we should use some general words in the legislation that they had to target general stability in general level of prices" (personal interview, 1998).¹²

The third dimension has already been foreshadowed, and that is the influence of the wider programme of state sector reform, and the theories and models underpinning that reform programme, on the design of the institutions of central banking.¹³ As we have already foreshadowed, and as the following section very clearly demonstrates, the extent of the embrace of the 'model of choice' for 'crown agencies' - the SOE model - was to become a point of contention between the Reserve Bank and the Treasury. But at the level of design principles, the conduct of monetary policy by an independent central bank and the conduct of policymaking and implementation as between Ministers and their agents shared a number of common elements - transparency of process and clarity of accountability in particular. Roderick Deane suggests a close

¹² Roderick Deane recalls that the preference for a model consistent with the Westminster conventions was not the only reason why the Bundesbank and US Federal Reserve models (both in federal political systems) failed to find favour:

"It's pretty much tightly focused on policy issues and it is more in the mode of the American and German models but much less consultative than those models. I mean the concern with those models was that the Fed had all the Branch Feds and they all got involved in the decision making process with the Fed even though the chairman at the end of the day as it turned out had developed a huge aura in the US - someone with the right personality for the job - so ... for the State Feds to overrule - it's not an easy business to overrule the President of the Fed. And in the Bundesbank we felt that New Zealand had been driven nuts by consultation and that we needed to move more towards the individual accountability model whereas the Germans somehow had made that work better than us and they'd made it work by sort of overlaying different boards within the Bundesbank..." (personal interview, 1998).

¹³ Reviews of the theoretical underpinning, and specific elements of the New Zealand programme of state sector reform can be found in Boston *et al.*, (1996), and Scott (1996).

affinity between the logic of state sector reform and the design of the institutions of central banking:

" ... we had thought out in our minds that the Reserve Bank needed that the only way in which we were going to get a sustainable monetary policy was to have greater independence for the Reserve Bank. Now the way in which that flowed out finally had not been worked out prior to '84 but some elements of the model had been ... I mean, the first stage of that was really the sort of introduction into the government public service thinking of agency theory and accountability arrangements and drawing in a way from the corporate world - how do corporations get things done and how do they cut through the bureaucracy? And maybe they've started to realise that it's one on one accountabilities that work better than committees deciding things - particularly in departmental committees which it used to do with economic policy stuff, produce papers and everybody would have to agree before it got to Ministers. It was just a shambolic waste of, time consuming waste, smoke-filled rooms, even when I was a youngster ... that first emerged in the form of the model for commercialisation and corporatisation of the government's trading enterprises ... So there we had this strong need to have a quasi-autonomous central bank to ease it away from all the mixed objectives. I mean one of the big drivers for the SOE process was to get rid of the mixed objectives, the social objectives, commercial objectives, political objectives, and we said these government businesses should just have commercial objectives and if you want to do social policy you should use social policy, etc. Now it was very much the same with monetary policy, increasingly it had come to the view that you can't use one instrument to solve six problems and so the idea was more popular at the time than it perhaps is today that your instrument should be assigned to objectives and it's got to be a properly defined set of equations and it never was in New Zealand. And so we said OK, government should run fiscal policy and the Reserve Bank should run monetary policy and monetary policy should be assigned to inflation and getting inflation down ... we were ... wanting more independence and then saying how does one achieve that. Well you achieve it by the same sort of route that was being recommended for the SOE's which was transparency of relationships with the Government, for SOE's it took place in the SOE Act which insisted on SOE's having a statement of corporate intent and so that model was in people's minds so then we said OK well, we didn't say well the statement of corporate intent for the Reserve Bank is the six monthly monetary policy statement but that's what it amounted to. People were thinking in this mode of how do you get autonomy. You get autonomy by giving accountability to the Governor and giving him some degree of separation from the Government in terms of his operational decisions. You get transparency in getting a public document that is the agreement between the Government and the Bank and you force the Government to be public about changing that, it can change it but it has to go public, it has to lay it in the House and you get delivery by putting the accountability on the head of the Governor as an individual not the Board collectively which allows everybody to escape for cover and no one is to carry the can when things go wrong. So it was very much the SOE corporate model translated into a mode of thinking about monetary thinking, recognising monetary policy quite - don't misunderstand me - nobody for a moment thought that the Reserve Bank was a commercial beast but it was how do you get those principles in place that gives the Bank a self sufficiency" (personal interview, 1998)

The fourth element is the contribution of the Australian model, and in particular the disputes resolution procedure prescribed in Section 11 of the Reserve Bank Act 1959, in the design of the emerging New Zealand model. Arthur Grimes recalls that:

"We looked at the various models and we quite liked the Australian model ... It's interesting their current legislation is more similar to our current legislation than it is to our old legislation in terms of the role of the Bank, because in our previous Act the Reserve Bank had no power whatsoever. Monetary policy was done by the government and by the Minister, whereas in Australia the monetary policy is done by the Reserve Bank Board and can be countermanded by the Minister. And essentially that is where we were looking to go - to retain that Westminster style of thing where the government has the ultimate decision but it should be the Board or the Bank, we hadn't worked that out yet ... it should be the Bank anyway that should be driving the decision and saying 'this is our decision countermand it if you will.' And that's the Australian model and it's the Canadian model basically ... In the end we decided that model - basically the Australian and Canadian model - was fairly close to where we wanted to get to ... we literally saw that as being almost the guiding light but ... what we didn't like was the lack of transparency that was implicit in those Banks especially the RBA. So we wanted to move to a situation where the Bank was making the policy, but the government could over rule it, but if it did so it had to do so in a transparent manner and that also helped us drive the way toward setting targets because we felt well, what does it mean to over rule something but we are not sure what it is that you are over ruling. So that's where we became much more explicit that what's basically in any other legislation as to setting targets with the Bank and then also having things like the six monthly statements where you have to announce what you intend to do and what you have done... So we wanted to make it very very transparent what the Bank was doing so that also it would also be transparent if the government was a) over ruling it or b) also making it transparent if for instance the Governor or the Bank was getting nobbled somewhere along in the process. So if you set up transparent targets you want to make sure that the Governor could come out and say 'this is what I am doing to achieve those targets' and every one looks at that and says this is patently, he is not going to achieve these targets by doing what he says he's going to do, then you can be fairly sure he will be nobbled somewhere in the process. So we wanted to make sure the Governor was honest..." (personal interview, 1998).

In summary, a number of elements combined in the development of the New Zealand model - an institutional culture within the Reserve Bank, and elsewhere that encouraged a measure of 'benchmarking' against central bank best practice - whether in institutional design or the conduct of monetary policy - the fact of New Zealand being a Westminster democracy in which convention established that, whatever limitations might be imposed on the rights of elected policymakers to implement policy, in the final analysis Parliament must be sovereign; the influence of literatures which identified the problems attendant upon dynamically inconsistent, and discretionary policymaking; the influence of literatures and models of institutional design speaking to reforming state sectors and optimising transparency and accountability; and finally, as regards

the respective roles and rights of the central bank and the legislature, the Australian and Canadian models in particular.

The following section details the sequence of discussions - at times vigorous debates within the ranks of the Government's advisers - and decisions that would eventually result in drafting instructions being approved by Ministers, and the Reserve Bank of New Zealand Bill being introduced into the House. For those within the Bank the project was one of determining an appropriate set of institutional arrangements which would satisfy the test of credibility, both within the finance sector, and within the international central banking community. As the analysis in the following section clearly demonstrates, it was the desire to impart a greater measure of credibility to the development and implementation of monetary policy that acted as the principal policy driver. The diagnosis - an institutional framework that was at best political porous, and at worst debased by opportunistic political manipulation - was, as the following sections clearly demonstrate, totally consistent with the rational economics literature surveyed in Chapter 2. Indeed one can not fully comprehend the rationale for and logic of the reforms without understanding the rational economics critique. And the institutional prescription - operational independence for a central bank tasked exclusively with securing and maintaining price stability - is the essence of the normative case underpinned by rational economic theory.

But within the 'policy network', and specifically within the 'official family', while there was general agreement on the theoretical case, there was a measure less agreement on some of the details of the institutional prescription. The import of the political economy literatures reviewed in Chapter 3 is that, in order to understand the logic of institutional reshaping within one nation, or differences as between institutions or trajectories of institutional reshaping between nations, requires a political economy framework. That framework suggests that relationships between the state and societal interests are pivotal, as are relationships between state actors. Within the institution of the New Zealand state differences on the specifics of the institutional prescription were to emerge. For the New Zealand Treasury the issue was less one of accommodating the unique status of the Reserve Bank as a central bank, than of determining a set of funding and accountability arrangements that satisfied the Treasury's concern to impose a measure of commonalty across all crown agencies - and for the Treasury, in the final analysis the Reserve Bank was a crown agency, and subject therefore to the kinds of disciplines that other agencies would be required to observe.

In search of a new model - the quest for credibility¹⁴

So far as the sequence of formal decision-making is concerned, the origins of the Reserve Bank of New Zealand Act 1989 rest in a decision of the Minister of Finance in July 1986 when he agreed to "the preparation of proposals to enhance the monetary policy independence of the Reserve Bank" (RBNZ, 5 February 1987).¹⁵

In July 1986 the Board of the Reserve Bank was provided with a memorandum headed 'Reserve Bank Autonomy'. The paper sought to, "survey the issues involved in greater Reserve Bank autonomy at a very general level, with a view to narrowing the scope of the discussion to a range of potentially useful and feasible options" (RBNZ, 4 July 1986). The paper noted, *inter alia*, that:

"In order to obtain significant separation from other aspects of economic policy, monetary and exchange management needs to be aimed at an objective where it has a comparative advantage in the sense that it will have a good chance of success even if not fully supported by other instruments of economic policy.

The leading candidate for such a single objective is domestic price stability, but most central banks (including the Reserve Bank of New Zealand) are charged with jointly satisfying generalised social welfare objectives of full employment, real growth, etc. It would be a relatively extreme position, in an historical sense, to discard all other objectives for the domestic price stability objective alone. While the degree of separation implied by the use of a single objective might not be necessary in order to make some degree of central bank independence worthwhile (given the possibility of a set of objectives with different weightings to those attached by other government agencies), a less extreme position would increase the need for co-ordination between the central bank and the other policymaking agencies" (RBNZ, 4 July 1986).¹⁶

Establishing the appropriate balance between central bank autonomy and accountability, it is argued, depends on the development of an appropriate incentive and accountability structure, and the 'SOE model' is identified as having applicability. But the paper refers to the 'constitutional proprieties' attendant upon central bank autonomy, noting two sets of considerations:

¹⁴ The genesis of the Reserve Bank Act, including developmental work by officials and the passage of the legislation through the Parliament is also summarised by Kelsey (1998: 159-167).

¹⁵ The 5 February paper to the Board confirms that the recommendations to the Minister of Finance, in the form of a memorandum, had their origins in a decision of the Reserve Bank Board:

"The Minister has agreed to the preparation of more detailed proposals to enhance the monetary policy independence of the Reserve Bank (Reserve Bank 1687)" (1987: 1).

¹⁶ The paper proceeds to canvass the 'desired constraints on policy choice', and it is suggested that 'central bank independence' provides an opening to a 'wider consideration of the limitations imposed on policies':

"It is now widely accepted that attempts to run ongoing fiscal deficits in the face of monetary restraint generates conflicts, usually showing up in the form of increasing real interest rates on government debt in particular" (1986: 2).

"First ... the framework ... is dependent on incentive and accountability factors which go towards determining who best can be trusted to make the right decisions from a national welfare perspective. Judgements are therefore required as to the relative merits of the political/electoral process, which provides a particular incentive and accountability set, vis a vis alternative processes such as those embodied in a variety of forms of independent central banks.

Second, the question of who determines the framework ... itself is a constitutional one. That is, who should make the judgements mentioned in the previous paragraph?" (RBNZ, 4 July 1986).

The discussion which follows provides a 'general bank view on the potential workings of a (class of) framework within which the Reserve Bank has greater autonomy than at present'. That framework goes, *inter alia* to a medium term focus on price stability, and the establishment of a suitable incentive (and associated accountability) set. In reference to the requirement for a medium term focus to policy, the paper notes that a medium term focus on price stability, "is not to say that price stability should be achieved without regard to the real consequences of monetary policy"; and that, "the view that monetary policy has a comparative advantage with respect to inflation objectives does not mean a denial of the role of other factors in determining the short run path of prices". The paper foreshadows the development of a framework, "within which an independent agency has the responsibility for determining the monetary policy approach according to predetermined objectives and within a carefully structured incentive and accountability set".

So far as the accountability and incentive arrangements are concerned, the paper notes that, as compared to the SOE framework objectives, for the Reserve Bank's monetary and reserves management policy functions, a set of non-commercial objectives are required :

" ... statutory objectives which have primary focus on medium-term price stability (but which also provide for consideration of the real effects of monetary policy actions) are consistent with the rationale for an independent central bank. The precise formulation of those objectives and the degree of weight given to factors other than price stability is a difficult but important task.

Necessarily, the wording of any statutory statement of objectives is sufficiently general to cover a wide range of potential circumstances. Allowing for flexibility does however create difficulties in the context of a statement of objectives which includes factors other than medium-term price stability. Specifically, the desirable weighting given to the individual factors within the set of objectives might at times be open to dispute" (1986: 7).

In a section on 'The Reserve Bank's View', the paper records that,

" ... the Reserve Bank believes that an appropriate framework could be devised which would allow the Bank to play a more independent role and thereby add to economic welfare. Central to that framework would be statutory objectives more closely focused on medium-term price stability, although not exclusively so" (1986: 8).

The spectrum of institutional choices available to government in providing for greater central bank autonomy are then canvassed, choices which cover issues of ownership, statutory powers, public disclosure, and Bank structure and appointment powers. On the issue of ownership the paper recommends against moving to private ownership in order to establish independence. On the question of the Bank's statutory powers, the paper notes that, under the legislative provisions prevailing at the time, the Bank enjoyed no formal right to influence either the choice of policy or its method of implementation.¹⁷ Moreover the multiple objectives provided in statute risked a situation in which the Bank would not be, "in a position to argue that a certain monetary policy approach is inconsistent with the statutorily defined objectives and functions of the Bank", and suggested options ranging from 'minimal' changes in which the Bank's advice to government would be subject to a much greater measure of transparency and public scrutiny, through to, 'at the other end of the spectrum', the establishment of central bank independence,

" ... more concretely in the context of a significant decentralisation of the determination of monetary policy. For instance, the Reserve bank (sic) could be given the statutory authority to determine and implement the monetary policy strategy, in accord with the statutory objectives set down by Parliament in the Reserve Bank Act but without the power for the Executive to direct the Bank to adopt an alternative strategy" (1986: 10).

The paper notes that this approach was not dissimilar to the institutional arrangements under which the US Federal Reserve and the Bundesbank operated at the time. And in relation to the transparency accorded the conduct of monetary policy, the paper noted a range of possible models, including the 'disputes procedures' under the Australian legislation, and the US Federal Reserve's practice of releasing FOMC (Federal Open Market Committee) minutes, and appearances before the Congress pursuant to the Humphrey-Hawkins provisions.¹⁸

¹⁷ Aside from the Reserve Bank Act, the paper noted the facility for government intervention available through the Economic Stabilisation Act, and the impact on the Bank's behaviour of legislation such as the Public Finance Act, and various Acts governing producer board operations.

¹⁸ In reference to the Australian provisions the paper notes that,

"[t]he Australian model forces greater public scrutiny only in cases where disputes on monetary policy between the Executive and the Reserve Bank are not able to be resolved privately. The disclosure provision in the Australian legislation has not been used, and it is debatable whether the implicit threat of its use, or concern on the part of the Reserve bank of Australia to preserve the working relationship with the Executive, has been the dominating force influencing policy outcomes" (1986: 11).

The paper advanced an approach to 'compulsory disclosure' characterised by three elements - the formulation of a monetary policy strategy by the Bank, the Minister of Finance being required to respond, with the response formally tabled in the Parliament, and both parties being required to spell out both the rationale for the strategy, and 'how they see the strategy conforming with the objectives for monetary policy set down in the Reserve Bank Act.'

And in reference to Bank structure and appointment powers, the paper foreshadows the need to review these arrangements:

"If a move to greater Reserve Bank independence was limited to an increase in the public scrutiny of the policy formulation process (together with a change in statutory objectives to emphasise medium-term price stability and a change to have the Bank initiate the policy formulation process), there might not be strong reasons to change the existing management structure or working methods ...

Some change in the ... arrangements ... might be a necessary ingredient of a change to a more fully fledged central bank independence ... A preferred approach might therefore be to spread more evenly both the authority and associated accountability between the Governors and the Board"

And, in an observation which goes to some of the central questions in the 'politics' of institutional design and central bank independence which this research seeks to illuminate, the paper notes that,

"[t]here are of course 'informal' incentives which need to be taken into account. The process of 'regulatory capture' - whereby the controlling agency in the absence of appropriate incentives and accountability provisions in effect comes to represent the interests of its clients rather than its political masters - is a well documented problem" (1986: 13).

A paper presented to the Board on the 5 February 1987 notes that, following the agreement of the Minister of Finance, "a team was set up to investigate the issues and many papers were produced and discussions held within the Bank over the subsequent six months. Following these internal discussions, a paper was prepared and sent to the Treasury for comment in December 1986. This paper set out the fundamental issues the bank felt needed to be considered in relation to the future role and operation of the Reserve Bank" (RBNZ, 5 February 1987). This paper indicates some measure of disagreement between the Reserve Bank and the Treasury - 'significant differences of approach' - the disagreement going to the relative merits of three institutional models:

"The framework being used by the Treasury for examining the organisation of the state sector involves the use of the 'corporatisation' or an 'SOE model' where clear commercial -type objectives can be set for the management of the

enterprise, and where performance can be readily assessed in relation to that objective ...

On the other hand, where such criteria cannot be applied, the Treasury framework involves reorganising agencies so that the relevant Ministers receive information flows which allow them to take active responsibility for the design and implementation of public policy. Treasury refer to this option as the 'residual ministries' model.

The Bank's proposal does not fit either of these two 'models'. This ... reflects a deliberate conclusion ... that neither of these two 'polar' models is suitable or appropriate for a central bank. Our proposal sits in the middle ground. It can perhaps be described as a 'Central Bank Model' since it is based on and consistent with the general structure of many central banks overseas" (1987: 1).

The Board paper notes the Treasury's preference for the application of the 'SOE model' to the Bank - including the use of quantified performance measures, and greater independence of monetary policy from political interference - and the Banks' concern that in the absence of any accepted technique for achieving price stability via monetary policy, the difficulty of devising performance and accountability structures:

"We do not believe that there is any empirical evidence of a sufficient level of stability through time in [the] currency note/inflation relationship for it to be specified in legislation as a satisfactory benchmark by which the Bank might operate and be judged. International developments over the last two decades show that the world-wide search for stable operating mechanism (monetary rules and targets, etc.) has failed to produce an arrangement which has been robust with respect to structural and institutional changes" (1987: 2).¹⁹

The emerging 'Bank model', on the other hand, detailed in the 5 February 1987 paper, represented a further development of the indicative proposals discussed in the earlier Board paper. The paper advances the conclusions that, *inter alia*:

"Greater Reserve Bank autonomy in relation to the formulation and operation of monetary policy is desirable in order to enable a sustained and systematic approach to be taken to the pursuit of lower inflation over the longer term, and in order to take advantage of the economic gains that will flow from the increased credibility with which policy commitment to medium-term price stability is perceived" (1987: 2)²⁰

The specific institutional arrangements proposed to realise this degree of autonomy provide that the Bank would formulate monetary policy within the constraints of the Bank's statutory objectives, with the Bank's proposed policy conveyed in writing to the Minister of Finance, and laid before the House, and the Minister retaining the right to direct the Bank to follow an alternative monetary policy, provided that any such

¹⁹ The 5 February 1987 Board paper includes a detailed analysis of the relevance and applicability of the two 'polar' models (RBNZ 5 February 1987: 7-14).

²⁰ The paper notes that: 'The Minister has already accepted this proposition'

directive was consistent with the Bank's statutory objectives, and that any such directive would be tabled in the House alongside the Bank's proposed policy. The need for policy credibility and for a clear objective for accountability/performance monitoring, it is argued, "justify the exclusive assignment of monetary policy to a single macro-economic objective. It is considered this objective should be price stability" (1987: 2).

The rationale advanced for a single price stability objective draws on the theoretical arguments reviewed in Chapter 2, although somewhat more conditionally than the final form of the legislation would suggest:

"Although it would be possible to supplement the price stability objective with other macroeconomic objectives such as full employment and growth etc., an inescapable consequence is that monetary policy would become subject to the same range of potentially conflicting objectives that face governments. Accordingly, there would be only limited gains in distancing monetary policy from the political process. However a single price stability objective does not mean that an inflation target would be pursued irrespective of conditions in the labour and goods markets since a medium-term price stability objective would be consistent with a variety of adjustment paths.

In any case, if the theoretical proposition that there is no long-run trade-off between output and inflation is accepted, it follows that monetary policy cannot affect employment except in the short-term. Employment and growth are therefore not suitable medium-term objectives. Also, the Bank would only have one instrument - namely monetary policy - and performance could not be measured unambiguously, nor could sanctions be realistically or fairly imposed, unless the single degree of freedom available was to be clearly assigned to a single price stability objective" (1987: 4).²¹

A Treasury paper to the Reserve Bank Board notes that following the presentation to the Board of the February paper, the Secretary of the Treasury (a member of the Board at that time) 'and others' expressed reservations, and that a special meeting of the Board was scheduled for the 11 March 1987, the day before the Board's next ordinary meeting. The Treasury paper (TR 9758 - 'The Role and Structure of the Reserve Bank'), was copied to the Minister of Finance, the covering note recording that,

"In our paper we argue that the same principles being used to evaluate public sector management issues should be used to evaluate both the structure of the Reserve Bank and the manner in which it is funded. In particular we consider it

²¹ And the rationale, as in the earlier paper, also goes in part to the disciplinary effect of an independent monetary policy on fiscal policy:

"Because of the trade-offs, attempts over time to run a fiscal policy that is inconsistent with an independently-determined, stable monetary policy would show up in increasing real interest rates, etc. Depending on the sensitivity of fiscal managers to these developments, a constraint can be placed on the prolonged use of inappropriate fiscal policies" (1987: 3).

critical that the different functions of the Reserve Bank be identified and the nature of objectives (sic) of those functions defined. This will enable the Bank to move towards greater independence in conducting monetary policy and at the same time provide much greater accountability on its Board and management"

Two other procedural issues are worthy of note. A covering letter from the Secretary of the Treasury (Graham Scott) to the Reserve Bank Governor (Spencer Russell) notes the intention of the former "to bring the key people who have worked on the paper with me along to the meeting. I intend, subject to your agreement, to bring Howard Fancy and Paul Atkinson with me"; and in a footnote to the introductory section of the paper it is noted that the "paper was prepared before the receipt of the dossier of documents which the Reserve Bank sent to directors on 6 March. It is based on the paper the Bank submitted to the Board in February, and takes into account subsequent discussions with Reserve Bank staff, but does not anticipate some (generally positive) changes in the Bank's position as set out in the more recent papers" (TR 9758, 9 March 1987).²²

In summary the Treasury paper attempts to recast the project of greater autonomy for the Reserve Bank within the context of the prevailing model of public service restructuring. The paper records the Treasury's 'full agreement' with the Bank's preference for a single objective for monetary policy, that objective being medium term price stability, and suggests that it "is desirable that institutional arrangements be established such that monetary policy be consistently directed toward this end" (TR 9758: 7). But the Treasury records its concern that the Bank's proposals do not go far enough in providing an institutional remedy to the dynamic inconsistency problem:

"Under present arrangements the Minister of Finance makes monetary policy decisions. The Minister of Finance faces a wide range of pressures, many of them conflicting. Since monetary policy adjustments can often change the various trade-offs over short time horizons the pressure faced by the Minister to use his (sic) authority over monetary policy inappropriately is intense. The result is that monetary policy has been directed toward shifting objectives over the years, without achieving them in a sustainable way. It would be preferable to insulate monetary policy from the conflicting and changing pressures which bear on the Minister of Finance in order to avoid its being directed at shifting and inappropriate objectives.

Treasury finds the Reserve Bank's proposal in this regard does not go far enough. To countermand the Reserve Bank's recommendations would give the Minister ultimate responsibility for the central bank's activities and would make it very difficult for him not exercise that power if he believed it was desirable. In practice, the situation would be similar to that prevailing at present, since all concerned will find it in their interest to avoid public disagreements. A strong Minister of Finance would continue to determine monetary policy"(TR 9758: 7).

²² The 'dossier of documents' referred to in the Scott/Russell correspondence was not included in the material released to the author by the Bank.

This paper also raises Treasury concerns about the respective roles of the Board and the Governor:

"An issue that requires further attention is the role of the Board of Directors, and its relationships with the Governor, the Minister of Finance and Parliament itself. The Reserve Bank's proposal appears to envisage the Board as being accountable for the Bank's performance, albeit in a way that is not clearly defined, although the Minister of Finance would have the power both to appoint the Governor and to countermand the Bank's policy recommendations. The extent to which it is envisaged that the Board, as distinct from the Governor and the Bank's staff, would make substantive monetary policy decisions is also unclear. Whatever the degree of commercialisation that can be envisaged for the Reserve Bank's operations, this area requires more thinking about" (TR 9758: 9).

The next significant development appears to be in April 1988, by which time matters had progressed to the point where the Reserve Bank had prepared a draft Cabinet Policy Committee proposing a basis for a new Reserve Bank Act. The apparent delay of a full year is explained in part by on-going conflict between the Bank and the Treasury. Arthur Grimes recalls that:

"Now at the same time all that was going on we had Treasury. They were just unbelievable, to be honest. They put two guys onto this ... they proposed and stuck with it for about a year - while we were developing this whole system - an alternative system, which said you have a limit on how much base money you put out, that can be quite a bit more than there is now, but over a certain time you can never go over the amount of notes and coins in circulation, and if notes and coins in circulation ever go above that level then a) the Governor gets sacked and b) the Reserve Bank gets declared bankrupt, which was their term.

Now this came from nowhere as far as I can tell, in the sense that it didn't interface with anyone else's views, but they were adamant, and they kept it up for a year, that this was a far better policy. They didn't like us trying to achieve something as tied down as inflation. They wanted to control us. They would set the target of course, the Treasury would set the target of how much base money you should be allowed and it was just bizarre to be honest. So much so that at least at one meeting [we] had a very senior person on each side threatening fisty cuffs. It was just bizarre ... but the views they were putting out were unbelievably ridiculous and we just couldn't get anywhere for a year. The rest of Treasury wouldn't take on these two guys, they wouldn't overrule them and so we were stuck. The reason why it took so long to get going was basically because of the delays during that period, which was probably about '87...

I think they had something in the back of their mind about money base targeting, but they didn't want to have a rule for money based targeting because they realised there would be a few problems with that, so they just wanted an upper limit on it, which you could go up and down to any amount of times before you hit it, without breaking the rule and they had some idea, I guess, that a) they liked money base targeting and b) they realised that there was a lot of instability in money base targeting and therefore you couldn't target it precisely

and therefore you just set some upper limit on the amount of money, notes and coins in circulation and that would be your ultimate backstop. Somehow thinking that declaring the Reserve Bank bankrupt wouldn't be problematic for the country - you can imagine the markets what they would do. They kept it up for at least a year and it just stalled things. But anyhow they got completely overruled in the end, but it was an enormous waste of time and resources ... it was partly about trying to control the amount of money the Reserve Bank could spend as well. I can't remember how this was supposedly going to do that. Whereas we said if you want to do that just put a limit on how much money the Reserve Bank can spend but don't try and do it through monetary policy. They had some weird sort of belief that this would stop the Reserve Bank and curtail its morning teas basically ...

Anyhow this is one instance where Treasury got completely overruled. Thank God" (personal interview, 1998).

A Treasury paper dated 27 April 1988 notes that, "the proposed Act would provide the Reserve Bank with greater autonomy regarding the implementation of monetary policy. It would make clear that the medium-term objective of monetary policy was price stability. It would also be designed to increase the accountability of the Reserve Bank in the operation and conduct of its monetary and non-monetary policy functions" (TR 3343: 1). However the paper notes that, while on a number of issues, the Treasury and the Bank were not in agreement, these differences went in the main to a range of 'organisational and funding questions', and in particular the application of the principles of state sector reform to Reserve Bank reform. In this sense the Treasury, while fully supportive of the case for a medium term policy focus on price stability, and of complete instrument independence for the Bank, was concerned to ensure that the Bank, in terms of its management arrangements, was located squarely within, and subject to, the disciplines applying more generally in the public sector. To this end the Treasury recommended, contra the Bank, that in respect of its non-commercial functions the latter should be funded by means of an annual parliamentary appropriation, and not from constrained seigniorage, as the Bank itself recommended.²³

²³ A subsequent Treasury paper to the Associate Minister of Finance, dated 22 August 1988, notes a decision of the Cabinet that the Bank, "should have an independent source of income to fund its monetary policy functions; that this income source should be limited and be designed so as to give appropriate incentives to the Bank to manage its balance sheet and expenditure efficiently; and that the Bank's independent income be subject to examination and review at five yearly intervals by the Government commissioning an examination of its financial performance" (TR 5143). The same Treasury paper reports that the Bank had recommended a 'modified constrained seigniorage' model which had gone some way to alleviating Treasury concerns. The Treasury's concerns appear to have focused, in part, on the lack of transparency associated with funding by way of constrained seigniorage, and the risk of an incentive on the part of the Bank to, "target real interest rates higher than assumed in the Bank's funding contract. This would have meant that the Bank would have faced a set of incentives which may have led monetary policy to err on the side of tightness. This would not necessarily be appropriate in all circumstances" (TR 5591: 3). As at 28 September 1988 the Treasury and the Reserve Bank were still recommending different policy remedies to the funding issue.

This Treasury paper does however indicate the nature of Treasury's views at the time on the target to which monetary policy might best be directed, and a clear preference for a regime predicated on quantity targets:

"We consider that a quantity-based approach to monetary policy that focuses upon the monetary base would prove much more effective in the long run. While discretionary judgements would still need to be exercised from time to time, we believe that a quantity-based system would provide a much better basis to operate monetary policy than would any arrangement centred upon the operation of the Public Account" (TR 3343: 6).

At this point, the principal issue in dispute between the Treasury and the Reserve Bank was largely a product of the desire of the former, in determining an appropriate institutional framework, to inextricably link the credibility of monetary policy and the Crown's financial management together. The note to Ministers detailed a series of recommendations, including that the Minister

"a Note the strong interactions between the issues raised by Reserve bank reform and reforms of state sector management ...

i Decline the proposal to fund the Bank through constrained seigniorage ...

ii Direct officials to report back within three months on alternative means of funding the different functions of the Bank and the implications of these alternatives for perceptions about the effectiveness of monetary policy, increasing public understanding and awareness of the policy intentions, and for the efficient management of the Bank" (TR 3343: 15-16).

Recommendation (i) appears to be the only recommendation not accepted by Ministers.²⁴

The fact that the Government intended to introduce a new Reserve Bank Act was announced by the then Minister of Finance, the Hon Roger Douglas, in his 1988 Budget speech delivered on the 28 July 1988. Douglas announced that it was the Government's intention :

"to place the Reserve Bank on a more autonomous basis that will improve the medium term consistency of monetary policy;

²⁴ Some indication of the Treasury's thinking on a funding/accountability set was provided in the earlier paper to the Reserve Bank Board in which it was suggested that the elements of a solution might include:

"... the terms and constraints governing note issue being determined outside the Reserve Bank so that it would not have an unlimited power to discharge its liabilities by using irredeemable pieces of paper. The simplest possibility would be for Parliament to put a statutory upper limit on the issue of notes, which would create a constraint within which the Reserve Bank must operate" (TR9758: 8).

to require the Reserve Bank to formulate and implement policies that make the maximum possible contribution to achieving and maintaining a stable level of prices; and

to require all Bank function to be separately accounted for" (NZPD, 1988: 5542-3).²⁵

The measures foreshadowed by the Government, Douglas observed, were designed to

"enhance the credibility, consistency and effectiveness of monetary policy", but would not, "reduce the right of Government to determine policy. Rather it will clarify the responsibilities of the Government and the Bank. It will clearly reveal the costs of intervention in financial markets and make it quite obvious if any future Government chooses to pursue inflationary policies" (NZPD, 1988: 5544-5, emphasis added).²⁶

In the course of 1988 - in advance of the introduction of the Reserve Bank Bill - Finance Minister Roger Douglas announced the Government's, and the Bank's commitment to a price stability target of an annual rate of inflation between 0 and 2 percent. Don Brash recalls that the 'decision' to target 0-2 percent inflation was arrived at by the Minister of Finance quite independently of the Bank:

"Now by the time I became Governor Roger Douglas has been asked, so the folklore has it, at a Press conference ... I think the story goes something like this. The CPI which had of course been above 10% for a considerable period, got down on a year on year basis to 9 point something percent and some reporters said to Douglas 'aren't you satisfied now' or something of that sort, and Roger Douglas is alleged to have said something like 'no, no, no, we're going for price stability like you know, 0-2%', and it is said that that's the origin of 0-2, that it came off the top of Roger Douglas' head in an attempt to explain to a journalist that 9.4 wasn't price stability. So the Reserve Bank did some work on what good targets should look like and 0-2 seemed like a pretty good description of price stability if you allow for bias in the measurement of inflation which most people suggest is probably in the order of about 1. So 0-2 can be thought of as genuine price stability plus or minus one as being the target" (interview, 1998).²⁷

²⁵ Grimes notes that, after September 1988 the Reserve Bank moved to a medium term focus on price stability, and from late 1988 the trade-weighted exchange rate index (TWI) was adopted as the major monetary indicator (Grimes, 1996: 256).

²⁶ The announcement of the foreshadowed changes to the formal institutional arrangements in the first part of the Budget speech was followed by a set of not unrelated observations on inflation, and on wages. Douglas reported that the CPI for the June quarter of 1988 represented the lowest quarterly increases in prices since December 1969, excluding the period of the wage/price regulation of 1982-84:

"Our inflation rate is now lower than that of Australia.

Based on price rises over the past year, our annual inflation rate was 6.3 percent.

Based on the latest quarter our annual rate of inflation would be just over 3 percent " (NZPD, 1988:5554).

²⁷ By the time the Bill was debated in the House the Minister of Finance had clarified the Bank's target as being an annual rate of inflation of between 0 and 2 percent by 1992.

In a memorandum (No. 2557, 4 August 1988) the Reserve Bank provided the Minister with drafting instructions for the Reserve Bank of New Zealand Bill, and a 10 August 1988 Treasury paper to the Associate Minister of Finance (Mr Peter Neilson) notes that it was the intention of the Associate Minister that the Bill be introduced into the House by the end of September 1988 (TR 5023). Treasury papers suggest that other key defining elements of the present institutional mix were included in the drafting instructions, specifically an accountability arrangement predicated on a contract between the Minister and the Governor of the Bank, and importing elements of a Policy Targets Agreement.

The narrative is clearly interesting as a contribution to the public record - the more so given that much of the preceding reflects an analysis of source materials accessed pursuant to the Official Information Act. More importantly the narrative serves to illuminate the drivers influencing institutional reform - in this case a regime shift. The process of policy change is one that was largely driven from within - a case of the central bank being an active participant (if not the key actor) in the process of institutional reshaping. That institutional reshaping clearly arises out of a concern to militate against any future loss of credibility attendant upon what was perceived domestically and internationally as a politically porous institutional framework, to act as a 'circuit breaker' in the event of any residual carry-over of that earlier credibility deficit, and to 'lock-in' the gains in inflation expectations (the early credibility dividend) associated with changes in the conduct of policy that predated the formal institutional shift. The institutional prescription was one that was very clearly informed by the kinds of theoretical literatures reviewed in Chapter 2, and codified into public policy within the institutions of the state. But a political economy framework postulates that regime shifts of the kind embodied in the 1989 legislation, while driven by state actors, are unlikely to be prosecuted in the absence of significant support from non-state economic actors. Moreover, an institutional change that privileges sound finance over 'real economy' interests suggests a configuration in which financial actors enjoy a dominant position. An analysis of the legislative process indicates the positions taken by financial and non-financial actors, and the relative influence of each in relation to the state directed policy network driving institutional change.

The Reserve Bank Bill 1989

The Reserve Bank of New Zealand Bill was introduced into the House and received its first reading on the 4 May 1989.²⁸ By this point Roger Douglas had resigned from the Cabinet. Introducing the Bill, the new Minister of Finance, the Hon. David Caygill, rehearsed the arguments in favour of greater central bank independence, and emphasised the increased credibility attendant upon greater transparency in policymaking and implementation²⁹:

"Under present legislation the Reserve Bank's monetary policies can be aimed at a number of sometimes conflicting objectives. At present, the bank can be directed by the Minister of Finance to follow a particular policy without that directive being publicly disclosed. In order to aid planning by both the public and private sectors, and to raise confidence in the medium-term consistency of monetary policy, it is desirable that the Reserve Bank be given clear objectives for its implementation of monetary policy.

That is particularly important to help consolidate lower inflationary expectations ... The Bill ... will force Ministers of Finance to be open about adopting alternative policies and their inflationary effects, and will make the Reserve Bank more independent by placing the implementation of monetary policy outside of day to day ministerial manipulation" (NZPD, 1989: 10425).

For their part the National Party Opposition supported the introduction of the Bill. The Opposition's Finance spokesperson, Ruth Richardson, provided, at the outset of

²⁸ The Reserve Bank Bill 1989, which foreshadowed the repeal of the Reserve Bank of New Zealand Act 1964, went to all the functions and powers typically associated with a central bank, including the regulation and prudential supervision of banks. As noted in the introductory chapter, the focus of the research reported in this volume is on the development and implementation of monetary policy, and not on prudential management and regulation. Accordingly the discussion that follows in the balance of this chapter is directed exclusively to those provisions of the Bill going to the monetary policy functions of the Reserve Bank.

²⁹ There was a significant measure of disquiet within the Government Caucus over aspects of the Bill, and the exclusive focus on price stability in particular. The Minutes of the 193rd Labour Government Caucus meeting held in the Government caucus Room on Thursday 4 May 1989 at 10.10 am record that:

"Hon David Caygill, Minister of Finance, secured Caucus approval for the introduction of the Reserve Bank Bill. An amendment from Richard Northey, Member of Parliament for Eden, that the Reserve Bank Bill be amended in an appropriate way to provide equal priority between price stability; maximise economic growth; minimising unemployment; and appropriate interest rates was defeated" (Labour Party Caucus Minutes, 1989).

Richard Northey recalls that MPs on the Caucus Economic Committee had been discussing the Bill, and that while there was general support for those provisions of the Bill making the Bank more independent, a number were concerned at the change to a single focus on price stability, and were not persuaded of the need for a single objective. A 'faction' of the Caucus, mainly 'left' MPs and including all but one of the 1987 intake met regularly on a Wednesday night, and while Northey was not a member of the Caucus Economic Committee some members of the 'Wednesday group' who were on the Committee had reservations and Northey was deputed to draft an amendment. Northey recalls that the amendment was debated by the Caucus, with the vote along similar lines to those evidenced in other contentious policy decisions such as the sale of Telecom (Northey suggests that the split was something like 28/13, or

the debate, what she described as a 'clear and unequivocal statement' of Opposition policy on the Bill:

"The National Party seeks autonomy for the Reserve Bank, with accountability. The National Party seeks price stability with growth and jobs. Those linkages are critical; autonomy with accountability; price stability with growth and jobs" (NZPD, 1989: 10427).³⁰

Richardson records that two provisions in particular were important in securing the support of the National Party caucus for the legislation - the override provision, "enabled me to argue that the bill did not preclude the government of the day from exercising sovereignty over monetary policy", and the long title of the bill, which Richardson recall she had some influence over at the Select Committee stage, "talked of 'continuing to recognise the Crown's right to determine economic policy'" (1995: 48).

The issue of the linkages between price stability, growth and jobs - the objectives in the charter of the Act that the 1989 legislation repealed - and to the accountability of the Governor of the Bank under the new regime, went less to the Bill than to the inflationary consequences attendant upon deficiencies in the wider policy environment at the time (in particular labour market structures), and problems of harmonisation as between monetary and fiscal policy. The Governor of the Bank, the Opposition argued, could not be held accountable for aspects of policy over which he possessed no

roughly 2:1 in favour of the recommendation from the Finance Minister) (personal communication, 1999).

³⁰ Richardson recalls the problems she faced in winning support for the Reserve Bank legislation within her own Caucus:

"To me it was a confidence issue; I could not have continued as finance spokeswoman had National opposed the legislation. I had little success with Bolger and Birch. Though Jim generally accepted, in theory, the economic reasoning behind the Act, he was reluctant to yield to the Reserve Bank day-to-day operating discretion. He was concerned the Act would tie our hands as a government. Bill was similarly sceptical.

It would be unfair to suggest that the motives of the two men were entirely cynical. Both had instincts deeply rooted in the hands-on economic management of the Muldoon era and their journey away from that type of management was slow one. Even after caucus had decided to support the legislation, Jim was still trying to persuade us to vote against the third reading of the bill. Even today [1995], while Bill has come to accept the framework of the Reserve Bank Act, Jim in his heart of hearts would still like to run monetary policy from the Beehive" (1995: 48).

In his unauthorised biography of Winston Peters, Hames records that the vote in the National Party Caucus was very finely balanced:

"At a critical caucus meeting there was a bare one vote majority in support of [the Bill]. Muldoon was absent from that caucus, seriously ill in hospital. As for Peters, he had not turned up. Perhaps he thought he would lose the issue. As it turned out, Peters' absence was the difference between winning and losing. Bolger does not vote in caucus unless the votes are tied. Had Peters turned up, Bolger would have used his casting vote against the Reserve Bank Bill. Richardson would have resigned as finance spokeswoman and history would have been different" (Hames, 1995: 99).

control. However the Opposition also voiced concerns about a lack of specificity in the definition of 'price stability' and the nature of policy targets, and rehearsed the Treasury argument on the funding of the Bank, Ruth Richardson arguing that:

"It is nonsense to say that because an appropriation must be made by the House it somehow compromises independence or autonomy... Parliament ought to insist upon consistency, and it ought to insist that the Reserve Bank should not be an accountable law unto itself in relation to its budgetary requirements. One issue that I shall subject to very close scrutiny at the select committee is a change in the mechanism for the funding of the Reserve Bank" (NZPD, 1987: 10430-1).

Other Government members, in some of the more 'political' contributions in the debate, sheeted the origins of the Bill back to the excessive manipulation of monetary policy that had occurred under earlier National Party governments. The Deputy Prime Minister, the Rt. Hon. Geoffrey Palmer, opined that:

"[t]he vital origins of the Bill have to do with the behaviour of the Minister of Finance in the National Government. That is the explanation for the Bill, and it is a matter of public record.

We have only to look at the dispute in early 1984. There was a public row between the Minister of Finance at the time and the Reserve Bank over monetary policy advice that the bank had been giving to that Minister in the previous 9 months. That Minister of Finance claimed that he had not known that private sector credit and the money supply were increasing, or were likely to increase, and that, had he known, he would have tightened monetary policy. He either said directly or implied that the bank had been faulty in advice its advice to him. The bank prepared a set of excerpts from memoranda to show what the bank's concerns about that credit policy had been, and that they had drawn them to the attention of the Minister of Finance in dramatic and repeated fashion ...

The power under the existing Reserve Bank legislation is such that the bank was powerless even to let the markets know what political directions had been given to it. That is the essence of the reforms in the Bill" (NZPD, 1989: 10431).

Former Finance Minister, the Hon. Roger Douglas, traversed a similar line of argument:

"[F]uture governments will no longer have the ability to tinker with monetary policy in secret as the National Government did through bureaucratic channels, without the informed knowledge of the business community and the public ...

Under the National Government the Reserve Bank was given instructions by the Minister of Finance of the time day by day, and that more than anything else was the reason that between 1975 and 1984 New Zealand had an inflation rate of up to four times its trading partners. In the name of so-called fine-tuning the National Government continually interfered with the operations of the bank between 1975 and 1984, and that interference destroyed any chance of achieving price stability. It became well known that monetary policy would fluctuate with the electoral cycle; that every 3 years there would be a phoney

boom that would give the appearance of prosperity, to persuade some people to vote for the National Party, irrespective of the costs that were laid on the community in the medium term ...

One has only to read the comments about the intervention that is likely to take place to know that a National Government would be likely to do that again ... Many Opposition members would like a return to a regime of interfering with the day to day activities of the Reserve Bank ... The Government wants a statutory peg hammered firmly in place to protect New Zealand, and that is what the Bill is all about" (NZPD, 1989: 10436-7).

The Bill having received its first reading it was referred to the Finance and Expenditure Select Committee, Chaired by the Government MP Mr Jim Sutton.³¹

Select Committee Submissions: a contest of coalitions

As we noted in the review of the political economy literature in Chapter 3, institutional regime changes designed to procure central bank independence may be viewed as a political phenomenon. Typically the process of institutional reshaping requires a critical mass of support by way of a 'societal coalition' prepared to support central bank independence. Somewhat more contentiously, but reflecting rational choice assumptions about the preferences of incumbent governments, the fact of an incumbent government prosecuting the case for central bank independence is viewed as a function of the imminence of electoral defeat, and the desire of an incumbent government to limit the discretionary power of its successor. In this section the focus is on the nature of the 'societal coalition', and in particular the non-state actors within the state directed policy network, that provided the critical mass of support required to effect an institutional regime shift. The support of that 'coalition' and the nature of the interests contributing to it, is suggested by the number and tenor of submissions to the Select Committee tasked with the consideration of the Bill.

To rehearse the argument advanced in the literature reviewed in Chapter 3, it is assumed that the banking and finance sector will tend to be supportive of institutional arrangements in which central banks are independent of elected governments and tasked, primarily, with delivering price stability, whereas 'real economy' interests, such

³¹ The other members of the Committee were, the Hon Trevor de Cleene (Labour), Mr Doug Kidd (National), Ms Ruth Richardson (National), and Ms Elizabeth Tennet (Labour). (In the course of the Committee's deliberations on the Bill a number of other members participated, including Dr Bill Sutton (Labour), Mr Harry Duynhoven (Labour), Dr Peter Simpson (Labour), Mr Ken Shirley (Labour), Mr Wyatt Creech (National), Mr Philip Burdon (National), Mr Ian McLean (National), and the Hon J.H. Falloon (National). The Committee received 25 submissions and a further 10 supplementary submissions; and heard 12 hours of evidence in 7 meetings, during which it received evidence from 19 witnesses. The Committee also heard evidence from Professor Charles Goodhart, formerly an adviser to the Bank of England, who had been invited to New Zealand by the Reserve Bank.

as manufacturers, farmers, and trade unions, will tend to favour institutional arrangements more accommodating of, and responsive to real economy considerations (such as favourable rates of economic growth, employment, exchange rate settings etc.). Moreover the literature tends to assume that, consistent with the pattern of partisan preferences in Australian and New Zealand noted in the preceding chapter, that parties of the left will tend to favour a 'real economy' orientation (and oppose central bank independence and rule-based policy regimes) whereas parties of the right will tend to favour policies and institutional arrangements directed to 'sound finance'. Very clearly this is somewhat of an over-simplification, and may be countered both on logical and evidential grounds. Logically those involved in the negotiation of a wages contract have as much interest as any other price setter in ensuring that the price of labour (real wages) is not compromised by dynamically inconsistent policymaking. And, as the capsule history in the preceding chapter indicates - although this could be viewed variously as militating against, and encouraging central bank independence - in the Australian case the Labor Party has had a preference, at times, for the authority to be vested in the Bank governor, and not the board.

Nonetheless we would anticipate that manufacturing and labour interests will, *ceteris paribus*, be opposed to an institutional reform designed to privilege 'sound finance' over real economy objectives (such as employment and economic growth), and that, conversely, financial actors will be more inclined to support an institutional framework predicated on optimising the credibility of institution and policy through an exclusive focus on price stability.³²

While submissions went to all aspects of the Reserve Bank Bill, including prudential regulation, most were directed to one or both of two issues - the mandate or charter to which the Bank was directed, and accountability and governance arrangements:

³² The application of 'pluralist' assumptions about the nature of the political process is however somewhat problematic. In part at least the political economy literature does import the assumption that, within a pluralist liberal democracy, policy will, *ceteris paribus*, reflect the 'decibel' rating of the interests variously aligned for and against it. As others have noted this assumption is of limited utility in seeking to explain the trajectory of policy under the Fourth Labour Government, and to a lesser degree, subsequent governments. As Richard Mulgan has argued, the actions of the Fourth Labour Government eroded the notion of an electoral mandate (Mulgan, 1993); and as one of the principal architects of the Fourth Labour Government's programme of structural reform has suggested, in a reversal of the logic of policymaking in a liberal pluralist democracy, opposition to policy was at times deemed to reflect the existence of privileged or vested interests, thereby accruing even greater 'credibility' to the course of action being pursued (see Douglas, 1989).

The Charter

As the Report of the Finance and Expenditure Select Committee would note, submissions were divided in their support for the proposed change to the statutory charter of the Bank. Clause 8 of the Bill, and now Section 8 of the Reserve Bank of New Zealand Act 1989 details the primary function of the Bank:

"The primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices"

Section 8 (2) of the 1964 legislation provided that:

"For the purpose of this Act, the Minister may from time to time communicate to the Bank the monetary policy of the Government, which shall be directed to the maintenance and promotion of economic and social welfare in New Zealand, having regard to the desirability of promoting the highest level of production and trade and full employment, and of maintaining a stable internal price level"

Federated Farmers was supportive of the change, noting that:

"Federated Farmers of NZ (Inc.) supports the Reserve Bank Bill for the emphasis it places on price stability. By providing the Reserve Bank with greater autonomy it consequentially reduces Government's ability to alter monetary policy without public notification" (1989).

And, reflecting the Federation's consistently held view that fiscal policy, as much as monetary policy should be directed to price stability, the submission noted that:

"We recognise that the primary function of the bank will be to formulate and implement monetary policy directed to maintaining price stability. While the Federation considers such an objective as being essential, we note with satisfaction that the Bill does not put all anti-inflationary responsibility in the Reserve Bank's hands. The Government still has an active role to play in achieving price stability through its fiscal policy and other legislative reforms" (1989).

Similarly, the New Zealand Business Roundtable, in a submission prepared with the assistance of Dr Bryce Wilkinson, the Head of Research at Jarden Morgan NZ Limited, was supportive of the change

"The Reserve Bank Bill represents a significant step towards improving New Zealand's chances of entrenching a much lower rate of inflation for the future than it has been able to achieve in recent decades ... Making price stability, rather than some other objective, the core focus of monetary policy fully

accords with the weight of both expert and official international thinking on such issues" (1989).

And in a memorandum to the Finance and Expenditure Committee dated 3 August 1989 the Treasury added its collective voice in support of the change, citing OECD Ministerial Council decisions in support of this view:

"The choice of inflation as the focus for monetary policy is soundly based in our view. There is a general consensus in respect of the technical argument that the lasting and predictable effects of monetary policy are largely confined to the price level. In our view the Bill's role in establishing a medium term focus for monetary policy in terms of achievable monetary policy objectives is correct. Questions about the appropriate inflation rate and the time frame for disinflation we see as policy questions for the Government of the day to address" (TR89/355).

As a proportion of all the submission received, more raised concerns about, if not objections to the proposed changes in the charter than supported those changes. Submissions were received from a mix of individuals - including a number of university and private sector based economists - and organisations.

Dennis Rose, at the time an economist employed by the New Zealand Planning Council, made a submission in a private capacity, and raised the issue of the trade-off between output and price stability in setting short-term monetary policy:

"... the issue of linkages between monetary policy and outcomes in terms of real activity and inflation and of the relative importance of those effects is a matter of substantial professional debate. The proponents of these clauses effectively adopt one position within this debate. If they are wrong then the outcome of following the proposed debate may be quite other than they envisage ...

As in most areas of economics both price and quantity adjustments are in play. Over the longer haul increases in the supply of money are needed to support increases in real activity and a failure to secure that expansion can inhibit growth ...

...the policy maker in this area need to be aware that any change in policy stance has potential implications for both price and real sector developments. The Reserve Bank's attention should not be statutorily focused on a single economic objective"(1989).

Two Victoria University economists, Jan Whitwell and David Sheppard, also raised concerns over the real economy consequences of an exclusive focus on price stability:

"While we agree that an objective of monetary policy should be to achieve and maintain stability of the general level of prices, having regard for the efficiency and soundness of the financial system, we do not accept the implicit premise contained in the setting of this objective, that the pace and pattern of economic

activity in the financial sector has no interface with that of the real sector of the economy. As a consequence, we prefer the representation of the Bank's functions, as set out in the 1964 Act, 'that monetary policy ... shall be directed to the maintenance and promotion of economic and social welfare in New Zealand having regard for the desirability of promoting the highest level of production and trade and full employment, and of maintaining a stable internal price level'"(1989)³³.

And Paul Dalziel, an economist at Canterbury University, advanced a similar line of argument, accepting the premise that primacy should be given to a price stability objective, but suggesting that the existing charter objectives should constitute a restraining factor in realising the principal objective:

"It is widely accepted that it is not possible to have price stability and employment as simultaneous objectives for monetary policy. At any particular time, they are contradictory objectives, and in the long-run monetary policy cannot force unemployment below the level implicitly chosen by wage-negotiators. Therefore I approve the effect of Section 8(1) in giving priority to price stability. However, the reform goes too far in removing employment completely from the Reserve Bank's statutory responsibilities ...

The problem is to find a device whereby price stability remains the primary objective of the Bank, but growth and employment considerations remain part of the Bank's policy setting process. " (1989b)³⁴.

Dalziel recommended that the text of the 1964 charter, requiring the government, and by implication the Bank - to have 'regard to the desirability of promoting the highest level of production and trade and full employment' - be included as an element of the Bank's new statutory charter:

" ... growth and employment would become an added restraint on the Bank's policymaking, rather than an equal objective as in the current Act ...

The change suggested in this submission does not change the primary function, but would require the Bank to include among its reasons an analysis of how its policies and means are expected to affect production, trade and employment. Such an analysis, I submit, is highly desirable, and if accepted by the community would considerably improve the policy's credibility" (1989b: 3, emphasis added)

In the context of the principal theoretical and policy issues which this research seeks to illuminate this last observation is an interesting and important one, and while quite possibly implicit in a number of the submissions made to the Committee, in this particular submission it is advanced quite explicitly - namely that the prospects for the effective implementation of a policy targeting price stability would be a function of the

³³ See also Whitwell, (1988, 1990).

³⁴ See also Dalziel, (1989a).

acceptance of that policy within 'the community'. Dalziel's choice of the word 'community' over 'finance sector' implies a notion of policy 'credibility' accommodating of the distinction drawn in an earlier chapter between credibility, on the one hand, and policy legitimacy on the other.³⁵

A submission made on behalf of Business and Economic Research Limited (BERL), a firm of private sector economists and analysts, argued that:

"This primary function is a non-achievable goal for a central bank, because price instability arises from causes beyond the Bank's control. General price stability is a dangerous function for a central bank to have as its major focus, because its single minded pursuit of price stability will cause all manner of unwarranted damage to industries exposed to international competition, such as primary production, manufacturing and tourism even though these industries may not be responsible for price instability ... We oppose the introduction of the proposed Bill while it retains the very narrow primary focus. The primary focus of the present Act (1964) is far superior, and more relevant" (1989).

The BERL submission supported the concept of central bank independence, in the sense of operational or technical independence, but raised concerns over the mix of operational independence and an exclusive focus on price stability:

"A new Act offers an opportunity to upgrade the primary focus of the Reserve Bank. It should be charged with providing monetary policies which support the objectives of enhancing the growth, vitality, productivity and competitiveness of the New Zealand economy, of guarding and strengthening the net capital value and resources of the economy, maintaining a sound financial and monetary sector which supports those objectives, and ensuring that the operations of the financial system are conducted in a manner which supports stability in prices and values .. [such] a primary focus ... would ideally be conducted by an autonomous and independent Reserve Bank, with accountability as proposed in the Bill. However, to make the Bank more autonomous with a narrow and flawed primary focus as set out in the Bill would be a tragedy, and we oppose it" (1989).

In their submission, the National Council of Women - an organisation which in 1989 represented a quarter of million women through some 50 nationally organised societies and 37 branches - advocated the retention of the charter objectives in the 1964 legislation, suggesting that, "NCWNZ believes that the formulation of monetary policy must be in relation to the social costs of any policy under consideration as well as to the efficacy and soundness of the financial system"(1989).

³⁵ And Dalziel has since commented that he did not mean to imply that these were alternatives: "My view was that ultimately credibility requires legitimacy, and we cannot expect to achieve the former in the absence of the latter by some sort of constitutional trick" (personal communication, 1998).

Submissions were received from two trade union organisations, the NZ Public Service Association and the Service Workers' Federation, and from the peak union organisation, the New Zealand Council of Trade Unions (NZCTU). In its submission the NZCTU recorded that those provisions of the Bill seeking to alter the main functions, powers and lines of accountability of the Bank, were viewed as,

" ... a misguided and dangerous initiative that is likely to result in gross imbalances in the application of macroeconomic policy (to the detriment of employment and economic growth) and which is a direct challenge to democratic control over the machinery of government ... The Bill purports to aim at the control of inflation. It will be effective at the cost of lower economic growth and rising unemployment" (1989).³⁶

The Reserve Bank furnished the Finance and Expenditure Select Committee with 23 reports on various issues raised in submissions made to the Committee, including a summary paper commenting on submissions. The submission made by the New Zealand Manufacturers' Federation elicited a 21 page rebuttal.

The essence of the Manufacturers' Federation submission was that an exclusive focus on price stability would result in unacceptable costs impacting on the real economy sector:

"The principal focus for the Bank in the proposed legislation has switched to a perverse version of monetarism based upon Monetary Analysis, adopted by the International Monetary Fund (IMF) in 1959 for small undeveloped countries with unsophisticated central banking mechanisms ... [A] major shift in focus for the Bank is indicated. Money and credit, production, trade and full employment have all been deleted. In other words the bank is now to be totally focused on maintaining price stability with only one other concern; the efficiency and soundness of the financial system. The Federation's concern is that a brief such as this requires the central bank to pursue the low inflation objective, regardless of the costs in terms of business failures, job losses, or the welfare of New Zealand's households" (1989)

Moreover the Federation contested the accepted orthodoxy that monetary policy was neutral in its impact over the long-run:

"The removal of concerns about production, trade and full employment, is based upon the supposition that monetary policy has no medium term impacts

³⁶ And, after Whitwell (1988), the NZCTU raised concerns about the transmission mechanisms attendant upon the Reserve Bank's approach to monetary policy:

"There is an implicit assumption in the Bill that an inflationary target can be pursued independently of the other main objectives of macroeconomic management, and that it can be achieved principally by the central bank's manipulation of those monetary aggregates that are more directly under its control. There is no empirical evidence to support either element of that implicit assumption, particularly in the case of a small, relatively open economy like that of New Zealand" (1989: 5).

on real sector developments. There is no evidence for this argument ... We are in strong disagreement with the proposed narrow focus on prices for monetary policy" (1989).

And the Federation argued that in the period since the election of the Fourth Labour Government the Bank had been acting ultra vires the 1964 legislation:

"The Reserve Bank has been operating monetary policy for the last four years as though the 1989 Bill were law. As such the Bank has been violating its own 1964 Act and has in this violation caused widespread disaster in the economy and society. The Manufacturer's Federation makes the strongest representations that the 1989 Reserve Bank Bill must not be passed. Further, the Reserve Bank must stop violating the 1964 Reserve Bank Act forthwith, and recommence giving equal weight to the issues of full employment and the highest level of production and trade as well as maintaining a stable price level"(1989).

In their critique of the Manufacturers' Federation (provided to the Select Committee, and subsequently released to the newsmedia/public on 26 July 1989) the Reserve Bank responded by pointing out that the 1964 legislation required the Bank to give effect to the monetary policy of the Government, and the Government to have 'regard to the desirability of promoting the highest level of production and trade and full employment, and of maintaining a stable internal price level':

"In our view, the Bank has consistently operated within the requirements of its Act, serving successive governments and implementing their monetary policies" (RBNZ Discussion Paper G89/5).

The Manufacturers' Federation had also questioned the academic integrity of the advice stream informing government policy:

"Federation members have been dismayed by the huge disparity between the economic realities and the economic theories plied by Government advisers. Federation has recently consulted with New Zealand's leading macro-economic theorists, including monetarists, and has learned that current monetary policy has little academic respectability and no precedent or provenance. Apart from economists within the financial sector, which is the beneficiary of the current zealotry, we have encountered no support whatever for current policies or the single-indicator Bill" (1989).

This resulted in the following rejoinder, which while directed at the Federation's submission was also clearly somewhat more apposite to the state of academic economics at the time:

"The Federation claims to have discovered no support among economists in New Zealand for the principles of the Bill, except in the finance sector ... the Federation's claim ... reflects the degree to which the economists they have consulted are out-of-step with mainstream economic thinking, both in academe and in the wider world. We accept that the general approach to monetary

policy being adopted in New Zealand does not enjoy universal support in the New Zealand academic economics community. However, given the broader international support received, we suggest that this lack of widespread local academic support says more about the state of New Zealand academic economics than about the correctness of the Reserve Bank's and the Government's approach to monetary policy ...

Most notable, of course, is the support for the approach to monetary policy received from the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) in their regular reviews of the New Zealand economy ... It is clear that neither agency would endorse the view of the Federation that current monetary policy approach and the price stability objective proposed in the Bill are obsessive or dangerous to the growth prospects of the economy" (RBNZ Discussion Paper G89/5).

And on the issue of the real economy impact of monetary policy, and the neutrality of monetary policy over the long-run, whereas the Federation argued that,

"[t]he major effect of a consistent, high-interest policy is to deter investment in the productive sector, and accordingly postpone indefinitely any recovery from the recession. The relationship between investment and interest rates is self-evident and elementary" (1989),

the Reserve Bank rehearsed the prevailing rational economic orthodoxy:

"There is no serious questioning in orthodox macroeconomics that price stability is the appropriate long run objective for monetary policy - indeed, that is the only long run objective monetary policy can successfully pursue. This issue is essentially a technical one, regarding the limitations of an instrument, not an ideological one. Simply put, over anything other than the very short-term, monetary policy cannot directly do anything to improve employment or output levels, or the competitiveness of the tradeable goods sector - such variables are determined at much more fundamental levels in their own markets in the real economy.

There is certainly no evidence to support the implicit contention of the Federation that low inflation and poor economic outcomes are positively correlated, or that interest rates will be held permanently artificially high, and activity and employment will be permanently depressed if price stability is to be achieved" (RBNZ Discussion Paper G89/5).

Management, governance, and accountability

A number of the comments reviewed in the preceding section indicate a linking of the pursuit of a prescribed policy target by an independent central bank with a wider set of issues going to the constitutional propriety of such independence. Submissions canvassed a range of issues spanning relatively technical matters going to reporting

arrangements in the public sector, through to issues of transparency and accountability, and the surrender of policy sovereignty by elected representatives.

The link between targets and accountability was raised by David Sheppard and Jan Whitwell who express concerns about those provisions of the Bill which serve to focus the attention of the Governor, Deputy Governors, and members of the Board on the Bank's primary function:

"... we are uneasy over the caveat that the Governor, the Deputy Governors and the non-executive directors of the Board may be dismissed if they fail to realise the set policy targets irrespective of how good a case they may make in defence of their failure. Indeed, it is of concern that no group from within or outside the Bank is charged with the duty of continuously or even intermittently evaluating the consequences of pursuing the prescribed policy target, especially with reference to the general welfare of the NZ community ...

we think it unreasonable that Parliament should not be entrusted with the duty of evaluating the Bank's recommendations ..." (1989)

Sheppard and Whitwell also raised concerns about the proposed changes in the composition of the Bank's board of directors:

"We stress that we welcome the increase in the autonomy of the Bank which the proposed Bill provides but add that we are somewhat disappointed that no representative from the NZ Treasury is designated as a Board member and that no Board member is required to have industrial or commercial experiences as the 1964 Act provides ... The directors, especially the non-executive directors should be individuals with expertise which relates to sections of the administration and the community which are likely to be affected by the Bank's actions" (1989)

In its submission the NZCTU also raised concerns about the dangers attendant upon a democratic deficit, suggesting that the Bank should be subject to a greater measure of control by government, that the override provision was unlikely to be effective given the risk of financial market instability attendant upon its use, and suggesting that, as a fall-back position, the Government might consider establishing an expert panel of review:

"Under the existing legislation, not only is monetary policy directed at a broader set of macroeconomic policy objectives, but the Reserve Bank is clearly the policy agent of the government ... there are grave dangers in setting a control authority of such central economic importance up as a virtual 'law unto itself'... A government may well want to challenge both the analysis and response of the Reserve Bank to a particular economic circumstance, and indeed it is elected with the responsibility to do just that. However a formal instruction to a reluctant Bank can easily be portrayed by political opponents as 'politicians' disregarding the advice of the 'experts' and telling them to 'create inflation'. The

political risks of an over-ride would be enormous, even if the government was convinced of the fallacy of the action the Bank was engaged in. The tendency will be for the bank to have virtually no accountability - or accountability only in exceptional circumstances - to the democratic controls of the machinery of government ... Ideally, the Bank should remain as a directly accountable agent of policy, but if that is not acceptable, then the very minimum requirement is that an independent 'panel of experts' should be set up to advise the government and make public comment on the methods of operation of the Bank

... it is important to use the law to establish administrative structures, not to enshrine a currently fashionable ideology in it and to build a wall around that ideology in order to protect it from democratic control. Unfortunately, the Bill diminishes the attempts to modernise by reflecting the hand of the ideologue" (1989: 8-9).

The Manufacturers' Federation submission also raised the issue of the democratic deficit:

"The Bill attempts to diminish the responsibility of the Minister of Finance, or any other elected person, for the determination of monetary policy settings. This is wrong in principle, undemocratic, and inflexible. It will add immeasurably to the 'ivory tower' image of the Wellington bureaucracy, which is already the subject of widespread criticism throughout the private sector ...

The Governor may suspend such business if satisfied that it is necessary or expedient in the public interest. The 1964 Act requires the prior consent of the Minister. There appears to be no requirement here for consultation with the Minister about this measure, let alone the consent of the Minister. Indeed, Clauses 9 and 19 together give the Governor considerable power. While we recognise that this is intended to provide a check on central government, we find the extent of this delegation of powers to an appointed official unacceptable

We believe that it is not in the public interest that so much power should be vested in the hands of the Governor of the Reserve Bank, with no clear line of Ministerial responsibility, with no recourse to the democratic system and public accountability, and without the checks and balances so necessary to ensure that monetary policy actually serves the well-being of people"(1989)

In their critique of this submission the Reserve Bank argued that reporting and accountability arrangements would be enhanced by what was proposed in the Bill:

"In this legislation the Bank will be given clearer instructions by Parliament, and the Minister will be setting clearer performance criteria for the Governor (the policy targets) and through this process the Bank will become more accountable to Parliament and to the Minister for both policy implementation and outcomes" (RBNZ Discussion Paper G89/5).³⁷

³⁷ The Reserve Bank's concluding observations on the Manufacturers' Federation submission were decidedly unequivocal:

"The Manufacturers Federation's submission contains very few criticisms of substance and nothing which should give grounds to alter anything in the Reserve Bank of New Zealand Bill as it stands. The submission is ill-researched, often inaccurate, and reflects a rather shallow and superficial view of developments in recent years, and of the scope and limitations of monetary policy" (RBNZ Discussion Paper G89/5).

For their part, while not commenting directly on the detail of governance and accountability arrangements, Federated Farmers expressed support for the greater transparency presaged by the legislation:

"In summary Federated Farmers supports the flexibility and transparency of the legislation. It preserves democratic principles and maintains consistency and transparency by preventing policy changes being enacted without the knowledge of the public. The Act will minimise the possibility of intervention in the financial markets or the manipulation of monetary conditions for the Government's own purposes"(1989)

The Business Roundtable contested the view that the changes presaged by the Bill would encourage a democratic deficit:

"Some critics of the Bill have interpreted it as an attempt to limit the constitutional power of the government to determine monetary policy objectives. The thrust of this submission is that, to the contrary, the Bill represents a major step towards ensuring that the government, alone, has responsibility for determining economic objectives for monetary policy and that the Bank is held much more accountable than in the past for achieving monetary policy targets or outcomes which are consistent with these objectives.

While ... section 8 of the Bill quite properly established price stability as the standard objective for monetary policy it very clearly provides explicit mechanisms in section 11 by which the Bank is required to achieve monetary policy outcomes which are consistent with whatever economic objectives the government may specify through the Governor-General by Order-in-Council. The Bank's subservience to such policy directives is put beyond doubt in section 11.

Furthermore the Bank is held accountable, to a remarkable degree, for its performance in setting monetary policy targets that are in accord with such directives and achieving them. Under section 14 it must publicly report on its performance every six months and it has a board, dominated by non-executive directors appointed by the Minister of Finance, which is required, under section 51, to keep the Reserve Bank Governor's performance in this and other respects under constant review and to advise the Minister of Finance, in writing, of inadequacies in the Governor's performance..." (1989: 1)

Regarding the composition of the Bank's Board the Business Roundtable submitted:

"We believe that it is essential that appointees to the Reserve Bank board be high calibre people who have a sophisticated understanding of capital markets ... and a keen appreciation of the costs of inflation, the dangers of imprudent lending behaviour, and the need for consistency and credibility in the execution of monetary policy"(1989).

However, support for the general scheme of the Bill notwithstanding the Business Roundtable argued that the accountability requirements detailed in the Bill did not go far enough:

"A general concern with the Bill is the rather low level of accountability both for ministerial instructions to the Bank and for the Bank itself in respect of many functions accorded to it" (1989),

and suggested that the Bank be required to publish cost/benefit analyses both in respect to ministerial instructions and the Bank's own functions.

Moreover the Business Roundtable added its support to the Treasury view, which has already been reviewed and to which we return below, to the effect that the Bank should be subject to the same reporting and accountability arrangements as other crown agencies:

"... the Bill is largely silent on the question of financial objectives for the Bank or equivalent disciplines for ensuring operating efficiency and the provision of services at least cost. The open-ended nature of the financial arrangements for non-monetary policy functions is an area where there appears to be a lesser degree of accountability to Parliament than is required for other public sector agencies under the new financial management procedures" (1989: 10-11).³⁸

Both the Law Society and Parliament's Regulations Review Committee (the former in a submission and the latter in a letter dated 8 August 1989) expressed concern at the constitutional implications of the override provision (Clause 11 in the Bill, Clause 12 in the Act) by which the Minister of Finance was empowered, by means of an Order in Council to amend or suspend the application of an economic objective which is prescribed by Parliament. The Reserve Bank sought a legal opinion on this matter and in a letter to the Reserve Bank Governor, the Bank's legal advisers suggested that the Bill, as drafted, was consistent with the constitutional conventions:

"... we consider that the appropriate tests are whether the provision is consistent with the maintenance of the sovereignty of Parliament, and the role of law, and whether it gives effect to a proper balance between the role of Parliament, and of the executive. In our view, the provisions in the Bill satisfy those tests" (Rudd Watts and Stone letter to Reserve Bank Governor, 1 September 1989).

Earlier in this chapter we reviewed the exchanges between the Reserve Bank and the Treasury over the relative merits of various models of accountability, and the Treasury's preference that the Bank be deemed a 'crown agency' for the purpose of the reporting arrangements generally applicable in the public sector.³⁹ While the Treasury

³⁸ The Business Roundtable also express concern about the reach of the Securities Amendment Act 1988, and in particular the fact that constraints on the use of 'inside information' may severely constrain the scope for suitable appointments of New Zealand residents to be made to the Reserve Bank Board

³⁹ Ministers appear to have had differing views on the merits of the Treasury's proposals to the effects that the Reserve Bank be defined as a Crown Agency for the purposes of the Public Finance Bill. In a

had failed to win the support of Ministers for their proposal that the Bank not be funded by a form of constrained seigniorage, Treasury submitted that the Bank should be subject to the statutory disciplines common to other 'crown agencies':

"The desire for improved accountability for the Reserve Bank can be considered in the context of moves towards more effective accountability generally in the public sector. The framework that has been applied in other areas with reforms such as the State Sector Act, the Public Finance Act and the State Owned Enterprises Act has clarified accountability and provided mechanisms for assessing and reporting on performance"(TR89/355).⁴⁰

One other matter which resonates with material canvassed in subsequent chapters is also of note. In the course of the Finance and Expenditure Select Committee's deliberations the Committee sought a justification from the Bank as to why the Reserve Bank required a Board of Directors. The Bank's response not only advances the case for the retention of a Board of Directors, but also sets out the Bank's views on the limitations of the 'SOE model':

"First the SOEs are largely responsible for carrying out commercial functions with little or no public policy responsibilities, whereas, the bank carries out principally public policy functions, but also with some commercial functions. Secondly, the SOE model makes no one person accountable to the Government for the SOE's outputs/outcomes. In the event of dissatisfactory performance the only option for the shareholding Minister is to replace the board or individual board members. Board responsibility was not considered a sufficient level of accountability for the Bank's monetary policy. Instead it was decided it

paper to the Minister of Finance dated 10 July 1989, Treasury recommended that the Minister decline the proposal by the Reserve Bank to exclude the Reserve Bank from the definition of Crown Agency (TR 9203). And in a later paper to the Associate Minister of Finance, Treasury registers its disagreement with the Bank's proposal to exclude the Bank from Crown Agency status, adding, "that this is not in accord with the position agreed with the Minister of Finance" (TR89/355). Treasury recommended that the Reserve Bank paper be amended. The Associate Minister, in signing off the paper declined the Treasury recommendation.

⁴⁰ For its part the Audit Office argued in a letter to the chairman of the Finance and Expenditure Committee dated 9 June 1989 that the Reserve Bank was a crown agency and should be defined as such for the purposes of the Public Finance Act:

"... we believe that the Bank should not be dealt with differently to other wholly-owned State-owned enterprises and similar agencies and therefore that the Audit Office should be the statutorily appointed auditor on behalf of Parliament. We think it is inappropriate, because of the potential for influence or compromise, both for the Minister to choose the auditor given the Minister's actual or potential involvement in the operations of the Bank, and for the Bank's directors to decide the amount of the auditor's remuneration"

By way of response, a memorandum from the Governor to the Finance and Expenditure Committee noted that:

"The present provisions in the Bill relating to the appointment of Auditors are permissive not prescriptive. If the Government wishes to appoint the Audit Office as the Bank's auditor, there is no legislative constraint to it doing so. We believe that it would be inappropriate for the Audit Office to have a monopoly, entrenched by legislation, irrespective of expertise, performance or cost" (Memorandum to the Finance and Expenditure Committee, 30 August 1989, RB/14.

would be preferable for the Government to be able to hold one person (the Governor) accountable for the success or failure of monetary policy.

Thus, rather than follow the SOE structure, it was instead decided to follow more closely the model adopted for government departments; but in the context of the Bank being a body corporate with its own constitutional structure (to maintain the perception of independence/autonomy) ...

There is no general norm for the role and structure of central bank boards across countries; the only common element being that most banks have a Board ... A possible repercussion if the Reserve Bank's Board was to disappear could be to diminish the Bank's independent status in the eyes of the financial and central banking community ...

Although in the legislation the Board's role may not appear to be major, the Board is central to two aspects of the Bank's proposed structure: policy autonomy and accountability.

The structure regarding the roles of the executive and non-executive directors contained in the legislation is consistent with the general principles outlined for other public bodies. The lines of accountability are clearly stated, with the Governor having the primary decision-making role within the Bank. At the same time, the Board has important responsibilities in the appointment of the Governor and the Deputy Governors, and has a strong role in the accountability process being the primary monitor of the Bank's activities ..." (Reserve Bank Memorandum to the Finance and Expenditure Select Committee, 16 August 1989, RB/11).⁴¹

The Finance and Expenditure Committee reported back to the House on 12 December 1989.⁴² The report back debate traversed the arguments variously advanced in the submissions to the Select Committee, and the Bill progressed through its second and

⁴¹ A paper prepared for the Board, over the name of Peter Nichol, and dated the 4 May 1989 (the same day that the Reserve Bank Bill received its first reading) outlined the roles of directors under the new legislation. The paper notes that,

"The role of the Bank's Board of Directors, could, in principle, vary from one extreme of having all Bank decision-making being undertaken by the Board to the other extreme of having a purely advisory Board. In the March 1987 Board paper No. D3, it was noted that there is no general norm for the role and structure of central bank boards across countries. Within New Zealand, work by the State Services Commission shows that there is also no consistency regarding the role and structure of statutory boards for various public bodies

... The SSC view, which is shared by the Associate Minister of Finance, Mr Neilson, is that the existence of boards with executive powers potentially confuses the line of accountability between a Chief Executive and the Minister. Both the SSC and Mr Neilson consider it best for the Minister, rather than the Board, to be able to direct a Chief Executive, with a board retaining principally an advisory role, possibly with some executive responsibilities where there is clearly no ambiguity between the responsibilities of the Chief Executive and the Board" (RBNZ Board Paper, 4 May 1989:2).

A later paper dated 6 July 1989 details the Board's monitoring role.

⁴² For the debate on the Report of the Finance and Expenditure Select Committee see NZPD (1989: 14501 - 14511). The Second Reading debate is recorded in NZPD (1989: 14676-14712).

third readings the same day.⁴³ The Reserve Bank Act came into force on 1 February 1990.⁴⁴

Conclusion - a credible outcome?

The political dimensions and implications of the development and passage of the Reserve Bank Act 1989, and in particular of the distribution of sectoral support for, or opposition to the Bill is a matter that we will return to in the concluding Chapter. The import of the New Zealand reforms to the Australian debates of the 1990s has already been foreshadowed, and is further developed in Chapters 7 and 8.

Clearly, a large part of the explanation as to how the Reserve Bank Act came into being is common to much of the package of structural reform pursued over the post 1984 period, and has to do with the relative ease with which policies can be prosecuted in a unicameral legislature elected under first past the post rules. Equally the development and passage of the Reserve Bank Act is consistent with the politics and style of policymaking characteristic of much of that period (see Douglas, 1989). But there is a strong nexus between the politics and style of policymaking - the 'logic' of deregulation and market liberalisation in particular - and the relative strength of interests within the wider political economy. As Roger Douglas argued in 1989, the political logic of the reform strategy - and the sequencing of reform in particular - was one that generated its own political momentum (see Douglas 1989). The unravelling of the politics of

⁴³ Speaking in the debate the National Party Opposition Finance spokesperson did however acknowledge the point that the Bill sought to remedy failings which had predated the election of the Fourth Labour Government:

"It is time to break with the tradition of monetary policy that New Zealand has had for about a decade. For example, there has been a swing from a substantial reliance on monetary policy to wind the economy up, to a substantial reliance on monetary policy to grind the economy down" (NZPD, 1989: 14504-5).

⁴⁴ The implementation date of the new legislation serves to illustrate a weakness in the statute reading measures of central bank independence that feature in much of the literature reviewed in Chapter 2. Clearly the substantive change in monetary policy predated the passage of the Reserve Bank Act 1989, whereas attempts to correlate central bank independence and macroeconomic outcomes date the regime shift from the 1 February 1990. In an interview in 1998 Reserve Bank Governor Don Brash indicated that he had raised this weakness with a number of researchers who had,

"... dated the change in regime in New Zealand from the 1st of February 1990 which was when the 1989 Act became law and in all of those studies I've written to the author saying ... of course you don't see much of a change because defacto this regime began at least three years earlier. 0-2 was being talked about publicly by Douglas in early 1988. In the Annual Report of the Bank for the end of March 1989 ... we talked about getting to 0-2 in that Governors report by March 1993 which was the end of our 1992-93 year ... So 0-2 was what we were clearly targeting from at least two years prior to the Act being effective. So you wouldn't expect to see for any great regime shift at that time" (personal interview, 1998).

domestic defence created new actors, and markedly reduced the influence of old actors. Liberalised financial markets created new financial actors, and empowered those actors within finance markets; the reduction in assistance to the primary production sector created a constituency for further liberalisation in product and labour markets, and for 'sound finance'; and reductions in tariff protection for domestic manufacturers and a retreat from arbitration as the primary instrument of wage fixation reduced the influence of manufacturing and trade union interests. Clearly the trajectory of public policy in the post 1984 period was not such as to engender a great deal of support among manufacturers, and the sequence of reform, which had seen deregulation and market liberalisation impact initially on the primary production sector, was such as to promote what was almost an inexorable logic of reform, as those subject to change demanded similar changes elsewhere in the economy - particularly, in the case of the primary production sector, in those other sectors constituting significant input costs for primary producers. Moreover typically one would expect domestic manufacturing interests to be less inclined to accept reforms of monetary policy institutions predicated on privileging 'sound finance' over growth in domestic economic activity. In this sense the stance taken by the Manufacturers' Federation was predictable. With the overlay of a programme of structural reform that included the removal of tariffs, and the experience of a monetary policy regime that had seen a significant appreciation in interest rates and the real exchange rate, the position of the Manufacturers Federation is all the more explicable. Moreover, because the Fourth Labour Government eschewed the soft corporatism of its Australian counterpart, the process of policy formation did not admit of any meaningful engagement between government and trade union or manufacturing interests. As Reserve Bank of New Zealand Governor Don Brash noted in his own review of the structural reform process,

"Douglas rejected the conventional view that reform can succeed only if political support for it has been established beforehand; this, he said, merely compromised the quality of the reforms, thus adding to their eventual cost and sowing the seeds of opposition. Instead, he said, consensus 'develops progressively after the decisions are implemented, as they deliver satisfactory outcomes to the public'" (Brash, 1996)

Both in terms of process and substance, the structural reforms of the mid to late 1980s created the kind of 'societal coalition' that would support 'central bank independence'. And the dimensions of that coalition, and, with the exception of the peak organisation of farmers, of the non-financial actors external to it, is captured in the submissions to the Finance and Expenditure Select Committee. Dr Arthur Grimes, recalls that Federated Farmers were always on-side, and attributes this, in part, to the fact that Peter Elworthy [President of Federated Farmers] was on the Board at the time of the

Bill's passage. The Manufacturers' Federation, on the other hand, was vociferous in its opposition.⁴⁵

Interviewed in 1998 Peter Crawford from the Federation suggested that a combination of the preferences of the leadership of the Federation at the time, and the experience of the adjustment process combined to shape the Federation's stance on the Bill:

" ... much of the thrust was lead by the person who was the President at that time [Barry Brill], but I think it did reflect the experiences of the reforms that had begun in '85 ... they'd been faced with a pretty high dollar and very high interest rates and the sector was heading downwards over that period from '85 to '91. The sector lost a quarter of its work force and I think people were pretty pessimistic about where manufacturing was going..." (personal interview, 1998).

In retrospect the present leadership of the Federation also attributes the Federation's stance on the Bill as a function of a loss in confidence on the part of manufacturers that the underlying inflationary pressures would be addressed - including fiscal policy settings, labour market, and micro-economic reforms - and, in the absence of any commitment to addresses those issues, that monetary policy, and in particular the exchange rate, would carry the burden. Peter Crawford notes that,

" ... we also had a new government at the end of 1990 that was more willing to consider those underlying factors ...

I think particularly in '89 because of the period that the Labour government itself was going through I don't think manufacturers were confident that any of those issues would be addressed so there was a concern about what would happen with the implementation of monetary policy if you got those sorts of pressures coming through and a government that was not wanting to address them. Because we had that sort of three year period of reform, and then sort of

⁴⁵ And the position of the Manufacturers' Federation made manifest the tensions within a National Party wrestling with the policy and electoral challenges of a post-Muldoon era. Those tensions were such as to bridge public and private interests, and informed policy making within policy communities, in which the Manufacturers Federation was situated.

Arthur Grimes views the Manufacturers' Federation stance on the Bill as, in part, a function of a leadership position with political links to the 'Muldoonist' wing of the National Party:

"Barry Brill was the head of [the Manufacturers Federation] and he had been a Minister under Muldoon ... Barry Brill was the ultimate Muldoon type ... They were never supportive of monetary policy even until then of course, which was when we were still trying to reduce inflation through that time ... I can remember at the time going to Man Fed, it must have been '87 or '88 it must have been somewhere around then and them saying "Oh look we can't possibly survive the exchange rate is high and you've got to devalue." Those are the days when there were wage rises and I said - there was a group of about 20 manufacturers there - 'well can you tell me what you've just given in the wage round' ... and everyone said 7% and I said 'well how can you tell if the exchange rate is too high if you've just given away a 7% wage round. Obviously you had that much to spare otherwise you wouldn't have given a 7% wage round' - they couldn't see the connection. They were still living in ... the world the way it was basically and they couldn't see that there was a new way of doing things and they weren't bringing in new blood at that time..." (personal interview, 1998).

another three year period because of turmoil within the government they really sat on their hands for another three years" (personal interview, 1998).

Whatever the imperatives driving the Manufacturers' Federation position at the time, the political-economy of the change does suggest - to the extent that the government of the day was at all concerned to marshal the support of a 'societal coalition' in support of the change - that any such support was viewed as coming from other than manufacturing or trade union interests. Peter Harris suggests:

"If you take my theory that the '89 Act merely institutionalised what they had been doing anyway, you can get some feel for how the non-financial world felt about the Bank by looking at responses to the Reserve Bank Bill. And the two institutions that were vehemently opposed to it ... were the unions and the Manufacturers Federation. Now I remember talking to Wally Gardner [Chief Executive of the NZ Manufacturers' Federation] at the time and him saying, 'Nowhere in the world would the government proceed with a major change to the economic policy in face of vehement opposition from organised labour and organised industry'" (personal interview, 1998).

The political-economy model that we have advanced views a regime shift of this kind - towards a more 'independent' central bank tasked with securing and maintaining price stability - as symptomatic of structural shifts within the domestic political-economy, with the locus of political and economic influence shifting from real economy interests to 'sound finance'. We have suggested that, in the New Zealand case the process and the logic of structural reform significantly shifted the locus of power away from manufacturing and labour interests to finance, and farming interests. The political-economic topography of the time is very clearly in evidence in the nature of the submissions made to the Finance and Expenditure Committee that considered the Reserve Bank. Moreover, to the extent that the wider programme of structural reform constituted the 'unmaking' of the politics and policies of domestic defence, shifts in the relative power and influence of economic interests or societal coalitions are suggested by the logic of that pre-reform paradigm. Manufacturing interests were sustained by tariff protection, trade union interests by a system of conciliation and arbitration which legislated for union recognition, provided minimum rate awards, and guaranteed the enforcement of those awards by way of state agencies. That statism was also in evidence in attempts by the state to manage foreign economic policy in the post Bretton-Woods era. The programme of economic reform would see tariff reductions and an end to import-licensing, and the trade union movement acquiescing in the removal of compulsory arbitration as one element in the transitional reforms for exiting the Muldoon wage-price freeze. Capital and finance market liberalisation would elevate domestic and international financial actors to an unprecedented position of influence, and the political logic and sequencing of the reform process would see the

farming sector embrace the reform agenda, and become an advocate for further reform in product and labour markets.

The 1989 legislation codified in statute that which had *de facto* been implemented progressively over the post 1984 period.⁴⁶ The import of this is that, the conduct of monetary policy with a floating dollar required the Bank to engage more directly with financial actors, and provided the Bank with an opportunity, as a political actor in its own right, to further develop a coalition supportive of statutory reform. Goodman has noted that,

" ... maintaining independence is easier than creating it, for creating an independent central bank requires an act of political will. Yet by making the central bank independent, governments add a new actor to the political system, one that surely seeks to preserve its own autonomy. This fact does not mean, however, that central bank independence is irreversible - only that the costs of reversal rise due to the central bank's ability to create a new external environment" (Goodman, 1992: 8).

The sequencing of the New Zealand reform process, in which *de facto* changes anticipated the *de jure* codification suggests that effectively the Reserve Bank of New Zealand possessed sufficient independence before the event to be a political actor in its own right. The Act in that sense did not add a new actor to the system as much as confirm the make-up of the cast after the intermission.⁴⁷ However the Goodman model

⁴⁶ Don Brash confirmed this sequence, observing that:

" ... it's my understanding that when the election took place, Roger Douglas, the new Minister of Finance, quite explicitly said 'I do not want to be involved in the day to day decisions of monetary policy. I want you at the Reserve Bank to get inflation down and I don't want to be bothered with precisely how you do that'. Now, it was shortly after that of course, that the New Zealand dollar was floated and that meant that for the first time in a sense, we had an independent ability to control monetary conditions in New Zealand to a significant extent unaffected by what the inflation rate was elsewhere. So *de facto* from that change of government, the government said we will tell you what the objective is and the objective is low inflation, but you will run the implementation of policy to deliver that outcome. In a sense, the 1989 Act was simply the legislative embodiment of that *de facto* situation. Before the 1989 Act was changed, of course, our own law was very closely similar to that in Australia where monetary policy was directed to achieve not only price stability, but full employment, growth and balance of payments, equilibrium, motherhood and so on. But since the decision making was all [the] governments, I guess they thought they were able to direct us within that general target to focus entirely on one aspect, but there were one or two people as I remember, who questioned whether the government had the legal authority to direct us to focus on a single part of that spectrum" (personal interview, 1998).

⁴⁷ In and of itself this in turn provides further support for the contention that research predicated on the statute reading approach will be limited, and will fail, in quantitative terms to capture cause and effect. Don Brash commented that studies of the effect of central bank independence which date the New Zealand reforms from the effective date of the statute fail to capture the proper historical sequence:

"I said of course you don't see much of a change because *de facto* this regime began at least three years earlier. 0-2 was being talked about publicly by Douglas in early 1988" (personal interview, 1998).

suggests that while shifts in the composition and relative influence of societal coalitions are necessary, they do not constitute a sufficient condition. Assuming a Downsian calculus on the part of political incumbents, it is argued that a government will only seek to facilitate the greater independence of a central bank where it is faced with an imminent electoral defeat, and where it wishes to tie the hands of a successor. This is a matter that we will return to in Chapter 8. At this point it is sufficient to note the principal political architect of the 1989 Act - Roger Douglas - embraced an approach to policymaking that tended to discount public support (Douglas, 1989). In this sense, seeking to apply the standard Downsian assumptions about the nature of the political/electoral calculus is problematic. However the rhetoric from the government benches that accompanied the passage of the Bill - examples of which we have cited above - does suggest that the rationale for the change was as much about 'Muldoon-proofing' the instruments of monetary policy, and limiting the discretion of a future government, as about securing a credibility dividend for the Fourth Labour Government. Moreover, the Reserve Bank Bill received its final reading on 15 December 1989 and came into effect on 1 February 1990. The first Policy Targets Agreement was signed on 2 March 1990 by Reserve Bank Governor Don Brash and Finance Minister David Caygill. A recent history of the Fourth Labour Government reports Caygill's assessment of the Government's electoral prospects in early 1990:

"I didn't believe at any stage during 1990 that we would win the 1990 election ... the writing was on the wall ... Frankly, even if David Lange had still been the leader I think we would have - more narrowly in the 1990 election - but we would have lost" (in Sheppard, 1999: 205).

Perhaps the legislation was more about constraining the actions of successive governments.

There are however a number of other factors which, while they do not detract from the utility of the political-economy approach, serve to more fully illuminate the circumstances of the New Zealand regime shift. We do not argue that they necessarily constitute an answer to the comparative puzzle which the research seeks to illuminate - while evaluation is an implicitly comparative process to generalise from the New Zealand case would be to risk an over-determination of observed difference. A number of factors are however clearly apposite to an explanation of the trajectory of institutional reshaping as evidenced by the New Zealand case.

The first is the fact of a unicameral legislature and single party majority government. Electoral and constitutional arrangements such as these invest in the executive of the

governing party almost unfettered powers to effect changes in statute and public policy.

Secondly there is the fact that the change was prosecuted by a Labour Government, and supported by the Parliamentary Opposition of the time. Theoretically, at least, there is nothing to suggest that a left-party government would not have an interest in seeking to facilitate greater central bank independence. To the extent that 'surprise inflations' prejudice the interests of all price setters, those responsible for the negotiation of wage contracts have as much to lose from dynamic inconsistency in policymaking as other interests. Ipso facto, one might entertain circumstances in which a left-party government with ties to labour interests might seek to prosecute greater central bank independence with the objective of ensuring dynamic consistency in monetary policymaking (and maintaining the 'real wage' integrity of contracts). However while advocates of the 1989 changes to the New Zealand arrangements would no doubt have advanced an argument of this kind in order to persuade trade union interests to the merits of the case, there is no evidence that it influenced union opinion to one of support for the changes, with submissions from union organisations focusing on what were perceived at the time (and since) as the deleterious consequences of a focus on price stability at the expense of macroeconomic stabilisation, problems of policy co-ordination, and the issue of the democratic deficit. While the process of making a central bank independent admits of the possibility of non-financial actors redefining their preferences and supporting central bank independence (Goodman, 1991: 333), there is no evidence of any significant redefinition within the New Zealand non-finance sector. If the statist excesses under former Prime Minister and Finance Minister Muldoon served to provide a ready economic and political rationale for the 1989 changes, to anticipate the discussion in the following chapter, the trajectory of policy predating the election of the Fourth New Zealand Labour Government, and that predating the election in 1983 of the Hawke Government could not be more different. Muldoon quite consciously rejected monetarism, despite the best efforts of the Reserve Bank to win support for the prevailing orthodoxy. In New Zealand low inflation had been secured, albeit temporarily by means of wage and price regulation, and the incoming government not only quite consciously repudiated any meaningful commitment to corporatist macroeconomic management (Oliver, 1989), but, arguably knowingly pursued policies (such as reviews of higher salaries within the core public service) which were always going to lead to cost-push inflationary pressures.

Thirdly there is the fact that, within what the state-directed network of the time, the changes enjoyed the support of key institutional players within the New Zealand State - the Reserve Bank and the Treasury in particular. While concerns were raised by academic and some business economists, the Reserve Bank and the Treasury embraced the objectives of reform, and assumed responsibility for the development of institutional arrangements consistent with those objectives. Within the official 'policy community', or state directed policy network, there were, as we have noted, significant differences as between the Treasury and the Reserve bank over the public management framework within which the Reserve Bank was to be located, a contest in which the Reserve Bank prevailed. And while this contest does not detract from the broad agreement on the first order project - an operationally independent central bank tasked with price stability - it does suggest that deterministic accounts of the state risk failing to capture the nuances of difference within a dynamic network of actors.

Fourthly there is the apparent convergence between a growing body of empirical and theoretical literature supporting 'central bank independence', and the search for an alternative institutional model within the New Zealand policy community. Respondents have confirmed the relevance of the dynamic consistency literature in the development of that alternative, and the timing of the publication of supportive empirical and theoretical work was clearly propitious, and arguably of much greater relevance in a policymaking environment in which incremental models of policymaking had been eschewed in favour of the 'rational-comprehensive' alternative (Lindblom 1959, 1979; Dror, 1964, 1968). The rational economics literature at the time supported the favoured institutional prescription far more unequivocally than would be the case some ten years later. Moreover the prevailing policymaking paradigm of the time was one that placed a premium on zero-based policymaking over incrementalism, and entertained a willingness to experiment in matters of institutional design.

Fifthly there is the fact, as a number of respondents have noted, that the parameters of institution reform had already been set, and particular institutional prescriptions tested, through state sector reforms, initially in the corporatisation of state owned enterprises and subsequently in the reform of the core public service. In this sense the Reserve Bank Act enjoys a common lineage with much of the wider programme of state sector reform, and reflects a common set of theoretical antecedents, in particular, 'public choice' assumptions about the motivations of elected policymakers and the dangers of discretionary policymaking, and contractual remedies suggested by agency theory, although insofar as the formal status of the Reserve Bank in the context of the wider regime of public sector accountability was concerned, the particular institutional

prescription arrived at represented a compromise between the more theoretically informed SOE model, and the 'central banking' model.

The combined effect of these last three factors is strongly suggestive of the existence of an 'epistemic community' (Coleman and Skogstad, 1995), with a particular 'world-view' - in this case a world-view consistent with the rational economics literature reviewed in Chapter 2 - being promoted by policy entrepreneurs within the central bank and the Treasury, with support from key non-state actors within the wider policy network.

The Reserve Bank of New Zealand Act 1989 came into effect on the 1 February 1990, and remains in effect. In the light of the literature reviewed in Chapters 2 and 3, there is a very clear political logic to the project that the Act constituted. Muldoonism might have been remedied by a variety of reform programmes, but the fact that it was almost a caricature of opportunistic and discretionary policy making suggested the kinds of institutional remedies that the theoretical and empirical literatures presaged. The fact of those remedies already having been deployed in the reform of New Zealand's state owned enterprises, provided a model, and an emerging literature of dynamic inconsistency and central bank independence, supplemented that model. A Government which, by 1988 was unlikely to secure a further election victory, and, including Ministers for whom electoral considerations were increasingly secondary to a high order project of reform, was more likely to wish to tie the hands of its successor, even if, in so doing, it further alienated its natural constituency. Structural shifts in the economy had diminished the influence of manufacturing and labour interests, and elevated the status of sound finance. The quest had become one for credibility, and this element of the emerging institutional regime was elevated above all others. In terms of the political economy of central bank independence, one might venture the observation that, if any set of economic and political circumstances were ever such as to promote a statute like the Reserve Bank Act, those circumstances existed in the post 1984 period.

Chapter 6

From Monetarism to Labourism

Introduction

On the 3 June 1994 the then Leader of the Federal Opposition, Alexander Downer, repudiated a defining element of the policy that the Liberal and National Coalition had taken into the 1993 Federal election. The Sydney Morning Herald reported that,

"[t]he Leader of the Opposition, Mr Downer, has promised to retain the full employment objective in the Reserve Bank's charter, dumping a controversial policy commitment made by the Coalition before the last election.

Mr Downer told the Herald yesterday that he did not want the bank to become "an inhuman organisation", suggesting this would be the outcome of an inflation-only charter.

'I think the Reserve Bank should be given greater independence but I don't think that we should remove from its sight the need for Australians to have jobs,' he said" (SMH, 3/6/94).

The Herald suggested that the pledge by Downer represented a 'symbolic departure' from the policies advocated by his predecessor as Leader of the Opposition, former Reserve Bank Official and university economist, Dr John Hewson.

Whatever the symbolic import, the announcement effectively signalled the termination of a campaign to revisit the formal institutional arrangements within which Australian monetary policy had been conducted, and within which governments and the central bank had interacted, since the passage of the Reserve Bank of Australia Act in 1945. While it would be grossly incorrect to suggest that continuity in statute might be seen as suggestive of continuity in policy and practice - both were to change quite markedly over the two decades from 1974-1994 surveyed in this chapter - Downer's announcement of the change in Coalition policy represented nothing less than an acknowledgment of the defeat of an institutional model; moreover the model was one largely informed by the rational economics literature reviewed in Chapter 2, and viewed in some quarters, New Zealand not the least, as constituting institutional best-practice.

The focus in what follows is on the contested terrain of the institutions of central banking - by which we mean the formal, largely but not exclusively, statutory arrangements within which the Reserve Bank of Australia operates. Couched in terms

of the literature reviewed in Chapter Two, the focus is on issues of both goal and instrument independence. In specific terms these 'dimensions' of independence go to the charter of the central bank, the governance of the institution, relations between the Bank and the government of the day, relations between the Bank and the finance sector, and between the Bank and the wider community. But the focus is as much on issues of behavioural, as of formal institutional independence, inasmuch as behavioural manifestations of a lack of independence - of corrupted or porous institutional arrangements - are typically cited in support of changes to those formal institutional arrangements. What follows does not purport to be an analysis of the trajectory of economic policy over the period under review. Clearly changes in the domestic and international economy, and the merits or otherwise of economic policy instruments and the policy mix inform assessments of institutional arrangements. But the focus is on the latter, and the political-economy of the institutions of central banking.

This, and the following chapter review the period from 1974 to 1996 - a period of quite radical change in Australian public policy generally, and in the conduct of macro-economic policy in particular.¹ It is a period that sees governments of a variety of partisan persuasions, both Labor and Liberal-National Coalition governments, under Whitlam, Fraser, Hawke, Keating and Howard. And it is a period over which approaches to the conduct of monetary policy were to change quite markedly. It is a period over which the standard trajectory of policy reform, in certain respects at least, is reversed - a period that opens with a monetarist flourish, and closes with the denial of aspects of the monetarist orthodoxy. It is a period that opens with fixed and managed exchange rates, and financial market regulation, and closes with a relatively clean float, and significant financial market liberalisation. It is a period that opens with monetary policy being informed by money supply growth targets, subsequently replaced by a 'checklist' approach, and then the introduction of a form of inflation targeting. It is a period that sees a significant realignment within the official family of institutional advisers to federal government - the emergence of the central bank as an independent policy adviser, and a more equal relationship between that institution and the Commonwealth Treasury. And finally it is a period dominated by strong

¹ The review follows the historical sequence, drawing variously on academic accounts, commentaries by economic and political commentators, articles published in the serious press, and official publications - in the main Reserve Bank of Australia Annual Reports, articles and speeches published in the Reserve Bank Bulletin. Print media sources are used to identify key episodes and events over the period - and in particular the 1983-1994 period. The use of these print media sources does not in any way approximate a content analysis - they are used to illuminate the historical narrative, and, while occasionally reference will be made to the fact that material is sourced from an editorial, and that this can be taken both as indicative of the 'policy' of the paper concerned, and of the fact that the issue was deemed sufficiently important to comment on in a leader, there will be no analysis of the placement of stories, or any use of other quantitative and qualitative measures.

personalities, and vigorous policy debate and contestation - personalities within parties and governments, and personalities within the public sector institutions of macro-economic management. It is a period that opens with the Whitlam Government, the unravelling of the Bretton-Woods consensus in the face of the oil shocks of the early 1970s, and the onset of stagflation.

To anticipate the discussion that follows, the historical narrative over the period from 1972 to the end of the 1980s, can, in terms of the model introduced in Chapter 3 be conceptualised as three distinct periods in the process of the institutional reshaping of the Reserve Bank of Australia. The first period can be characterised as being one of a statist monetarism. It starts, albeit in a tentative and contested fashion in the closing years of the Whitlam Government, and continues under the Fraser Government, and the influence of the Coalition Treasurer, Philip Lynch. While arguably the conduct of monetary policy is by definition a 'statist' enterprise, the term is used here to illustrate the lack of independence of the Reserve Bank. Over this period policy decisions on monetary policy settings were typically made by the Cabinet Monetary Policy Committee, not the Bank. And over this period we see the adoption, and at a much earlier point than 'monetarist' administrations in other jurisdictions, of the targeting of monetary aggregates by the monetary authorities. It is a period of fixed, or 'moving peg' exchange rates. And while it is a period during which policy is very much informed by the tenets of the rational economics literature reviewed in Chapter 2, it is one characterised by tensions and inconsistencies between the arms of macroeconomic policy, and by rising unemployment. In terms of policy design, the imperatives are clearly towards maximising credibility and fighting inflation first; so far as policy outcomes in the wider political economy is concerned, it is a period in which policy fails to satisfy the test of legitimacy.

The second period is one which approximates the equilibrium condition of high endowments of both credibility and legitimacy. It is a period in which a number of confluences come together - most obviously it is, from 1983, a period of ALP Government. From opposition the Australian Labor Party had sought to craft a clear, in both procedural and substantive terms, an alternative to the statist monetarism characteristic of the closing years of the Whitlam Government, and much of the Fraser Government. Most importantly, in crafting that alternative industrial and political Labor had identified the need for a policy mix, and a set of institutional arrangements that would optimise both credibility and legitimacy - effecting a balance between the need for stable prices on the one hand, and employment growth on the other. That mix is one characterised by a corporatist (or bipartite, and labourist) accommodation on

wages and incomes, secured through a series of peak level Accords between industrial and political labor, and codified through the institution of the arbitration system. It is a period which sees the start of a process of significant structural adjustment, and the liberalisation of product and finance markets - most importantly it is a period that sees the floating of the Australian dollar, and the locus of responsibility for the development and implementation of monetary policy shifting to the Reserve Bank of Australia. Moreover, the institution of the central bank (including the central banking statutes) are accorded a renewed status through the Campbell Committee Report. The vehicle used to place the issue of financial market liberalisation and the opening of the capital account on the policy agenda, also reaffirms the defining elements of the post World War II 'Coombsian' design as being appropriate to the independent conduct of monetary policy. In short these confluences produce high endowments of institutional credibility and legitimacy. A statist monetarism is replaced by a credible labourism.

The third period sees the initial endowments of credibility undermined by a combination of factors, and presages the partisan contest for the central bank that we focus on in Chapter 7. From the literatures reviewed in Chapters 2 and 3 it is clear that the 1980s and early years of the 1990s would see the rational economics case for 'independent' central banks - goal dependent banks tasked exclusively with the achievement and maintenance of price stability, and provided with the operational independence to pursue that goal - reach its zenith. The 'Coombsian' institutional scheme was at variance with this prescription - whatever its substantive merits, the fact of it being viewed as the product of the Keynesian settlement was sufficient to call the credibility of the arrangement into question. More substantively, a charter directed to multiple objectives, an institution governed by a board (comprising professional and lay directors), and a relationship of consultative independence as between central bank and government were all at variance with the emerging orthodoxy. At times over the transition from the targeting of monetary aggregates to the use of open market operations the Reserve Bank did little to enhance its own credibility by being less than transparent about its own intentions and the stance or bias of monetary policy. In the closing years of the 1980s these perceived deficiencies would be made all the more apparent by the less than flattering comparisons drawn between the Australian arrangements, and the emerging New Zealand model. The appointment of an 'outsider' to the position of Reserve Bank Governor, a Treasury Secretary reputed to be wary of the power of interest rates, committed to the use of a multiple policy instruments directed to a broad set of goals, and enjoying a good working relationship with the Treasurer of the day would also be perceived, by some, as indicating at the very least a somewhat equivocal commitment to the policies of 'sound finance'. And, arguably more

important than all the foregoing, this period would see Australian economic policy making dominated by a charismatic politician with a capacity to move the market for good and for ill. It would see perceptions of the credibility of the institution of the Reserve Bank, and of the conduct of monetary policy more generally severely dented by Paul Keating's infrequent, but no less telling tendency to paint a picture of an institution that was, at best, lacking independence, and at worst, subject to direct political direction. In an environment where the perceptions of off-shore financial actors were shaped by political theatre and, at best, a superficial understanding of the Australian institutional arrangements, any suggestion of a central bank being in a politician's pocket would inevitably result in a loss of credibility, and the imposition of a risk premium. By the end of the 1980s these various factors would come together in a partisan contest over the Bank. By 1994 that political contest would be over, with the Reserve Bank itself becoming an active participant in the process of institutional reshaping, and in the restoration of its once eroded credibility.

The Whitlam Government 1972 - 75

The Whitlam Government came to office inheriting a relatively high inflation rate, and would leave office, in controversial circumstances, having arguably failed the test of economic management. But, to the extent that the test was indeed failed, that was as much a failure of the prevailing orthodoxy of the time, as of will on the part of Whitlam, and the diverse talents of his various Ministries. In 1979 Bob Hawke suggested that the former Prime Minister was "more interested in what was going on in Outer Baluchistan than in M3" (Hughes, 1980: 62), but Hughes suggests that,

"If he was lacking in economic ability and interest, he nevertheless sought and accepted the advice of those who were supposed to know about such matters. If he is to be faulted, then so much the advisers, whose views represented a fair reflection of the majority of economists at the time. Outer Baluchistan, or more likely China and Southeast Asia, might have been on Whitlam's mind, but he implemented the recommendations of the economists" (1980: 65).

Those economists had mixed views both on the prognosis for the Australian economy, and on the relative merits of monetary and fiscal policy as instruments of economic management. Monetary policy was largely informed by an emerging monetarist orthodoxy - monetarist in the sense that the focus of policy was directed, somewhat unsuccessfully, to the control of growth in monetary aggregates, but without a formal and explicit commitment to any kind of non-contingent money supply rule.

While inflation was on the policy agenda from the earliest days of the Whitlam Government, the policy response was anything but coherent. Whitlam and his advisers, who included former Reserve Bank of Australia Governor Dr 'Nugget' Coombs, were conscious of the inflationary consequences attendant upon the Government's fiscal policy settings:

"As 1973 unfolded it became quite clear that earlier fears of an economic relapse were unfounded. The government's advisers, particularly those in the Treasury who had never stopped believing that a boom was imminent, but also members of Whitlam's personal staff like Dr Coombs, began to worry about the possibility of demand inflation. The economy was rapidly approaching full employment at a time the government appeared ready to unleash a burst of spending in pursuit of its policy objectives. The danger was that the spending would strain resources and lead to inflation" (Hughes, 1980: 63).

In the 1973 budget Treasurer Frank Crean indicated that the 'anti-inflationary fight' was to be based on a mix of tariff cuts, revaluations of the currency, and a Price Justification Tribunal (Hughes, 1980: 66). However the policy mix was spectacularly unsuccessful and as late as September 1973 money supply growth (M3) exceeded 25 per cent per annum (Hughes, 1980: 67).

With the benefit of hindsight, more than twenty years later, John Edwards would observe that, the resistance to 'monetarist' remedies notwithstanding,

"[o]n Sunday 9 September 1973, in a decision that had quite as much to do with the subsequent electoral rejection of the government as the antics of Rex Connor, the Prime Minister, his deputy and the Treasurer agreed to an increase in interest rates and an increase in the exchange value of the Australian dollar" (1996: 122).

This 'dramatic' tightening, Edwards suggests, was on the advice of the Reserve Bank and Treasury. But it was insufficient, and in 1974 with the inflation situation deteriorating Whitlam and his Ministers were being advised the Federal Treasury to administer a 'short sharp shock' to the economy - and to inflation expectations in particular - by means of a monetary policy tightening.² Addressing the Premiers Conference on the 7 June 1974 Whitlam suggested that:

² Hughes suggests that one of the consequences of the splits within the ALP Government was that Treasury was effectively side-lined from the policy debate:

"But it had only itself to blame, putting up on this occasion as on so many others only a single method of attacking the problem. It is not a defence, even if true, to suggest that theirs was the only policy that would work. They were not prepared even to try the alternatives that had been suggested. It is this basic arrogance that has to be the main mark against senior officers, particularly the key policy adviser, John Stone" (1980: 89).

"Inflation must be checked, and it must be checked decisively We - all of us - must break those inflationary expectations. We must show that those who bank on double digit inflation continuing will be proved wrong and see that they find the lesson an expensive one..." (in Hughes, 1980: 86).

But Whitlam was unable to carry the day within his own Cabinet, and in delivering the 1974 Budget Treasurer Crean outlined a policy prescription that was very much at variance with the 'short sharp shock' being advocated. Crean advised the House that:

"The conventional response to inflation has relied almost entirely on the creation of mass unemployment. Those who advocate such a course in present conditions are unable to say what level of unemployment would markedly reduce inflation. The government is not prepared deliberately to create a level of 4 or 5 percent, or perhaps even higher unemployment ...

Crucial as the fight against inflation is, it cannot be made the sole objective of government policy ... The government's overriding objective is to get on with our various initiatives in the fields of education, health, social welfare and urban improvements. The relatively subdued conditions in prospect in the private sector provide the first real opportunity we have had to transfer resources to the public sector" (in Hughes, 1980: 91).³

By early 1975 Bill Hayden had replaced Crean as Treasurer, and, against the wishes of a hostile ALP caucus a more orthodox approach to macroeconomic management had been put in place. The 1975 Hayden Budget indicated a break from any orthodox post-war Keynesianism, and a repudiation of long-run policy trade-offs. Hayden stated:

"We are no longer operating in that simple Keynesian world in which some reduction in unemployment could, apparently, always be purchased at the costs of some more inflation. Today it is inflation itself which is the central policy problem. More inflation simply leads to more unemployment" (in Whitwell, 1986: 217).

The Fraser Government 1975-83

With the sacking of the Whitlam Government Malcolm Fraser came to power, at the head of a Government convinced of the need for a clean break with the post-war

³ For its part the Reserve Bank, while acknowledging the challenges posed by the onset of stagflation, favoured a more restrictionist policy prescription, noting in its Annual Report for the year ended 30 June 1975 that,

"The complex relationships emerging between levels of unemployment and the rate of growth in prices make it exceedingly difficult to choose the most appropriate policies; nevertheless, there are strong grounds for belief that, in current circumstances, over-reliance on simple expansionary policies may do more in the medium to longer run to fuel both inflation and unemployment than to cure either of them. Firmer policies would perhaps be associated with lower levels of activity in the short term, but seem to offer the best chances for sustained reductions in both inflation and unemployment over the longer run" (RBA Annual Report, 1974/75: 45).

economic orthodoxy, and looking to monetarist policy alternatives. Phillip Lynch, who was appointed as Treasurer, "had been the pioneer convert to monetarism amongst Liberal politicians. Now he was Treasurer with the full servicing of a department also committed to an inflation first strategy" (Hughes, 1980: 126).

In January 1976 monetary policy was tightened using Australian Savings Bonds, a tightening which Hughes suggests indicated "the dominant role of monetarist theory at court" (1980: 129). In a Ministerial statement on the 4 March 1976 Lynch identified the primacy attached to controlling inflation:

"If there is one single element which is fundamental to all that I shall have to say today, it is the absolute necessity of combating inflation ... A recovery which took place with inflation poised to take off again from its present double-digit rate would inevitably be short-lived..." (in Hughes, 1980: 132)

The Government, supported by the Reserve Bank of Australia and the Treasury, espoused an 'inflation first strategy', with monetary policy - targeted at a money supply growth target range - and fiscal, and wages policies directed to reining in inflation. Whitwell observes that in 1977 Treasury argued that,

"... 'control of inflation is fundamental to the achievement of other economic policy objectives'. The other major problem, that of unemployment, had to stand in line behind inflation and could not be attended to until prices and wages had been brought into order. That the twin problems of inflation and unemployment could not be dealt with simultaneously and that the unemployment situation might in fact deteriorate in the meantime, was taken to be an unfortunate but unavoidable fact of life, yet another of the Treasury's 'economic realities' that the community had to bear with patient acceptance. Top priority was given to the restoration of business confidence. This required a marked improvement in the profitability of business activities and the restoration of some sort of normalcy in the historical relationship between wage and profit shares" (1986: 217).

This preference for policy directed at the control of inflation was reflected in prescriptions that, in part at least, bore the hallmarks of the neo-classical paradigm. Policy was to be directed at the medium term, and designed to manage expectations, and maximise credibility. But policy discretion was still valued over adherence to a rule based regime - it was monetarism practised within a constrained discretion:

"The Treasury argued that another useful role the government could play was the establishment of monetary targets or ranges. Unlike Friedman, the Treasury stressed that it was in favour of 'conditional projections' rather than 'precise and rigid' M3 targets. But it believed that the announcement of projections could provide a greater degree of certainty and predictability for decision makers ...

More specifically, the announcement of monetary projection ranges had three main aims. First to 'demonstrate that the aims of monetary policy fit within a coherent overall policy'. Second, and again the Treasury departed from Friedman with its reference to the need for some discretion, to 'indicate that greater medium-term "steadiness" in monetary management is to be pursued but without abandoning an appropriate measure of discretionary responsiveness'. Finally, and perhaps most important to the Treasury, 'by providing a peg of stability, attempt to exert a direct influence upon public expectations, which in present -day conditions are central to the inflationary process' ...

... by the mid 1970s ... the Treasury had become sympathetic to the neo-classical line that intervention should aim to provide a stable, orderly environment for economic activity by setting rules and establishing a clearly defined framework. Such a framework did not of course preclude changes in policy. But the Treasury insisted that changes should occur only gradually, should be clearly articulated, and should be understood by all. The discretionary element had to be exercised with extreme caution" (Whitwell, 1986: 228).

In their advocacy of a neo-classical policy prescription the Commonwealth Treasury and the Reserve Bank were at the leading edge of what, under Thatcher, Reagan, and others was to be an intellectual climate in which policy was very much informed by varieties of monetarism, and more generally, a commitment to market liberalisation and a minimalist state.

"... in Australia the Treasury took the lead in the 1970s in propagating the neo-classical faith. Standing aloof from those who sought a solution to economic instability by the adoption of a prices-incomes policy, that 'particular piece of witchcraft' as John Stone called it, the Treasury insisted on the need to give greater scope to market forces, to 'fight inflation first', to forsake expansionary policies and move towards budget balance, and to take inflationary and rational expectational responses into account" (Whitwell, 1986: 264).

Over time, that prescription would see central banks increasingly possessed of operational independence in pursuit of price stability mandates. But the preference for fighting inflation first was not reflected in any great measure of formal independence for the Reserve Bank. Key monetary policy decisions were made by Cabinet Committees, and in 1977 Fraser established a Monetary Policy Committee and a Wages Committee to replace a Cabinet Economic Committee. However one consequence of the establishment of these Committees, was that the Government had access to a wider range of policy advice, and the Reserve Bank started to come out from under the wing of Treasury. Weller observes that,

"The Monetary Policy Committee was responsible for issues that had traditionally been kept isolated in the Treasury, or had finally been decided by the prime minister and the treasurer. It brought crucial economic decisions (on, for example, interest and exchange rates) into the cabinet arena, so that departments other than Treasury became involved in advice on economic

policy. The Reserve Bank became more influential, so did PMC [the Department of Prime Minister and Cabinet] ... "(1989: 128).

Part of this improvement in the status of the Reserve Bank relative to the Treasury can be sheeted back to tensions between Treasury Secretary, John Stone, and both Prime Minister Fraser and successive Treasurers, tensions which were to continue to characterise the relationship between the Treasury, under Stone's stewardship, and the incoming ALP Government in 1983. One of the results of the at times strained relationship between Stone and his Treasurer was that the latter was increasingly inclined to seek policy advice from elsewhere. The Reserve Bank was a beneficiary, with Treasurer John Howard exhibiting a preference for seeking advice from the Reserve Bank to complement, if not at times contest, that provided by the Treasury. Those differences between Treasury and the Reserve Bank would surface in the preparation, delivery, and response to the Report of the Campbell Committee Inquiry into the Australian Financial System,

The Campbell Committee Inquiry into the Australian Financial System

In February 1978 the Cabinet Monetary Policy Committee took a decision to initiate an inquiry into the Australian Financial System, and on the 18 January 1979 Treasurer John Howard announced the establishment of a committee headed by Mr J K Campbell, the Chairman and Chief General Manager of Hooker Corporation Limited. The Reserve Bank was represented on the Committee by Mr J S Mallyon, the Bank's Chief Manager. An interim report of the Committee was tabled in Parliament on the 28 August 1980, and the Committee delivered its final report on the 29 September 1981.

The Report of the Campbell Committee is cast in terms of the need to promote a financial system that would be efficient, competitive, and stable; and to this end a raft of recommendations are advanced, the essence of which is captured in the following:

"The Committee's study ... has led it to recommend the immediate or ultimate abandonment of a wide range of direct controls and a shift to almost total reliance on open market methods of intervention in domestic financial markets. It has also recommended reduced levels of intervention in foreign exchange markets, freer entry conditions to banking, and the disposal of some government-owned financial institutions. In these areas the Committee is, in effect, asking that more confidence be placed in the disciplines and processes of the market" (1981: xxviii, emphasis in original).

The Committee recommended the removal of interest rate controls, entry for foreign banks into the Australian banking system, the relaxation of exchange controls and the floating of the Australian dollar (Whitwell, 1986: 248).

The terms of reference for the Committee required it inter alia, to,

"Inquire into and report on the structure and methods of operation of the Australian financial system including ... the Reserve Bank of Australia",

and

"[t]o make recommendations ... concerning the existing legislation relating to the financial system including more importantly the Reserve Bank Act ..."

As a consequence the Campbell Committee Report provides a very detailed examination of the conduct of monetary policy by the central bank, and the appropriateness of the institutional arrangements within which that policy was to be determined and implemented - an examination informed in part by the submissions made to the Committee. The significance of the Campbell Committee Report recommendations for the Reserve Bank, recommendations which were, in large part, to be implemented by the Hawke ALP Government, cannot be overstated. And as the discussion in this and subsequent chapters will indicate, financial deregulation and the floating of the Australian dollar in particular would be the single greatest driver of changes in the role and status of the Reserve Bank, and the absence of statutory changes notwithstanding, of the institutional arrangements within which the Bank would be situated. The Campbell Report recommendations would result in a greater measure of independence for the Reserve Bank of Australia. This is not to suggest that changes to the formal institutional arrangements were not countenanced. The Committee considered the challenge posed by the Bank's multiple objectives, acknowledging that

" ... at times, it may be difficult for the Bank to reconcile its chartered responsibilities to seek, concurrently, price stability, full employment and the economic prosperity and welfare of the people of Australia. However, the Committee does not consider it appropriate to seek to confine the Bank to a narrower, more exclusive objective, such as price stability. The various objectives of the Bank are inextricably linked. They are also affected by policy decisions and responsibilities which extend beyond the limits of the Bank's powers. Discussion of the role of the Reserve Bank, particularly its relationship to government, needs to reflect these interdependencies" (1981: 19).

So far as the vexed question of the Bank's formal relationship with the government of the day was concerned, the Committee was not prepared to support legislated

independence, citing the constitutional primacy of democratic government over independent governance:

"[P]roposals to make the Bank fully independent of government would, in the Committee's view, amount to the substitution of bureaucratic for political discretion which would be inconsistent with the processes of democratic government. Quite apart from constitutional limitations, it would be thoroughly undesirable for the Bank to hold to a monetary policy which did not have the support of the Government and the Parliament" (1981: 19).

The Committee went on to state that it was,

"... firmly of the view that the ultimate determination of and responsibility for overall economic policy - including monetary policy - cannot be effectively divorced from government and Parliament. It is also important that the monetary authorities be effectively accountable to the public and the Parliament. This requires a clear identification of responsibility. To the extent that the present arrangements create uncertainty in the public's mind as to where responsibility lies for overall monetary policy, it is desirable that they be clarified. Similarly, it is desirable that the community be kept well informed of the objectives underlying the Bank's monetary policy and any constraints on the implementation of that policy" (1981: 20).

However the Committee acknowledged that the Bank's mandated charter objectives could place it in a situation of conflict with a government concerned to exploit monetary policy for short-term electoral advantage:

"The Committee recognises that the policies desired by government may cut across, to some extent, the Bank's statutory responsibility to the general community. Thus a government may wish to see official interest rates held at a level which is not realistic in the view of the market; this may impinge on the Bank's responsibilities, as a central bank, to protect the stability of financial institutions and markets; it may also bear heavily on the Bank's obligation to pursue monetary and banking policies designed to preserve the stability of the currency and to promote the Bank's full employment and community welfare objectives" (1981: 20).

This threat notwithstanding, and, arguably, in the full knowledge that the drivers in liberalised financial markets would in and of themselves impart disciplines on the central bank and on governments, the Committee recommended in favour of the existing institutional arrangements, concluding that:

"... the Bank's broad legislative powers are both appropriate and sufficient to enable it to pursue effectively its chartered objectives. The system as a whole encourages consultation and co-operation between the Bank and the Government; if the Bank believes it is being pushed beyond reasonable limits it has the discretion and the obligation to hold firmly to its view and ensure its concerns are brought to the attention of the Parliament. Ultimately, however, the Bank cannot rise above the source of its powers - government and

Parliament - and must be responsive to the direction which governments may deem fit to give" (1981: 20-21).⁴

The recommendation was for the retention of the status quo:

" the Committee recommends that:

- (a) Existing provisions of the Reserve Bank Act defining the overall policy relationships between the Bank, the Government and the Parliament be retained.
- (b) In particular, the Committee sees no need for change in the present provisions for resolution of differences of opinion between the Reserve Bank Board and the Treasurer (Section 11).
- (c) Arrangements relating to the implementation of monetary and banking policy should be such as to ensure that the Bank has clear capacity to respond to market developments" (1981: 21).

And while some submissions had argued that the Reserve Bank should enjoy a greater measure of independence from the Treasury, in the name of enhanced policy co-ordination the Committee recommended against the removal of the Secretary to the Treasury as a member of the Reserve Bank Board:

"In the Committee's view, it is highly desirable that close liaison be maintained between the Bank and other policy agents of the Government - particularly the Treasury - as the basis for efficient co-ordination of economic policy, especially in policy matters of mutual or overlapping responsibility. The Committee endorses, as appropriate to this end, the continued presence of the Secretary to the Treasury as a member of the Board. Liaison at the working level between officers of the Bank and Treasury and other areas of the Public Service should not only lead to greater co-ordination of overall policy, but also minimise the use of resources in areas of mutual responsibility including advice to the Treasurer or the Government. Liaison between the Bank and other areas of the Public Service should not always require the direct intermediation of the Commonwealth Treasury" (1981: 22).

⁴ The Committee commented that:

" 2.32 ... The present arrangements appear to have provided a good framework, and are appealing from a number of viewpoints:

- The Government properly has ultimate responsibility for the determination of overall monetary policy.
- Subject to this, the Reserve Bank has all the formal powers it needs to effectively formulate and implement monetary policy. In this respect it should be noted that the adoption of the Committee's recommendations in other chapters of this report will tend to shift the emphasis of monetary policy away from instruments such as bank interest rates - which at present, formally require the approval of the Treasurer before change is effected - towards instruments such as open market operations, which are matters where greater discretion has already been given to the Bank.
- There is a sensible presumption in favour of the Bank, Government and Parliament reaching consensus on important issues of monetary policy ..." (1981).

Clearly a premium was to be placed on policy co-ordination, but this was not to be at the expense of a subservient central bank, with a balance being sought between unnecessary duplication in advice to government - the minimisation of 'the use of resources in areas of mutual responsibility' - and some measure of contestability in that advice flow. The Reserve Bank was to be a member of the 'Official family' in its own right, not at the behest of the Treasury or its permanent head.

The Committee recommended that:

- "(a) The Secretary to the Treasury should continue to be ex officio, a member of the Board of the Reserve bank.
- (b) There should continue to be regular liaison between the Reserve bank and the Treasury, and appropriate liaison between the Bank and other economic policy areas in the public sector" (1981: 22).⁵

In addition, the Committee noted approvingly the greater openness, and increased accountability attendant upon the kinds of arrangements by which the Chairman of the US Federal Reserve reports to Congress and Congressional Committees (the 'Humphrey-Hawkins' arrangements).

So far as the 'governance' arrangements for the Bank were concerned the Committee advised that care would need to be taken if any change in the balance between 'full-time' (or public service) and 'part-time' appointments to the Board were to be entertained, suggesting that such changes might impact on the trade-off between, or relative weighting of, co-ordination on the one hand and independence on the other. The Committee reaffirmed the continuation of the prohibition on appointment of individuals from the finance and banking sector to the Bank board, recommending an extension of the prohibition to financial intermediaries:

"... that the present provisions of the Reserve Bank Act designed to preclude from Board membership persons involved wholly or mainly in the business of banking should be extended to apply to persons associated with the operation or management of businesses which are wholly or mainly financial intermediaries" (1981: 25).

⁵ This desire that the Reserve Bank enjoy a greater measure of independence was also reflected in the Committee's view that the Bank should enjoy a measure of quasi-constitutional independence such that reporting relationships of a bi-partisan kind might be appropriate:

"... the general climate of government in Australia would be enhanced if there were greater opportunities for meetings between the Reserve Bank and members of Parliament, especially the Leader of the Parliamentary Opposition" (1981: 22)

A number of other possible changes to the governance and management of the Bank were considered by the Committee, including

- a person other than the Governor being chair of the Board
- increasing the size of the Board
- prescribing the membership of the Board to ensure representation of specific sectors and interest groups
- prescribing that no more than two members of the Board be engaged full time in the work of the Bank
- extending the term of non-executive directors from 5 to 7 years

While recommending that no change be made to the status of the Board as the source of policy decisions, the Committee suggested that the Governor of the Bank be the institution's one 'unequivocal spokesman', chairman of the board, and Chief Executive Officer. The Committee concluded that it saw,

" ... no particular benefits flowing from any changes to the legislative prescription of the Board's composition. While endorsing the nexus of the positions of Governor and Chairman of the Board and accepting the legislative possibility of other executive members, the Committee considers that a majority of the Board should continue to be drawn from outside the Bank and Public Service " (1981: 26).

The issues traversed by, and recommendations emanating from the Campbell Committee are significant for a number of reasons. In terms of the mix of policy the Committee clearly saw no disjunction between the retention of the formal institutional status quo, while at the same time recommending what was at the time, and would subsequently be perceived as being, a fundamental reconfiguration of the Australian financial system. Far from being anachronistic, the Committee saw in the 'orthodox' institutional arrangements - the Coombsian Scheme - a capacity to accommodate the demands associated with financial deregulation. However the Campbell Committee Report and recommendations were not to see meaningful closure on the question of the independence of the Reserve Bank of Australia, the nature of its mandate, its governance, and its relationship with governments. The issues traversed in the Campbell Committee Report would continue to be debated and contested, and to engender a high degree of polarisation over the most appropriate institutional framework for the Australian central bank.⁶

⁶ Moreover the implicit agenda adopted by the Campbell Committee in reviewing the Reserve Bank and its governing Act, is largely reflected in the policy debate over the period reviewed in this chapter - the charter, the role and composition of the Board, and relations between Bank and government (including the utility of the statutory disputes procedure). This 'agenda' serves as a template in structuring the analysis in subsequent chapters.

Explaining the reluctance of Malcolm Fraser and Treasurer John Howard to implement the recommendations of the Campbell Committee Report is outside the scope of this chapter. The record suggests that while the Reserve Bank was somewhat more enthusiastic than the Treasury, both institutions harboured reservations about key elements of the Committee's package of recommendations, and that, as a result, there was a lack of political will on the part of Ministers:

"It is too simple an explanation to blame Howard alone; the Peacock leadership challenge, a tough budget debate, the furore over tax evasion, were all time-consuming, particularly for the new deputy leader who had increasingly become the government's trouble-shooter, the voice of a beleaguered government. The report was complex and integrated. Importantly Treasury was opposed. According to one adviser: 'Every single deregulatory measure through to the floating of the Australian dollar and the licensing of new banks was opposed by either Treasury or the Reserve Bank, every single one of them'. The government was not prepared to act in the face of Treasury's opposition and was not confident that the Treasury would implement enthusiastically a policy it opposed.." (Weller, 1989: 382).

For its part the Reserve Bank commented in its Annual Report for the year ended June 1982 that the Bank was,

" ... in broad agreement with the Committee's basic objectives of a less regulated, more open and competitive financial system, with adequate attention being paid to stability. By its nature the Report is concerned with the characteristics of a more efficient financial system, rather than the means of moving to the desired state; it is essentially a blueprint for a future financial system. The Bank, on the other hand, is concerned with the merits of the recommendations and with the feasibility and most efficient methods of introducing them...

Reform is likely to be a more drawn out and uneven process than some might wish. For its part, however, the Bank will continue to work at devising improvements in the system, even though implementation may have to wait upon future suitable opportunities" (RBA Annual Report, 1982).

From Fraser to Hawke: the emergence of the 'labourist' alternative

The standard political taxonomies fail to capture the complexity of the policy mix, and the ideas informing policy design, under the Fraser Governments over the period from 1975 - 83. The Government did enjoy some short run success in bringing down inflation, which had peaked at an annual rate of 17.6 per cent in the year to March 1975, but which was down to 7.9 per cent for the year ended June 1978. However by the end of the decade the Reserve Bank was reporting that, for the year ended June 1980, the consumer price index had risen by 10.2 per cent, year on year, some 2 percentage points higher than in 1978/79. Moreover, while employment growth

strengthened in 1979/80, unemployment averaged 6.1 per cent, or a little under 400,000 (RBA Annual Report, 1980).

In terms of the ideological seams from which policy emerged, Hughes suggests that the approach reflected a trinity of disparate ideas:

"Friedman's monetarism (which seems initially to have been sold to Lynch rather than Fraser) could be used to support a connection between government spending, deficits, money supply growth and inflation. Fraser's physiocracy (again with assistance from Friedman) established the nexus between government spending and taxation, and, given monetarism, supported the proposition that bigger deficits, if they were not to be inflationary, would have to be financed by higher interest rates. And the Treasury's espousal of another Friedman idea, inflationary expectations, gave further respectability to the proposition that curbing government spending (in reality to maintain unemployment for a period) was necessary to reduce inflation" (1979: 39).

For the Government's part, there appears to have been some attraction in monetary growth targets, expressed as a range, being included with the Budget documentation. Weller reports that in preparing for the 1979 Budget the Cabinet's Co-ordination Committee decided to include a projection, the range to be determined by the Committee or by the Prime Minister, his deputy, and the Treasurer (Weller, 1989: 243). Certainly the analysis advanced in the Reserve Bank Annual Reports towards the end of the decade is strongly suggestive of a monetarist approach, at least in the narrow sense of targeting growth in monetary aggregates. In the Annual Report for the year ended 30 June 1980 the Bank reported that:

"The immediate objective of monetary policy in 1979/80 was to achieve some slowing in the rate of growth of money and credit. The purpose of this was to support a more general aim of bringing about a lower rate of inflation. Achievement fell short of the objective.

In fact, in 1979/80, for the second year running, the monetary aggregates grew much faster than was needed to sustain activity and at the same time to control inflation ...

The year's increase in money volume (M3) was nearly 13 percent more than in any year since 1975/76, and contrasting with the recent low of 8 percent in 1977/78" (RBA, Annual Report, 1980: 4-5).

For its part the Treasury was also committed to an anti-inflation strategy predicated on controlling the growth in monetary aggregates and managing expectations over a medium-term time-frame:

"As Stone argued in 1981, a 'prime requirement' of economic policies 'is that they should promote a high degree of certainty as to basic philosophy and

approach; there should be a public knowledge that certain courses will be pursued with determination and that an ad hoc and band-aid treatment will be abhorred. These sorts of ideas ... lay behind the department's support for the announcement of conditional projection ranges for growth in M3. The Treasury argued in TEP no.9: 'In a world characterised by high inflation and, partly related to that, instability and uncertainty, an appropriate and credible monetary protection provides an element of stability and certainty and a manifest (sic) of the anti-inflationary intent of policy - a 'light' for the private sector to steer by" (Whitwell, 1986: 267).

The following year the Reserve Bank's Annual Report was again couched in terms of movements in monetary aggregates:

"Monetary policy was aimed at reducing the rate of expansion in money and credit but, for the third successive year, achievement fell short of the objective...

The overall outcome was one of too rapid growth in money and credit. A widely used measure of money, M3, increased by 12.7 percent, its highest rate of growth since 1975/76 ... When viewed in the context of strong monetary expansion in preceding years, monetary policy is seen as having been more accommodating to increases in wages and prices than was desirable..." (RBA Annual Report, 1981: 4)

The Report also suggested that decisions on 'officially controlled interest rates' - those rates set by the Cabinet Monetary Policy Committee - had been inconsistent with the objective of controlling inflation:

"Policy can best contribute to growth in activity by exerting downward pressure on inflation. With this in mind, the need to reduce the rate of growth in money and credit remains of central importance. Recent experience suggests that this will require greater willingness to adjust officially controlled interest rates in response to changes in market conditions.." (RBA Annual Report, 1981: 4).

The Bank concluded that, "[o]n a broad view of these developments, it appears that monetary policy has been unduly accommodating to inflationary pressures" (1981: 15).⁷

On the 5 March 1983 the Australian Labor Party (ALP) assumed federal office under the leadership of Bob Hawke. Paul Keating, who had served briefly in the Whitlam

⁷ The suggestion that the threat to an anti-inflation strategy rested with those responsible for controlling 'official interest rates' - who were also responsible for the budget strategy - is shared by Hughes who, in commenting on the merits of 'Friedmanite' money growth targets suggests that:

"The idea has a sorry history in Australia. In the 1978 budget John Howard told employers at large and the Arbitration Commission in particular that wage increases bigger than implied by the firm money supply guidelines it had adopted could only lead to 'throwing more people out of work'. In the event, however, the government proved less than resolute, abandoning its self imposed monetary target to keep down interest rates. Money supply (M3) rose by 11.8 per cent rather than the 6 to 8 per cent range originally specified. It was governmental resolve that cracked rather than the desire for wage and price increases" (1980: 220).

Cabinet, was appointed Treasurer. The Government came to power with a programme underpinned by an ALP/ACTU policy agreement, pitched both in political and policy terms as an alternative to the prevailing monetarist orthodoxy.

In the aftermath of the defeat of the Whitlam Government the ALP had sought to identify a 'third way' policy approach differentiated both from the orthodox Keynesianism and fiscal excess of the Whitlam years, and the quasi-monetarism of Fraser:

"The Whitlam government had failed in its efforts to reduce high inflation and high unemployment by means of a Keynesian strategy of managing demand. The Fraser government's 'inflation-first' approach ..., which had some basis in monetarist economic theory, concentrated in reducing the growth of the money supply and public sector spending. It accepted unemployment as a cost factor and sought a reduction in real wages. But this too failed to overcome the malaise of stagflation. Labor, therefore, had to find a policy that would simultaneously tackle inflation and unemployment, offer an alternative to Keynesian and monetarist strategies and be attuned to Labor's philosophical objectives" (Singleton, 1990: 100).

The answer was seen to rest in a two-dimensional approach - "long-term democratic economic planning as a modification of Keynesian demand management, combined with an incomes policy focused on wages and tax indexation to provide wage restraint to dampen any inflationary side-effects of the economic recovery" (Singleton, 1990: 111). The 1979 ALP Conference endorsed an approach to the Australian Council of Trade Unions with a view to the negotiation of an incomes policy that would meet the objectives of both wings of the labour movement - Labor in government and the trade unions (Singleton, 1990: 119). At that Conference a compromise position was advanced by the passage of an amendment moved from the floor of the Conference by a Victorian delegate. That amendment provided that the ALP,

"... consult with the trade union movement to develop and implement an anti-inflationary policy which will encompass prices, wage incomes, non-wage incomes, the social wage, taxation reform, and elimination of tax avoidance, and which will achieve a more equitable distribution of our national wealth and income" (quoted in Singleton, 1990: 116, emphasis added).

It is noteworthy that the point of departure, in terms of policy objectives, was the need to develop and implement an alternative means of delivering price stability. The positioning of an incomes policy as a solution to both high inflation and high unemployment was to be feature of early drafts of the Accord. In a document prepared by a Working Party of the Australian Labour Advisory Committee (ALAC) - "Discussion Paper on Economic Policy" - the ALP and ACTU representatives

advanced a 'Statement of Accord' in which an alternative policy prescription was foreshadowed:

"[W]ith inflation being high when unemployment is high, sustained economic recovery sufficient to restore and maintain a situation even remotely resembling full employment is not possible whilst reliance is placed solely on conventional economic weapons of fiscal, monetary and exchange rate policy, however varied and applied" (1982: 3-4).

The monetarist solution, the key feature of which, the authors argued, "is a severe restriction of the rate of growth of the money supply, on the assumption that this will gradually bring inflation down to low levels, thus breaking inflationary expectations, and enabling a non-inflationary expansion of the economy then to occur" had, it was argued, proved to be disastrous. The alternative to the Fraser Government's adoption of monetarism was seen to rest in the development of a mutually agreed prices and incomes policy:

"Such a policy offers by far the best prospect of enabling Australia to experience prolonged higher rates of economic and employment growth, and accompanying growth in living standards, without incurring the circumscribing penalty of higher inflation, by providing for resolution of conflicting income claims at lower levels of inflation than would otherwise be the case" (1982: 5, emphasis added)

This 'discussion paper' drafted by a joint ALP Working Party that included Bill Hayden, Ralph Willis, Charlie Fitzgibbon, Bill Kelty, and Jan Marsh, would serve as the basis of the first of a number of Accord Agreements which would underpin policymaking under successive ALP Governments. It is particularly noteworthy that the genesis of the Accord reflects a concern to address inflation and unemployment. Moreover of those who were involved in the drafting of the 'discussion paper' - the progenitor of the successive Accord agreements - one, who had formerly been a Reserve Bank board member was to become Prime Minister, one was a former Treasurer, and would eventually be appointed Governor-General, one would be appointed as Treasurer in the Keating government, and two others would serve terms as members of the Reserve Bank board, - Charlie Fitzgibbon serving on the board from 8 December 1983 until 7 December 1988, and Bill Kelty, the ACTU Secretary, serving on the board from July 1987 up until shortly after the 1996 election. The involvement of key individuals whose interests and competencies traversed the industrial relations system, and the issues of macroeconomic management more generally would presage an orientation to macroeconomic management that placed a premium of policy co-ordination directed to multiple objectives, one of which was price stability.

Within the Reserve Bank and the Treasury the preference was very clearly for a medium term strategy directed to bringing inflation down through the use of money supply growth targets (albeit expressed as a range), fiscal discipline, and wage restraint. Monetary policy decision making, while formally vested in the Board of the Bank was shared between the Bank, Treasury, and a Cabinet Committee advised by officials. Day to day operational decisions about the exchange value of the dollar were made by a committee of officials - the Secretary of the Treasury, the Secretary of the Department of Prime Minister and Cabinet, the Secretary of the Department of Finance, and the Governor of the Reserve Bank (Edwards, 1996: 214). The recommendations of the Campbell Committee Inquiry had not been actioned, reflecting in part a lack of political will on the part of a government that had tended to resort to regulation over market liberalisation in its latter years, and considerable resistance within the 'official family' - and the Treasury in particular - to much of what had been recommended. Moreover a lack of transparency in monetary policy making was reflected in an information asymmetry that worked against Ministers. Weller reports that an economic adviser to Prime Minister Malcolm Fraser, "complained that as usual Treasury and the Reserve Bank had retained a monopoly over information about the money supply and that he wanted to see the basis of their estimates " (1989: 253), and Edwards suggests that the incoming ALP Government was equally hamstrung:

"When Labor took office the official (though secret) quarterly forecasts of output, inflation and unemployment were still controlled almost entirely within Treasury. Through his chairmanship of a four member committee that instructed the Reserve Bank foreign exchange desk, the Secretary of the Treasury controlled exchange rate policy for Australia. Treasury also controlled monetary policy, through its control over the funding of government operations and thus, by a little noticed extension, the buying and selling of government debt by the Reserve Bank" (1996: 179).

The Reserve Bank's Annual Report for the year ended June 1983 was released in August 1983, some four months after the election of the Hawke Government. The Report noted that over the 1982/83 year the Australian economy, "suffered a severe shakeout. The conjunction of our high inflation and the prolonged sluggishness of the world economy caused a serious weakening in activity and employment, accompanied by a sharp increase in unemployment" (RBA Annual Report, 1983: 4). For the year ended June 1983 the consumer price index increased by 11.2 per cent, and unemployment had reached 10.3 per cent. The Annual Report suggests problems with policy co-ordination as the Bank sought to bear down on inflation, while at the same time attempting to accommodate fiscal policy settings:

"Like the other elements of overall economic policy, monetary policy began the year principally directed at the persistent problem of rapid inflation. Although

concerned at the high level of interest rates, the Board sought to conduct policy to maintain a firm grip on monetary conditions and to continue to slow the growth of financial aggregates. The best chance of a sustainable reduction in interest rates would lie in a lower rate of inflation" (1983: 4).

In the face of a contracting economy the Reserve Bank was reluctant to tighten policy, but equally reluctant to risk an increase in the Australian rate of inflation which, the Bank noted, was out of line with rates in the rest of the world. In deciding against a tougher approach the Bank was concerned not to further depress already weak economy activity, and at the attendant damage to both the legitimacy of the institution and 'sensible policies' over the longer-run:

"In the circumstances of late 1982, a tougher approach, intensifying the pressure on the private sector, would have resulted mainly in further cuts in employment and increases in bankruptcies. It had to be recognised that inflation in 1982/83 had its origins in earlier monetary conditions and in past increases in labour costs and government charges. As well as pushing up prices in the near term, these cost increases were leading to a fall in activity which would, in time, help to restrain further inflationary pressure. A significantly tougher monetary policy might have hastened this process and brought inflation down more quickly but it could also have jeopardised the longer-run acceptability of sensible policies" (1983: 5).

Clearly the task of bringing down inflation was one that, in the Bank's assessment, would require a measure of harmonisation and co-ordination across monetary, fiscal, and wages and incomes policies. Moreover the economic and political costs attendant upon a 'tougher approach' were such as to call into question any policy of an exclusive focus on price stability. Interestingly the Report suggests a degree of discomfiture with an overly orthodox monetarist approach:

"An important exception to the general slowing in the growth of financial aggregates with the movement in M3 in the second half of the year. While eschewing inflexible adherence to monetary targets, the Board felt that the projected range of growth in M3 of 9-11 per cent for 1982/83 as a whole, as indicated by the then Treasurer in his Budget Speech, would be achievable and consistent with the expected needs of the economy. The Board believes that a difference between the projected range and the outcome in any year should not be regarded as a formal measure of the success or failure of monetary policy. It is nevertheless, disappointing that the rate of growth in M3 again exceeded the projected range and, more particularly, that growth did not continue to slow in the second half of the year" (1983: 5-6, emphasis added).

The Bank's Annual Report is however significant for a number of other reasons. In marked contrast to its predecessors, the Report is written as a report from the Reserve Bank Board. An editorial in the Australian Financial Review remarked that this constituted

"... an uncommon degree of visibility for the Reserve Bank board, which usually slumbers between meetings and virtually never makes an appearance in annual reports" (AFR, 26 August 1983).

The Report also indicated that it had been the Board of the Bank that had written to the incoming Treasurer in late March 1983 about the economic outlook and the role of monetary policy. That letter had identified the threat posed by a rate of inflation higher than Australia's major trading partners, and stressed the importance of maintaining the confidence of the domestic and off-shore financial community:

"To this end it was most important that the Government show itself to be in control of the economy and that it had realistic plans to reduce its fiscal deficit in subsequent years" (1983: 7).

However the Financial Review editorial suggests that if this greater prominence for the Board were to be reflected in a greater measure of policy activism on the part of the Board, the development was not necessarily a positive one. Given the lack of expertise on the part of Board members, it was argued, an activist Board was not necessarily a development which should be welcomed. The editorial suggested that not many members of the board of the Reserve Bank have any expertise in matters of monetary or general economic policy:

"That has, of course, always been the case. But a passive board has allowed the Reserve Bank, for good or ill, to make policy when it has not simply been making obeisance to Treasury" (AFR, 26 August 1983).

Where the Board could play a positive role, the editorial concluded, was in protecting and insulating the Bank Governor and his staff, "from the kind of crude bullying from Treasury it has suffered in the past", and encouraging, "the publication of independent policy analysis by the bank" (AFR, 26 August 1983).

Moreover the editorial referred in closing to the acrimonious history of relationships between the central bank board and former Labor governments, a history that, as the previous chapter indicates, had encouraged a preference on the part of the Labor Party for a direct accountability relationship between the Governor and the government of the day. The central bank board, in Labor's experience, had served to advance the interests of domestic and foreign capital over those of elected governments, and place the soundness of the currency over general economic welfare of the community:

"Two issues await resolution. One, is the board going to try to use the bank as power base for attacking the new government, as happened in the thirties in the old Commonwealth Bank? Two, can the economists and the bureaucrats of the

Reserve Bank provide a source of public information which is as independent as Treasury but not marked by its silliness?" (AFR, 26 August 1983).

For its part the incoming Government appears to have diminished the role of the Cabinet in favour of a more discretionary role for the Treasurer. Paul Kelly cites Cabinet Minister Peter Walsh as suggesting that the Cabinet was not involved in monetary policy decisions:

"In the first budget and possibly the second, Cabinet decisions were made about a monetary growth target, but when we abandoned targeting monetary growth I do not recall any specific Cabinet decision being made on monetary policy. There were discussions about the economy which touched on monetary policy from time to time. But formal decisions were outside the Cabinet" (Kelly, 1992: 368).

For Kelly this was an 'extraordinary situation', and one that provides an insight into what he perceives to be a concentration of power in the hands of Keating. Keating adviser Don Edwards is cited approvingly as providing support for this view, observing that, "Keating as Treasurer bore the political responsibility for the conduct of monetary policy and it is a responsibility he acknowledges and accepts" (1992: 369).

The extent of Keating's influence over monetary policy is one of the constant and recurring themes in political and policy debate over the course of the Hawke and Keating governments. While Keating undoubtedly recognised, intellectually, that the Australian economy would pay a price for any credibility deficit attached to the determination and implementation of monetary policy, his own statements would serve only to fuel speculation that the institutional arrangements within which Australian monetary policy was conducted were politically porous, and the central bank a dependent institution.

The early years - Bob Johnston and the float

When Labor came to power the Reserve Bank was under the stewardship of Bob Johnston, appointed by the Fraser Cabinet on the recommendation of the then Treasurer. Johnston had represented the Reserve Bank on the Committee reviewing the recommendations arising out of the Campbell Committee Report, and was markedly more supportive of the general tenor of those recommendations than his counterpart in Treasury, John Stone.⁸

⁸ What is also interesting about the appointment of Johnston to the position of Governor is that in the period leading up to the appointment the Board of the Reserve Bank had acted with a measure of both

John Edwards observes that,

"[t]here was not much in Johnston's experience to commend the wisdom of governments to him, and he had also acquired in London and Washington a strengthening conviction that the way of the world was now towards financial deregulation, to the 'market', to the mingled result of the clipped telephone bids and frantic hand signals of hundred of recent graduates, many who found a degree quite unnecessary but could yet produce a better result for the Australian economy than the best efforts of aged and experienced treasurers and their Cabinet colleagues, with and without the advice of John Stone" (1996: 212-3).⁹

Johnston was also somewhat less averse than his predecessor when it came to the public scrutiny and transparency demanded of central banks in their relations with the markets and the wider community. Of his predecessor, Sir Harold Knight, it was observed that he,

"... was hard to read and understand; even those who worked within the bank found him enigmatic, prone to getting people offside. His reputation for antipathy to the media went ahead of him; his dislike of any publicity fed on minor (and some major) incidents of misunderstanding, which in turn were often fuelled by the central bank's obstinate silliness and unwillingness to communicate" (AFR, 25/11/83).

Johnston and the Bank, it is suggested, while not gung-ho for financial deregulation, were far more sympathetic than the Treasury. For his part Keating had some sympathy for financial deregulation, and was encouraged by the Prime Minister in these views. Edwards notes that Keating sat next to Campbell at a barbecue on the last day of the April 1983 Economic Summit:

"[H]e told him he would implement some of the report. Campbell had replied that even to implement a bit of it would make a big difference. The following day Campbell died suddenly. Keating thought Campbell was the most public spirited businessman he had ever met. He had some of the same qualities possessed by Sir James Vernon, chairman of the famous Menzies era report, but a stronger intellect. Of the business people Paul knew, Campbell had the best and biggest idea of how it all fitted together, and he also had the idea of public service, of doing something for the country" (1996: 207).

independence and assertion in writing to the then Treasurer to insist that the successor to Sir Harold Knight should come from within the Reserve Bank, and not be an outsider. The concern at the time appears to have been the suggestion of a political appointment to the Governorship - former Treasurer Sir Philip Lynch and two of the Fraser Government's academic advisers, Professor John Rose and Professor John Hewson - having been identified as possible candidates. Lynch was appointed to a vacancy on the Board, but Johnston - the Reserve Bank insider - was appointed Governor (see Alan Ramsey in the National Times, 20-26 July 1984).

⁹ On the contest between Johnston and Stone, and differences in their personalities, experience and

In May of 1983 a Committee was convened under the leadership of the former chief of the Commercial Banking Company of Sydney, Vic Martin, to review the Campbell Committee recommendations. While accounts of the sequence of consultations and decisions leading up to the float of the Australian dollar are contested (particularly between Bob Hawke and Paul Keating - see Edwards, 1996: 217), Keating suggests that the operation of the exchange rate system was first discussed with the Governor of the Reserve Bank as early as April or May 1983 (Edwards, 1996: 217). Subsequently the matter of exchange rate policy, that went at one policy 'extreme' to a clean float of the currency, was canvassed by Cabinet, by Ministers, and officials within the Treasury and the Reserve Bank. Stone and the Treasury were opposed to a float, Johnston and the Reserve Bank in favour, the latter supported by officials from the Department of Prime Minister and Cabinet, and the Private Office of the Prime Minister.¹⁰

On Friday 9 December a meeting of Ministers and officials in the Prime Minister's Office decided to recommend to the Cabinet Economic Committee that the dollar be floated and exchange controls removed. Treasury Secretary Stone argued against the decision. Edwards account of the decision suggests that the support of the Reserve Bank for the float was critical, that Keating and Reserve Bank Governor Johnston had agreed on the desirability of a float early in 1983, and that the Bank had provided material relating to exchange rate policies and the float in July.

It is widely accepted that one of the long term consequences of the float was to bring the Reserve Bank out from under the Treasury wing. In a political sense Johnston's enthusiasm for and strong advocacy in support of a float served to consolidate a relationship with the new Treasurer. Moreover with the float, the institutional mechanism required to make exchange rate decisions were no longer required, and their demise removed a significant vehicle through which the Treasury Secretary had maintained an institutional dominance over the Reserve Bank. In May 1984 Ross Gittins commented in the Sydney Morning Herald that,

"The rising influence of the bank can't be separated from the process of deregulating the financial system begun by Mr Howard and continued at a faster pace after receipt of the Campbell report...

[D]eregulation will - and probably already has begun to - increase the bank's influence compared with Treasury in the provision of advice to the Government on monetary policy" (SMH 2 May 1984).

preferences see Edwards (1996: 210-212).

¹⁰ Which is not to suggest that Treasury was united in its opposition. Edwards reports a meeting between the Treasury and senior Treasury Officials, including the Treasury Secretary, John Stone, Ted Evans, and other officials, at which Evans indicated his clear support for the Treasurer's position, and his opposition to the line being pursued by Stone (see Edwards, 1996: 224).

This assessment is shared by Edwards who, with the benefit of hindsight, comments that:

"Perhaps the most important long-term result of the float, and one that Stone attempted to prevent, was that the Reserve Bank became increasingly independent of Treasury. Stone and his Canberra colleagues were no longer determining a rate that the Reserve Bank would implement. In a little more than a year money supply targets were also dropped, which took Treasury out of the monetary policy formulation except as a junior partner to the Reserve Bank. Keating's relationship to the Bank became stronger and more direct as the Bank itself came out from under the Treasury wing. Though Keating was criticised later for influencing Bank decisions - and he certainly did, and believed he should - the float and the later dropping of money supply targets made the Reserve bank a far more powerful and independent institution under Keating than it had been at any time in the past" (1996: 230).

In October 1996 Reserve Bank Governor Ian Macfarlane remarked that:

"[t]he big change for the Reserve Bank was financial deregulation. It swept away the interest rate controls, freed up the exchange rate and made it possible to finance the budget deficit fully at market-determined interest rates. This left open-market operations, which effectively determined short-term money market rates, as the only instrument of monetary policy. This was entirely in the hands of the Reserve Bank, which put us operationally in the same position as the US Federal Reserve or the Bundesbank. For the first time, the intentions of the Act and the capacity of the Reserve Bank were in accord" (RBA Bulletin, October 1996).

And a number of respondents, interviewed in 1997, suggested that, while the Reserve Bank Act itself has not been amended, the 1983 float had significantly changed the status of the Reserve Bank, and the conduct of monetary policy. Treasury Secretary Ted Evans recalled that the 1983 float had provided a watershed, and that, while the period from 1983 to 1996 did not see any significant institutional changes, the Bank became increasingly independent in the conduct of policy - one of the consequences of the independence being that the Secretary of the Treasury no longer exercised the degree of influence evidenced in the pre 1983 period. Moreover Evans recalled that in the period following John Stone's retirement as Treasury Secretary, the Treasury itself became a much more vocal advocate of central bank independence. Barry Hughes recalls that the float significantly changed the distribution of power and influence within the official family, but that it took some time for the Bank to appreciate the nature of the changed environment within which it was charged to operate:

"until 1983, until the float, and even then, they [the Reserve Bank] really didn't believe they had too much power, you get these sort of plaintiff things, 'no one told us we could do that'...

the power influence until the float was Treasury, and the Bank was supportive, as elsewhere in the world. The deregulation of financial markets has empowered the Bank at the expense of Treasury ... and may be our bank was a bit slow on the uptake" (personal interview, 1997).

Hughes recalls a defining moment in the evolving relationship between the Treasury, the Reserve Bank, and the government of the day:

"... there was an absolute symbolic moment, when having floated the dollar and deregulating the controls in December 1983 the then Secretary of the Treasury, John Stone refused to flank the Treasurer in the subsequent press conference, so he flanked him with Bob Johnston the then Governor of the Reserve Bank, and that was just neatly symbolic .. it wasn't just that Stone had lost ... it took the Bank a while after that to realise that they were in a much stronger position" (personal interview, 1997).

Financial journalists and commentators Alan Wood and Max Walsh also view the float as a defining point in the evolving independence of the Bank. Wood observed that, "as to independence, well it didn't really arise in a sense until we deregulated financial markets and floated the dollar and opened the system up because prior to that the system was basically an administrative one - interest rates were effectively set by Treasury and the Bank implemented policy"(personal interview, 1997); and Walsh concurred, suggesting that, "[i]t was only with the deregulation of the banking system that you could talk seriously about independence anyway. We had a very regulated system up until then" (Walsh, interview, 1997).

Bernie Fraser

In September 1984 John Stone retired as Secretary of the Treasury to be replaced by Bernie Fraser.

Fraser was a 'boy from the bush', the son of a railway fettler, and was raised and educated in the New South Wales town of Junee. A private person, Fraser gave few interviews on matters other than the institutions and policies for which he was responsible. In a profile published initially in the Sydney Morning Herald, based on a series of interviews with the Sydney journalist and academic Craig McGregor, the following picture is painted:

"He's no wimp. An ex-working-class bush boy from Junee, he wasn't averse to giving school bullies 'a punch in the throat' and has held on to these values ever since ...

He was, he says, 'fairly big at school, which helped'. It stopped him being picked on as the poor kid in sandals from the house with all its windows broken"(reprinted in The Age, 23 November 1991).

Fraser won a scholarship to the University of New England where he studied arts and economics, and in 1961 joined the Department of National Development in Canberra. Two years later he successfully applied for a position in the Treasury. Rising to a senior position in the Treasury Fraser was Deputy Secretary of the Department of Resources and Energy under the Fraser Government. It was his predecessor as Treasury Secretary, John Stone, who prevailed upon Fraser to return to the Treasury as a Deputy Secretary, and, it was reported in an article in the Sydney Morning Herald, it was John Stone - who was to be elected as a National Party Senator after his retirement from the Treasury, who recommended Fraser to Treasurer Paul Keating as his replacement (see the SMH, 5 April 1989). Within the Treasury Fraser, together with his colleagues Chris Higgins, David Morgan, and Ted Evans, constituted a 'Gang of Four' committed to the internationalisation of the Australian economy, to the reduction of border protections, and to micro-economic reform.

Treasury had traditionally been opposed to negotiated incomes policies of the kind suggested by the ALP/ACTU Accord - policies which were tantamount to a 'particular piece of witchcraft', to use the Stone description - and advised the incoming Government and Treasurer accordingly. In the early months of the Hawke Government, Keating - sceptical of the value of the Accord - was caught between the advice of his department, and the enthusiasm of the Prime Minister, and of Keating's principal economic adviser, Barry Hughes, for the Accord:

"Treasury pulled him one way and Hawke and Barry Hughes the other. In those first months of government Keating frequently went to Hawke's office after dinner, and the two men would sit talking late into the night. Hawke told him that ACTU Secretary Bill Kelty was 'solid gold'. His word could be relied upon. Back in his own office, Barry Hughes would argue the centrality of an agreement with the ACTU to Labor's economic policy. Without it, wages would take off when growth resumed, inflation would rise, and the government would have to cut it off with high interest rates " (Edwards, 1996: 201).

Bernie Fraser for his part was one in Treasury who saw in the Accord an alternative to an over-reliance on monetary policy as an instrument of internal stabilisation. Edwards observes that, while in his opinion,

"[t]here was nothing remarkable in [Fraser's] history or his personality ... there was something remarkable indeed in Fraser's ideas about economic policy.

Unusually for the Treasury official, Fraser was very wary of the power of interest rates" (1996: 257).

Early in the life of the Accord Fraser saw an opportunity to use the coordinative potential of the Accord to take the pressure off interest rates. Edwards reports that in January of 1986 Paul Keating would find an ally in Fraser in seeking to reduce interest rates, and transfer some of the burden of adjustment to wages policy:

"Keating had an ally in his Treasury Secretary, Bernie Fraser, who consistently pushed for a tighter budget and lower wage increases as an alternative to higher interest rates ... Then, as later, Fraser wanted to 'lighten the relative load being borne by monetary policy'. Although 'the Government/ACTU wage agreement does not appear capable of being renegotiated to yield wage restraint, the government will need to squeeze every last drop of restraint out of the present agreement'..." (Edwards, 1996: 292).

In 1989, following Fraser's appointment as Governor of the Reserve Bank, Robert Garran would comment in a profile of Bernie Fraser that "Fraser's support of the Government's accord with the union movement has perhaps been the cornerstone of Treasury agreement with the Government's economic policy" (The Age, 6/7/89).

Interviewed in 1997 Fraser observed that,

"... very early on before I became Secretary to the Treasury I became aware of the fact that on its own monetary policy was not going to deliver low inflation except at a very high cost. I joined the public service in January 1961 and in September 1960 there was, by those standards, an almighty credit squeeze directed towards inflation ... unemployment shot up ... It took quite a while to recover from this onslaught of credit policies and it was a salutary lesson for me really. I had come in and began to get involved, or observe, at this early stage, how to grind inflation down. You could hit it with a sledgehammer, and that would hit inflation, but it had a much more powerful effect on employment and activity. From that time on, and there have been other episodes, whenever monetary policy on its own has tried to control inflation, it's either been pretty ineffectual, because the inflationary pressure have arisen from things that monetary policy can't always get at, or when it has been effective it has had a pretty high social cost in unemployment ...

And things changed a bit in the 1970s and 1980s ... Once inflationary expectations became part of the reality, as they did, workers demanded compensation, they demanded wage increases ... wages became an important part of the inflation scene, and wages policy became important, fiscal policy became important in terms of grinding down or restraining inflationary pressures, not just monetary policy. So it was my view based upon both observation and experience that monetary policy on its own was a pretty blunt weapon, and a more sophisticated approach really needed co-ordination with these other policies. In the 80s/90s wages policy through the Accord process was quite a significant contributor to low inflation" (personal interview, 1997).

From monetary aggregates to the 'checklist' - policy as 'snugging'

In an article published in the Bulletin in April 1985, John Edwards - later to work for and write a political biography of Paul Keating - wrote a piece examining the conduct of monetary policy making under Bob Johnston's leadership of the Bank. The article usefully illuminates aspects of decision making within the Bank, and the conduct of relations between Bank and government. The decision making procedures outlined suggest a high measure of confidentiality in decision-making, a deference on the part of the part-time members of the board to full-time officials (including the Secretary of the Treasury), and a high degree of consultation between the Bank and the Treasurer. Referring to the role played by the board Edwards reported that:

"The seven outside board members receive briefing appears a week before the meeting. Each of the papers is numbered so that tracing any leak will be less difficult. The papers may not be shown to anyone other than the board members and must be returned intact to the Secretary. Such a powerful ceremony of privilege surrounds these papers that even the bank may never show them to outsiders - even years after the papers have lost their pertinence" (1985: 66).

Edwards reports that no minutes of board meetings are taken, nor are votes used to decide on policy matters - such as monetary policy settings - but that the Governor and Deputy Governor get a sense of the meeting:

"We come to a recommendation about what should be done. Its not woolly but it's not over-precise" (Johnston, quoted in Edwards, 1985: 68).

The article also quotes Professor Tom Valentine of Macquarie University as suggesting that the board effectively acted as a rubber-stamp for decisions made by the Governor and the Secretary of the Treasury, the suggestion being that, "the decisions to tighten or relax come from Johnson and Fraser, with an eye to what Keating will accept, and are then taken to the other board members for endorsement" (in Edwards, 1985: 68).

This issue of the relative influence of the part-time and full-time board members, the accusation that the former simply acted as ciphers for the latter, the lack of transparency in Bank policy making (relative to those central banks that publish board and/or monetary policy committee minutes), and, more generally, the relationship between the Bank, its Governor, and the Treasurer are recurring themes in commentary on the Bank and monetary policy, and in the political and public policy discourse over the period reviewed in this chapter.

In January 1985 the Bank and the Treasurer decided to dispense with monetary targeting. This decision represented at one level an acknowledgment on the part of the monetary authorities that the changes to the monetary system attendant upon market liberalisation and the float were distorting the various measures of monetary aggregates used by the Bank (see Edwards, 1996: 259)¹¹. At another level the change represented a move from a quasi-rules based regime to a much more discretionary environment. While the Bank had, after the 1983 election eschewed any sense of being constrained by a rigid money supply growth rule, the money supply growth targets used by the Bank, incorporated into budget documentation, and reported on in the Bank's annual reports had provided some 'quantitative' measure by which to evaluate performance. Monetary policy, and the manipulation of interest rates - notwithstanding the sizeable outside lags - was now to be used as a short-term or swing instrument. At a further level the demise of the checklist represented, in terms of the political economy of the time, the ascendancy of the new Labourist paradigm over its quasi-monetarist predecessor. Paul Keating suggested that the alternative to dropping monetary targeting, "was to crack down on monetary growth and raise interest rates to bring M3 growth back down within the target. He says: 'The risk we faced was that a stalled economy would destroy the Accord'" (Edwards, 1985: 73).¹²

Moreover Edwards suggested that the Bank itself had not only resiled from a monetarist approach, but was also less inclined to any theoretically informed management of market expectations. A monetarist view, it was suggested,

¹¹ The Bank's Annual Report for the year ended 30 June 1985 observes in relation to the conduct of monetary policy over the preceding 12 month period that,

"... the Board's general approach was to try to maintain financial conditions which would support continuation of the recent downward trend in inflation without jeopardising the recovery of economic activity. This approach was seen initially as consistent with the Government's provisional projection of growth of M3 in the range of 8 to 10 percent; this projection assumed no reintermediation. In the event, structural changes substantially distorted growth of monetary aggregates, leading to suspension of the M3 projection in January. The difficulty of assessing the true state of monetary conditions and periods of doubt about the strength of economic recovery resulted in monetary policy lagging behind events for part of the year" (RBA Annual Report, 1985).

¹² Barry Hughes, in 1983 a member of Paul Keating's personal staff, suggests that the policy in the early years of the ALP Government was a hybrid of monetarism mediated by corporatism:

"... the Bank went in in 1983 with a monetarist position - the problem was that with the then crude monetarism the equation started to break down ... there is a bit of a dispute as to who wanted to break it ... [the use of money supply growth targets] it certainly wasn't me ... for a variety of technical reasons the framework we had ... was essentially ... a marriage of convenience between monetarism and the Accord ... the Accord idea was to try to work out what was desirable and feasible in terms of nominal GDP growth ... out of Accord targets we knew what growth we wanted, we had some idea of how much inflation we could manage out of the system, and then you ~~added~~ those two together and took 1 per cent off, and you set your monetary targets as a backstop ... and so if you like monetarism was there, but it was the junior partner - it wasn't the kind of M minus one stuff that Friedman was going on about" (personal

"is nowhere evident among the top officials of the Reserve Bank or in its conduct: It could not be less monetarist ... Johnson, Sanders and Phillips [both Deputy Governors] are the kind of pragmatic bankers who drive Friedman wild. They do not believe in a money supply rule, they do not believe in announcing targets for money growth and they have developed only the most primitive means of exercising control over money... As one Reserve Bank economist said cheerfully: 'The flood tide of monetarism is well past'" (Edwards, 1985: 75).

With the demise of 'monetary targeting' a 'checklist' approach to the conduct of monetary policy was adopted. This checklist of factors, the make-up and relative weighting of which was not to be made explicit, in conjunction with an approach in which changes in monetary policy settings were not articulated explicitly, was, over time the subject of a great deal of criticism.¹³ In an editorial in the Australian Financial Review in October 1985 the Bank and its Governor were criticised for a lack of transparency attendant upon what was viewed as an increasingly discretionary approach to monetary policy, and, in addition, for sanctioning a loosening in monetary policy in late 1984 influenced by what were referred to as 'non-economic factors' - an easing associated with a federal election. The leader posed the questions - "Why are central bankers so incapable of admitting that they may be capable of making mistakes? Why does the Reserve Bank insist that its actions be so sacrosanct as the catechisms of the medieval church?" (AFR, 31 October 1985).

An editorial in The Australian of 21 April 1986, under the headline, "Reserve Bank keeps its information in reserve" was highly critical of a lack of transparency in the conduct of monetary policy - at issue was the deleterious effect on the Bank's credibility. At the Bank's urging, it was suggested,

"the Government has dispensed with monetary targeting all together and, for good measure, removed whatever remaining credibility there was from the different measures of money supply.

Instead we have a check list or shopping list of items that the Reserve Bank takes into account when it sets monetary policy.

interview, 1997).

¹³ The Bank's Annual Report for the year ended 30 June 1986 betrayed a measure of sensitivity about the use of the ubiquitous 'checklist':

"The Bank does not have any targets for the 'checklist' items. At no time has any item, or group of items on the 'checklist' been raised to the status of a policy objective. Commentators sometimes profess to know or to judge that the Bank does, in fact, have a target for some item on the 'checklist', e.g. the exchange rate. Although exchange rates (and the balance of payments) are important indicators for deciding policy, the Bank has not sought to establish any particular exchange rate or to go past its well-documented practice of testing and smoothing transactions in the market" (RBA Annual Report, 1986: 14).

Yet, if the monetary aggregates are as useless as it makes out, how does the Reserve know, after consulting its shopping list, what it has actually bought?...

The confusion over monetary policy has made planning impossible.

Until the Reserve Bank takes us into its confidence, economic forecasts become no more than hot air"(The Australian, 21 April 1986).

Multiple deficits - budgets, the current account, transparency and credibility

The lack of transparency in the conduct of policy was contributing to a growing credibility deficit. The Bank had now eschewed the use of monetary targets in favour of a checklist, but had not yet fully appreciated the need to take the markets into its confidence. In part this reflected the fact that inflation was a second order issue - the instruments of macroeconomic policy were directed instead to the quest for external balance, remedying Australia's growing current account deficit. As a result monetary policy, mediated through the exchange rate, could be directed either to moderating the level of domestic demand (and of imports) through interest rate increases, or to improving the competitiveness of the export sector by using an easier monetary policy to effect a lower exchange rate. Monetary policy was directed to external balance, fiscal and wages policies to internal balance. The trajectory of policy, and of policymaking over this period is not such as to support the assumption that politicians are habitually disposed towards easier monetary conditions, and central bankers (and Treasury officers) to sound finance. But the lack of transparency, coupled with, at times conflicting policy objectives and problems associated with the coordination of policy instruments would all conspire to create the sense that policymaking was at best, too secretive, and at worst politicised. The growing credibility deficit would, in turn, strengthen the case of those advocating a revisiting of the Coombsian scheme.

In the face of a depreciation of the dollar towards the end of 1985, interest rates were increased. Edwards reports that, anticipating a recessionary impact, Treasury Secretary Bernie Fraser was opposed to a policy-induced tightening. The Treasurer however, in an approach somewhat evocative of the Whitlam 'short sharp shock', "thought a sharp, dramatic increase would crush expectations of a falling dollar" (Edwards, 1996: 285).

However in the early part of 1986 economic data confirmed Bernie Fraser's earlier prognosis of a contraction, and Treasurer Keating started pressing for interest rate cuts, against the wishes of Governor Johnston and other senior officials within the Bank. Keating was concerned in part at the threat to the current account deficit posed by an easing in interest rates - "I was on the phone every day", Keating recalled

(Edwards, 1996: 291). In February 1986 the average 'policy' interest rate was 18.16%, by March it was 16.74%, and by May 12.31%.

On the 14 May 1986, in one of the defining moments of his term as Treasurer, Paul Keating made what has since been referred to as the 'Banana Republic Statement'. The 'statement', made in the course of a radio interview, defined the task facing the Government as one of tightening fiscal policy, in preference to a reliance on tight money which would, Keating argued, risk creating an economy more characteristic of a banana republic. Informed by the notion of 'twin deficits' - that the size of the current account deficit was a function of the budget deficit - an Economic Statement in May 1987 initiated cuts in government expenditure. In July the Hawke Government was comfortably re-elected in a General Election. However the current account deficit continued to be a concern, and Keating's personal staff, and in particular his economic adviser Dr Don Russell, continued to advocate an interest rate reduction to lower the value of the Australian dollar. What is of interest here is evidence of a conflict in the advice being proffered by Russell, and that tendered by Bernie Fraser, the latter concerned not to reduce interest rates. Fraser argued that, "to engineer a dramatic decline in interest rates would be unwarranted" (in Edwards, 1996: 315). The suggestion, that on issues of monetary policy, Fraser was on each and every occasion on the side of the doves is clearly not substantiated.

In July 1987 ACTU Secretary Bill Kelty was appointed to the Reserve Bank Board, where he joined former ACTU Official Charlie Fitzgibbon - both had been members of the joint ALP/ACTU, Australian Labour Advisory Council Working Group that had developed the first, pre 1983 election drafts of the Accord. They joined an earlier Keating appointee, Sir Peter Abeles, who had replaced Sir Philip Lynch following his death. A Fraser Government appointee, Hugh Morgan, had earlier not been re-appointed.

October 1987 saw the crash in international share markets, in response to which Australian interest rates were lowered. It has been suggested that by mid 1987 the Reserve Bank was increasingly concerned that the economy was overheating, but assumed that the October crash would act as circuit breaker and take the pressure off monetary policy. However in the Bank's Annual Report for the year ended 30 June 1988 the Bank would report that,

" ... a preliminary assessment that the size of the market fall would check growth in demand and credit and remove the need for any re-tightening of

monetary conditions. That assessment proved to be wrong" (RBA Annual Report, 1988).

Kelly notes that in January 1988 Treasurer Keating was suggesting to Reserve Bank Governor Bob Johnston that it might be time to increase interest rates (Kelly, 1992: 374). While some in Treasury were recommending a tightening in February 1988, the official advice was to wait. The Reserve Bank Board met on the 29 March 1988 and was not convinced of the need to tighten. Edwards suggests that both Johnston and Bernie Fraser were reluctant to move sooner - the latter,

"would be the most reluctant of Keating's senior advisers to support the push to higher interest rates ... Privately within the policy-making community, Fraser held the same critical attitude to the emerging monetary policy as many academic economists. His consistent position for most of 1988 was that, if wages and government spending could be restrained, then raising interest rates should not be necessary" (1996: 322).

On the 30 March 1988 Keating met with Johnston and Fraser and recommended a 2 per cent increase in the overnight rate. Both were opposed (Edwards, 1996: 327). Eventually monetary policy would be tightened in May 1988, and subsequently. In March 1988 cash rates stood at 10%, by November 1989 they would be at 18%; 90 day bill rates went from 11% to 18%, and home loans increased from 13% to 17%. However the change in policy was not announced, which, given that the objective was to influence expectations, was, as Edwards observes, somewhat ironic:

"Keating was later criticised for failing to declare publicly and forthrightly that interest rates were rising. Had he done so, the argument runs, the effect of the increases might have been magnified and accelerated, lessening the need for increases later ... Keating himself asserts this argument quite strongly, and insists that it was the Reserve Bank that insisted upon this policy of lifting rates without declaration, a policy known as 'snugging'. Bank officials assert it was Keating who was reluctant to announce the new direction of policy ... It was not until Bernie Fraser became Governor that the Bank began to publicise its moves. If Keating had wanted to announce the change hard enough, however, I have no doubt he would have found a way to do it. He could not have pressed very hard, and for its part the Bank does not seem in this period to have pressed at all" (1996: 329).

Edwards suggests that the events surrounding the interest rate increases of 1988 suggested a multitude of variables and actors:

"How and why those interest rate increases were decided upon is a story of intertwining of economics and politics, of conflict and uncertainty within the inner circle of advisers, and of the difficulties of economic prediction" (1996: 320).¹⁴

¹⁴ See also Tingle, (1994: 25).

Given the accusations, many of them encouraged by Keating's own observations, that monetary policy was politicised by way of the Treasurer's opportunistic and determining interventions, it is noteworthy that Keating desired to tighten policy much earlier than his officials, and yet failed to effect the desired change. Paul Kelly comments that one of the myths associated with Keating's stewardship of the Treasurer's position was that Keating habitually overruled his officials on monetary policy matters:

"In fact the reverse was true. The conduct of monetary policy during 1986 and 1987 when the foundations for the boom were laid reflected the majority position among the family of Treasury-Reserve senior advisers" (Kelly, 1992: 383).¹⁵

A further consequence was a tendency on the part of the Treasurer to share the view that monetary policy making was more of an art than a science, and to entertain a somewhat extra-rational approach to policy making. On more than one occasion Keating would remark that monetary policy was more of an art than a science, a view subsequently echoed by Bernie Fraser as Governor of the Reserve Bank. John Edwards reports a conversation with Paul Keating in 1992 in which the latter observed:

"I'll tell you what. This is all bullshit about the science of monetary policy. All bullshit. Every month for years we had papers on credit growth, the yield curve, etc., etc., the relation to GNE, and it was never any good at prediction. Never. You have to be able to feel what is happening" (1996: 320).

So far as the objectives to which policy was directed, there is the suggestion that the reluctance to tighten - which in turn accentuated the amplitude of the business cycle - reflected a desire to place the emphasis on economic growth over the stability of the economic system, and specifically, the stability of prices. Paul Kelly suggests that,

"Labor was determined to err on the side of economic expansion rather than economic contraction; it preferred to tolerate inflation rather than unemployment; it wanted monetary policy to encourage investor confidence rather than price stability; it sought a gradual solution to the external payments crisis, not a faster solution. As an instinctive political animal Keating had always aspired to achieve economic growth superior to the somewhat mediocre levels of past Coalition governments" (1992: 383).

This implicit priority of growth over other policy targets - restraint in particular - is reflected in the advice of Bernie Fraser to Paul Keating in late 1988. With real interest rates at a higher level than at any previous stage in the past two years, Fraser was

¹⁵ See also Tingle, (1994: 27).

concerned to avoid any further tightening, and to spread the policy load; he wrote to the Treasurer suggesting that he

"... would prefer to see some time elapse for the effects of that latest tightening to show up before there was any further substantial tightening. I would not like to see a return to earlier and largely fruitless attempts to deal with wages problems through excessively zealous monetary policies: we jettisoned all that five and a half years ago" (Fraser quoted in Edwards, 1996: 348).

And then there was the issue of transparency, or more to the point the lack of transparency in the conduct of policy and the effect that this had in militating against credibility (and shifts in expectations) within the markets. In the succeeding years the Bank would become more open about its actions and intentions, but in the 1987/88 period the traditional 'mysteries' of monetary policy continued.

On the 27 July 1988 Dr Peter Jonson, Deputy Managing Director of James Capel Australia and the former Head of Research at the Reserve Bank of Australia gave a talk to the Economic Society of Australia - "Reflections on Central Banking". Jonson's observations which, in the context of much of his later commentary it would have to be said, were rather mild, if not in fact somewhat supportive of the institutional status quo at the time (he suggested that there had been no overt attempts to influence the Bank politically, that the 'checklist' approach to the conduct of policy was appropriate, as were most of the formal institutional arrangements specified in statute, save for the disqualification of people from the finance sector in terms of the membership of the Bank board, and an argument in favour of the appointment of executive directors from the staff of the Bank). But Jonson suggested that the challenge for monetary policy makers was "likely to be the appropriate degree of firmness ...", and continued:

"My prescription is clear. Australian monetary policy should be more self-confident in its application. As a nation we must be prepared to steer the appropriate course on domestic monetary policy more independently of international forces. This will almost certainly require greater flexibility in the value of the Australian dollar - particularly upward flexibility at times of bullish sentiment - and this will not always be comfortable. But the challenge for general economic policy is to find ways to cope with this" (Jonson, 1988).

The prescription was for sound finance, even at the expense of an over-valued dollar. And Jonson went on to advocate strongly in favour of much greater transparency and accountability:

"[T]here should be greater public accountability by the bank in explaining and justifying its decisions and views ... the Bank still does not publicly present

regular and fully articulated commentary on the evolving economic situation and the needs of policy There are two reasons for seeking to do more. The first is that unelected officials have a responsibility to explain their views and decisions, and current Australian practice falls short of the ideal... The second reason for accountability is both more pragmatic and closer to my central themes. The discipline of having to explain itself more thoroughly is likely to lead in various ways to better standards of analysis within the Bank" (1988, emphasis in original)

The Jonson speech was welcomed by a number of commentators in the press. Max Walsh penned a piece under the headline, "Time for the Reserve to come out of the closet"; The Australian wrote the speech up under the head-line, "Former Reserve official attacks 'secrecy on policy'"; and an editorial in the Sydney Morning Herald on the 29 July 1988 welcomed the Jonson speech, and advocated a more independent and assertive role for the Reserve Bank.¹⁶

On the 1 August the Sydney Morning Herald's Ross Gittins joined the fray, criticising the Bank and the Government for the lack of transparency attached to monetary policy-making:

"How often has the bank refused to acknowledge a policy tightening, or sought to conceal it within the tax collection season? The most recent tightening, in April-May is a case in point, although this time the bank had no choice. Once Paul Keating had denied the tightening in Parliament, the Reserve Bank could hardly contradict him. Only when Bob Hawke had changed the Government's tune could the bank change its own tune. On other occasions, it has had less excuse. You'd think it would be more aware of the way its obfuscation damages its credibility"(SMH, 1 August 1988).

The same Gittins article advanced the suggestion that the Bank had, in the past been subject to political direction. Referring to an easing in the lead up to the 1984 election Gittins stated that he had no doubt that the easing was made, "under political instruction". The twin, and arguably functionally inter-related vices of a lack of transparency, and political dependency were linked. Issues of transparency and political dependency (compromised central bank independence) were to be integral elements in the discourse of Australian politics over the balance of the period reviewed in this and the following chapter.

¹⁶ Interestingly, the editorial makes reference to an episode in 1981 when the Reserve Bank "screwed up its courage and said something mildly critical of the Fraser Government. It caused a sensation." The episode referred to may in fact have been the successful resistance by the then Governor, Sir Harold Knight, to the move in the 1982 Budget to free up Statutory Reserve Funds for Housing. The independent stance of the Bank was defended by the then Treasurer, John Howard (see the reference to the 1982 episode in 'Keating favours an 'outsider' for Reserve's top job', the Sydney Morning Herald, 16 February 1989).

The case for institutional reform - central bank dependency and political control

The debate over the extent of the independence of the Reserve Bank of Australia, and in particular over the period from the election of the ALP Government in 1983 through to the change to a Liberal-National Coalition government in 1996, is one that goes to the formal or institutional aspects of independence - the claim that the 1945 legislation allows for, if not encourages a porous relationship between the Bank and the government of the day. Moreover the case for reform tends to be predicated on behavioural manifestations of that alleged lack of independence, instances when direct political intervention has caused the Bank to act in a manner that it would not otherwise have chosen to do. In part the debate is descriptive, in part evaluative, and in part prescriptive or normative, deficiencies in institutional design, it is argued, remedied through amendment or repeal of the existing statute.

At times the case for institutional reform has had the quality almost of a moral crusade. In 1988 Peter Jonson had indicated a measure of comfort with the institutional status quo. However by 1990 he would suggest, in support of greater independence for the Reserve Bank of Australia, that,

"... inflation is the persistent erosion of the money standard. Allowing inflation to arise and to persist is tantamount to endorsing theft. In an inflationary economy it should come as no surprise that standards of private and public morality come under pressure" (1990:2).¹⁷

For Jonson the role for central banks is tantamount to that of a moral crusade;

"Just as there is a role of theological and moral philosophers to oppose the moral expediency of the day, there is a role for central bankers to oppose the economic expediency of politicians" (1990:5).

By 1990 Jonson would suggest that achieving the elimination of inflation, "would be more effective if the Reserve Bank were to be given as its main task the achievement and maintenance of price stability." (1990:7, emphasis in original). Similar sentiments were expressed by Sir William Cole, who in 1990 suggested that the Reserve Bank's charter should be limited to price stability objectives:

¹⁷ The suggestion that inflation constitutes 'moral rot' has been canvassed by Barry, who notes that the sense of inflation as a corrosive force has been a persuasive one in some quarters:

"Inflation... is merely the monetary aspect of the general decay of law and respect for law... ; laxity about property and laxity about money are very closely bound up together; in both cases what is firm, durable, earned, secured and designed for continuity gives place to what is fragile, fugitive, fleeting, unsure and ephemeral." (quoted in Barry, 1985:285)

"... the anti-inflation cause needs a champion with teeth and could have it in the form of the Reserve Bank if that institution did not have its objective cluttered up with other national economic policy objectives which the bank cannot pursue directly." (Cole, 1990:5)

Cole also suggested changes to the Board of the Reserve Bank designed to improve the Board's performance and the exercise of independence - changes premised in part on the assumption that the predominance of 'lay' people on the Board of the Bank had resulted in a body ill equipped to deal with the complex issues of national importance that came before it, asymmetries in information allowing the Officials present on the Board - the Governor, Deputy Governor and Secretary to the Treasury - to dominate proceedings (1990:6).

Cole advocated a number of changes, including making the Board somewhat smaller, and appointing three full-time directors with 'qualifications relevant to the responsibilities of the positions', who, while not participating directly in the management of the bank, would have access to the resources of it, and would be 'housed' within it. Moreover, the Secretary to the Treasury would no longer occupy a position on the Board.¹⁸

With the passage of the Reserve Bank of New Zealand Act in 1989 advocates of greater independence for the Reserve Bank of Australia were provided with a very proximate model of institutional and policy best-practice. In 1992 former Treasury Secretary John Stone would argue in favour of a new charter for the Reserve Bank of Australia enjoining the bank to focus exclusively on a quantified price stability objective designed, not to lower, but completely eliminate inflation. Summarising the strengths of the New Zealand model, which by this time, as we shall see below, had become an important element in the Australian policy debate, Stone observed that,

"[a]lthough the New Zealand legislation has been in operation for barely two years, by any objective judgement it has been an outstanding success" (1992: 50).

Moreover Stone, as we noted above, a critic of incomes policies of the neo-corporatist kind, noted that in New Zealand, "importantly, wage bargains are now being struck between employers and their employees in the confident expectation that inflation is no longer a factor which need enter their negotiation" (1992: 50). Stone concluded by suggesting that the Reserve Bank of Australia, "cease starting at shadows, start taking

¹⁸ But having advanced these proposals, Cole goes on to suggest that legislation to make the Bank more independent is neither necessary, nor desirable - "the Act gives the Bank independence now..." (1990:8).

some notice of what is happening across the Tasman, and be prepared to follow what increasingly seems to be an excellent example" (1992: 50).¹⁹

From Johnston to Fraser

The next five years would see the locus of the debate shift very much to the political sphere. In October 1988 the Federal Opposition questioned the integrity of monetary policy making and the independence of the Reserve Bank. Opposition shadow Treasurer John Hewson claimed that the Government had held down interest rates on a number of occasions, including in the lead up to a NSW State election, and in Parliament Opposition Leader John Howard that the Government had been 'bludgeoning' the Reserve Bank into holding interest rates down (SMH, 1 October 1988). In what was seen at the time as a rare intervention into the political domain, Bank Governor Bob Johnston suggested that the accusations reflected on the integrity of the Reserve Bank Board:

"I find it a very severe slur not only on the Board but on the staff of the Bank.

The Board ... would have been appointed or re-appointed by the Fraser Government or the Hawke Government and are not sycophants by any means" (SMH, 1 October 1988).

An editorial in the Australian Financial Review on the 5 October 1988 was more explicitly critical of John Hewson:

"He has suggested plain, old fashioned collusion.

It is ironical that Dr Hewson, who has been a strong supporter of the float and financial deregulation in general, has raised the old 'money power' spectre of Mr Keating's political mentor, the populist, interventionist Premier of NSW in the early 1930s, Mr Jack Lang. Indeed Mr Lang would be proud of Dr Hewson...

¹⁹ More recently Kirchner has advanced a detailed case for institutional reform based very much on the New Zealand model (Kirchner, 1997). However Kirchner sees 'central bank independence' (along the lines of the New Zealand model, which, he argues satisfies the tests of 'best practice') as an intermediate stage, with free banking as a long-term solution, and logical progression from the concern with the independence of central banks:

"A move to a free banking system requires only that the government allow free entry into the note-issue, payments and settlements businesses and remove other regulatory restrictions on financial institutions. The government could freeze the existing stock of government fiat money to act as a base money for this deregulated financial system and maintain its existing notes in circulation. This would eliminate many of the transitional uncertainties that might otherwise affect a move towards a more competitive monetary system. Free banking, far from requiring a massive leap into a new and unknown world, could be allowed to evolve more or less spontaneously out of existing developments in monetary institutions" (1997: 127-28).

Dr Hewson is in the big league now. If he is to continue making charges of such seriousness, he should be prepared to offer some hard evidence to back them up.

Otherwise, the only conclusion that others will reach is that it is he who is playing mere politics - not the Government or the Reserve Bank" (AFR 5 October 1988).

In the early months of 1989 the imminent retirement of Governor Johnston led to public speculation over his likely successor. On the assumption that an insider would be appointed, Deputy Governor John Phillips was seen as the most likely successor, but in February there was some speculation that an 'outsider' might be appointed. The names of three Treasury Officials were mentioned - David Morgan, Chris Higgins, and Bernie Fraser. In later February the concern over an outside appointment - the assumption being that an 'outsider' might compromise the independence of the Bank - was elevated in a speech by the Treasurer that was to cast a long shadow over central bank - government relations for years to come. In the speech Keating implied that the Reserve Bank essentially acted on his instructions. The Australian reported Keating as stating that the Reserve Bank, "do what I say. I can assure you of that" (The Australian 20 February 1989). Keating had observed that:

"Monetary policy in this country is not conducted as in the United States with a division of responsibility between the central bank and the Treasury.

It's conducted on a bipartisan basis, and I can just say that never at any stage I have been Treasurer have monetary conditions or monetary policy been out of line with the arrangements which basically I have agreed with myself and the Governor"(The Australian, 20 February 1989).

Moreover the suggestion that the Bank was subject to the Treasurer's political control was linked to the possibility of the appointment of an 'outsider', and speculation that Phillips would be overlooked in favour of Treasury Secretary Bernie Fraser. The Australian suggested that:

"Because he will be overlooking a respected candidate in Mr Phillips, Mr Keating - should he appoint an outsider to the top job just to show he can - risks doing considerable harm to future financial market perceptions about how the Reserve Bank operates ...

Financial market reaction to Mr Fraser's appointment would not be based on a judgement of his capabilities, but would flow from the perception that Canberra was extending its political tentacles by appointing a close policy adviser with a reputation for pragmatism"(The Australian, 20 February 1989).

Commenting in the Australian Financial Review Padraic McGuinness suggested that the Reserve Bank had not given any indication of its own independence, and that there

was no reason why, "such a seasoned head-kicker as Paul Keating would risk the possibility...[T]o give the RBA appointment to a Treasury Official would simply establish the case for abolishing the bank, as well as destroy what residual confidence the market has in its independence" (AFR , 24 February 1989). Possibly in response to the concerns at the apparent lack of independence on the part of the Reserve Bank - concerns amplified by the Treasurer's remarks - and the lack of transparency in the conduct of monetary policy, Reserve Bank Governor Bob Johnston gave a speech to a business audience on the 29 March 1989 which was seen as constituting a significant step towards increased independence on the part of the Bank. Johnston warned that the Bank would keep interest rates higher in the face of strong demand in the domestic economy, and announced that the Bank would seek to improve the quality and frequency of its comments on influences on the markets. The speech was welcomed in an editorial in the Australian Financial Review under the head-line, "Not before time, Bob".

In March there was increased speculation that Bernie Fraser was Keating's preferred candidate as successor to Bob Johnston, and suggestions that Fraser's appoint would constitute an attack on the independence of the Reserve Bank. Opposition Leader John Howard argued that:

"the next governor of the Reserve Bank should come from within the bank or the private sector ... I hold this view not because I doubt the competence of Mr Fraser as head of Treasury [but] because I strongly believe that the Australian Government will be better served by economic advice if the streams of advice which come to it from the Treasury and Reserve Bank retain their separate and distinctive characters"(The Australian 3 April 1989).

Paul Keating defended Fraser:

"The Treasurer says Mr Fraser has been the subject of 'shocking attacks' and 'tawdry remarks' from the Opposition. '[Mr Fraser] has served all governments he has ever worked for well . He's a career bureaucrat...

'To have Hewson and Howard now wandering around suggesting that he is a political mate - I mean they are offended by the fact that a Labor Government can make the institutions of the country work for it, and work with it'" (The Australian 3 April 1989).

The following day the Australian Financial Review was somewhat more sanguine, and, as subsequent events would confirm, more prescient in its assessment:

"Although Mr Johnston was appointed by Mr Malcolm Fraser, he has clearly been able to work comfortably with a Labor Treasurer for almost six years. In the central bank structure inherited by Australia from Britain, the Reserve Bank ultimately has to do what it is told.

Mr Fraser will do the same. But there is no reason to believe he will be unable to provide at least the same level of independent advice as his predecessors, who emerged through the bank's own ranks.

...[O]bservers have discovered precious few instances of genuine disagreements between governors and treasurers. Indeed, it is already widely known that Mr Fraser stood out for a while among the Treasurer's intimates as a lone 'dove' on monetary policy.

The move may ruffle some capital market feathers - but not for long. It is as probable that an appointee from the private sector would have quickly transmogrified into Mr Keating's poodle. And 'safe' appointments have had a strange history of turning into highly independent-minded heroes. Who knows? Mr Fraser could turn into Mr Keating's Sir Thomas More or Thomas a Becket"(AFR, 4 April 1989).

On the 5 April an editorial in the Canberra Times adopted a similar position on the prospect of Fraser's appointment as Governor, suggesting that Fraser's credentials were "well suited to the job", and taking Opposition Shadow Treasury John Hewson to task for the latter's suggestion that the appointment of Fraser would constitute the patronage of a 'political mate' (Canberra Times, 5 April 1989).

In June the speculation over the pending appointment to the Governorship continued, and a further variable was added to the Australian policy debate as details of the New Zealand Government's Reserve Bank legislation became available to the Australian audience. The merits or otherwise of Fraser's appointment to the Bank, and the wider issue of the independence or otherwise of the Reserve Bank of Australia were debated against the back-drop of a model that some saw as an appropriate institutional benchmark. In the Sydney Morning Herald Max Walsh observed that in contrast to the 'sound finance' policies adopted by the United States, Canada and New Zealand, Australia was following an heretical path, evidenced by what was increasingly seen as the probability of Fraser's appointment as Governor:

"His appointment is largely regarded as a reward for services rendered to the Hawke Government - a semi-retirement in Sydney for all the long hours and hard work he has put in on the fiscal front over the past few years.

We are, in short, getting the wrong person for the wrong reasons...

... Mr Fraser has sat on the board of the Reserve Bank in a position one suspects should be described as *primus inter pares*. Mr Keating has said that the Reserve bank does what he tells it to do. The inference must be that Mr Fraser has been the messenger boy..

... there is the question of Mr Fraser's independence as a Governor of the Reserve Bank and how the market would perceive this.

At any time, this is an issue of great importance. But this is a time when the maintenance of confidence in the integrity of monetary policy is paramount, given the crisis prone nature of the linked problems of excessive foreign debt and an over-leveraged corporate sector.

While an announcement that Mr Fraser is to become the new Governor would certainly not trigger a collapse of confidence, it would add another element of uncertainty to what is a very dangerous situation...

It is significant that political leaders throughout the world have come to realise the limitations of democracy when it comes to imposing unpopular policies. That's why they have appointed strong independent central bank governors prepared to stand up publicly, absorb the heat from noisy vested interests, and take the long view of their nation's economic future.

Of all the decisions the Government has to take this year, the appointment to the Reserve Bank is the most important"(SMH, 29 June 1989).

The same day an article in The Australian reported the release of a Liberal-National Coalition policy statement by shadow Treasurer John Hewson foreshadowing significant institutional changes, along the lines of the nascent New Zealand model, under a Liberal-National government. Dr Hewson suggested that:

"[t]he Bank should be given the medium term task of pulling down the rate of inflation and therefore interest rates by monetary policy. A medium term apolitical orientation in that I think they need to be more accountable"(The Australian, 29 June 1989).

Conclusion

A new Governor would be appointed in July 1989. His tenure would see a concerted attempt to revisit the post 1945 institutional arrangements, informed in part by the enthusiasm for a new institutional model that would soon be codified into statute by the New Zealand Parliament, and the merits of which would subsequently be extolled by the many in the financial markets.

Monetarism had been tried, and found wanting, tentatively under Whitlam, and with somewhat less equivocation under Fraser. However even the cautious embrace of monetarism under the Fraser Government was markedly at variance with the monetary policy adopted by Malcolm Fraser's New Zealand counterpart, Robert Muldoon, who, we noted in the previous chapter, was reluctant to use the power of interest rates to control economic activity (unless those rates were controlled by way of executive regulation).²⁰ Australia experimented with a statist monetarism, New Zealand

²⁰ But in other areas - the use of wages pauses or, in the New Zealand case a 'freeze' by regulation - there was a greater measure of common ground. Both Prime Ministers had a tendency to contest the policy

adopted a statist regulation. In Australia the process of disinflation, coupled with disjunctions as between monetary, fiscal, and wages policies, would see an early variant of the rational economic prescription failing the test of legitimacy. In New Zealand, the statist excesses of Muldoonism would see low endowments of both legitimacy and credibility. Both jurisdictions fell short of what we have identified as the equilibrium condition - high endowments of both legitimacy and credibility. As we noted in the previous chapter, the response of the incoming fourth New Zealand Labour Party Government was to embrace the orthodoxy suggested by the rational economics literature reviewed in Chapter 2. That embrace would see a new set of institutional arrangements codified in the 1989 statute. The disequilibrium of Muldoonism was punctuated, and a new institutional regime put in place. In Australia the quest for credibility (and legitimacy) resulted in a markedly different trajectory. The monetarist experimentation under Whitlam and Fraser had ensured that the quest for low inflation was firmly on the policy agenda - credibility of policy was a paramount consideration. And in very many respects - and perhaps somewhat unusually for a social-democratic party in the early 1980s, the point of departure in Labor's development of the neo-corporatist, 'labourist' alternative was the requirement to secure and maintain a lower rate of inflation. For 13 years of ALP Government the 'labourist' Accords would be a centre-piece of the Government's programme of macro, and increasingly, microeconomic management. The 'Coombsian' institutional scheme was reaffirmed by the Campbell Committee - a significant vote of credibility to the post War institutional framework in a report that in some many other respects set the direction for a sweeping process of financial liberalisation. However credibility, now found, would increasingly become credibility at risk of being lost. Financial liberalisation and the float of the dollar would empower financial actors whose desire for theatre was matched only by a preference for institutional arrangements that reflected the rational economic orthodoxy. The Campbell Committee's affirmation of the Coombsian scheme would be lost in a culture which placed a heavy discount on any institutional regime with a Keynesian progenitor. The Australian regime was 'unfashionable', the Australian central bank, while operationally independent in the post-float environment, struggled to shake off the traditional secrecy so characteristic

advice tendered by government ministries and central banks. In the case of Fraser his own Department was positioned as a counter to the Treasury, and to a lesser extent, the Reserve Bank. Muldoon's reluctance to heed the advice of either Treasury or the Reserve Bank has been well documented. And in the relationship between the two Treasuries and their respective Ministers there is a common pattern, albeit for different reasons. Treasurer Howard's relationship with the Treasury was strained, in large part due to the personality of John Stone, but also as a result of the Treasury's reluctance to embrace the recommendations of the Campbell Inquiry into the Australian Financial System. In this sense the preferences of Minister and department were the inverse of the situation that obtained in Wellington. In Canberra the Treasury opposed many of the recommendations of the Campbell Inquiry, and, in the main, although with markedly less unity of purpose, did so up until the decision to float. The New Zealand Treasury's 1984 post-election briefing papers suggest a markedly different perspective.

of the 'old' regime. The markets found in the nascent New Zealand arrangements a more fashionable model - the lines were clean and simple, and it appeared to be a very exportable 'brand'. There was some theatre for the markets, but it was singularly unhelpful for a central bank concerned to maximise credibility. Credibility demanded a large measure of central bank independence, and the suggestion that the central bank was in some way under the influence, if not the direct control, of the Treasurer seriously undermined the credibility of the institution, and of monetary policy. We suggested at the close of Chapter 3 that a condition of institutional disequilibrium that is unable to be managed and contained within a state directed policy network, will spill over into the domestic political arena as societal (economic) actors seek to prosecute their claims in other ways. As the decade of the 1980s came to a close a credibility deficit - perceptions of the dimensions of which were very clearly variable across the range of financial and non-financial actors - would surface as an important element in domestic politics. In the next Chapter we examine the political contest for the Australian central bank.

Chapter 7

The Contest for the Central Bank

Introduction

The political economy model elaborated in Chapter 3 treats central bank independence - more generally the particular features of the formal institutional arrangements within which central banks are situated and monetary policy developed and implemented - as endogenous. Particular institutional forms, in a static sense, and trajectories of institutional reshaping in a more dynamic sense, can be located or mapped within 'credibility/legitimacy space'. Moreover, because the framework is a political-economic one, the assumption is that preferences as regarding the relative importance of credibility and legitimacy will reflect particular societal and economic interests. Financial actors will, *ceteris paribus*, place a higher premium on credibility (and its policy proxy, price stability), whereas other economic actors may be more inclined to place more weight on legitimacy, which goes to economic objectives in addition to price stability, and more inclusive and transparent modes of policy governance. We have argued that the equilibrium condition is one in which endowments of credibility and legitimacy are maximised, and that within a state directed policy network the objective will be one of securing institutional arrangements by maximising endowments of both. We have also argued that the failure of a state directed policy network to accommodate demands, variously for credibility and legitimacy, may be manifested in those demands for institutional reform spilling into the domestic political domain. Institutional disequilibrium - the failure to maintain the equilibrium condition by actors within the state directed policy network - may result in institutional reshaping of a more formal kind being prosecuted through legislative change.

Seeking to locate a particular institution within 'credibility/legitimacy' space, or to map the trajectory of institutional reshaping within that space is clearly problematic inasmuch as it may involve the aggregation of preferences, and differential weightings being allocated to the preferences of particular actors. It is entirely possible, for example, that a location at any given point in time will reflect the particular historical exigencies of the time, or that the perceptions of a different set of actors will result in markedly different assessments (placements in 'credibility/legitimacy space'). An assessment informed solely by a reading of central bank statutes would perhaps result in a markedly different set of locations for any given set of central banks, than would

an analysis of the behaviour of central banks and governments, and the record of macroeconomic policy over time.

In essence, explaining trajectories of institutional reshaping requires firstly an assessment of the relative influence of actors within the political economy and the nature of their interests and preferences, and secondly, an assessment of the capacity of a particular set of institutional arrangements (within a state directed policy network) to accommodate these interests and preferences. A regime shift of the kind evidenced in the New Zealand change suggests a response to (or perhaps the anticipation of a repeat of) an episode of acute institutional disequilibrium, and the remaking of a state directed policy network. A trajectory of institutional reshaping of the kind suggested by the notion of institutional dynamism, suggests a capacity for the management of institutional reshaping, within an existing policy network, and without recourse to more formal modes of legislative change.

This Chapter reviews the trajectory of the institutional reshaping of the Reserve Bank of Australia over the period from 1989 through to 1996 - Bernie Fraser's tenure as Governor of the Reserve Bank of Australia. It is a period that opens with the Bank itself seeking to come to terms with the requirement for greater transparency in the conduct of policy, and increasingly having to contend with demands for changes to the formal institutional arrangements - specifically changes in the charter and the governance of the Bank. The case for change is one couched in terms of the requirement for central bank independence, with those prosecuting case for change suggesting at best, the appearance of a politically porous institutional framework, and at worst, the fact of direct political manipulation of the Bank on the part of the Government; and those defending the institutional status quo (or perhaps more correctly an incremental process of institutional reshaping) repudiating accusations of political control. The case for a regime change would be one predicated, in the main, on a growing credibility deficit (a deficit that would, in part at least, be manifested in bond rate differentials) and the existence of a very proximate institutional solution in the New Zealand model (a model that would, in the early part of the 1990s, be very much in vogue within the international financial community). It would be a case predicated on 'credibility lost', and a prescription largely informed by the rational economic orthodoxy that would see the issue of 'central bank independence' becoming a key element in the partisan contest of ideology and politics over the course of the 1990s. It would be a contest that, by June 1994, was over, with the Reserve Bank itself having become the key player in a process of institutional reshaping that would see 'credibility regained'. The decade had opened with the Bank embracing an orthodox monetarism, and would close with a repudiation of that orthodoxy - one that had now been codified in the New Zealand

statute - in favour of dualist objectives, governance and policymaking by a Board, and the retention of many of the other elements of the original 'Coombsian' scheme.

As we noted in the conclusion to the last Chapter, those prosecuting the case for a radical revisiting of the Coombsian scheme - both within Australia and without - cited the lack of congruence between the legislative scheme, and the prevailing international orthodoxy, suggested by the rational economics literature, and evidenced most clearly in the New Zealand model. Multiple objectives, a dualist charter, the involvement of 'lay' outsiders in the development of policy, and the involvement of what, from a reading of the statute, appeared to be a representative of the Commonwealth Treasury (and, assuming Westminster conventions, the government of the day), all conspired to produce a credibility deficit. But the period from 1989 to 1996 would see the Bank itself actively reshaping the institutional environment within which it operated. It would see a more transparent approach taken to the development and implementation of monetary policy - a move away from the mystery and mystique of Montagu Norman; it would see the Bank recommending a direct reporting and accountability relationship with the Commonwealth Parliament, through a Parliamentary Committee; it would see the Bank progressively developing its own inflation objective, and the Government of the day (and other key stakeholders within the labourist policy community) embracing that objective and importing it into wages and fiscal policy settings; and by 1996 it would see the Bank taking the lead in formally codifying into an exchange of letters with the Coalition Government aspects of policy and practice which had, somewhat incrementally and informally, been developed within the Bank. This period would also see a vigorous political contest over the Bank - a contest that the Bank, as it sought to shape the Coombsian scheme to the new political and economic realities, would participate in through the deeds and words of the Governor and other senior members of the Bank's management. The contest would be one as between two models - a model suggested by the rational economics literature reviewed in Chapter 2, and most clearly articulated in the post 1989 New Zealand arrangements, and a model that would evolve out of the Coombsian scheme, retaining the formal legislative features of that settlement, while at the same time extending it to accommodate the new realities of the Australian political economy.

Changing the guard at the Bank: from Johnston to Fraser

On the 5 July 1989 Cabinet endorsed the appointment of Bernie Fraser as Governor of the Reserve Bank of Australia. The appointment was immediately criticised by the

Federal Opposition on the grounds that Fraser's appointment would do little to place the central bank on a more independent basis:

"[T]he Opposition treasury spokesman, Dr Hewson, said Mr Fraser was not the best qualified candidate for the position. He said Mr Fraser, because he came from the Treasury, would not be completely independent of the Government ...

'There ought to be a very strong and independent Reserve bank, and if you are looking to fill the position of governor to meet that criteria there are a number of candidates who come in ahead of Bernie Fraser'" (*The Age*, 6 July 1989).¹

The fact that Fraser was, notwithstanding his membership of the Board of the central bank as Treasury Secretary, seen as an 'outsider' was clearly a consideration, including for the outgoing Reserve Bank Governor, Bob Johnston who was quoted as suggesting that the appointment of Fraser was, "a great disappointment to the people in the Reserve Bank", but went on to say, with more than a hint of irony, that,

"[t]here won't be any outcry or taint attached to this because the bank will go on. Firstly, because Bernie Fraser himself is a very able person and a very pleasant one and secondly because the bank will absorb him anyway and thirdly because, as most of you know, the Reserve Bank doesn't matter very much"(*SMH*, 15 July 1989).²

The extent to which the Bank would absorb Fraser, or Fraser, for his part, was to be instrumental in shaping the culture within the institution he was to head for seven years, is a matter to which we return in this and succeeding chapters.

In his valedictory speech Bob Johnston was to defend the Bank against the accusations of political dependence on its part:

¹ A similar line of criticism was also pursued in an editorial in *The Australian*:

"... he [Fraser] has been so closely identified with Mr Keating while head of the Treasury there is some fear that his appointment to the bank could tighten the Treasurer's grip on what should be an entirely independent organisation"(*The Australian*, 7 July 1989).

² In the context of the ongoing debate over the independence of the Reserve Bank of Australia Johnston defended the Bank (and the Government and Treasurer of the day) against the accusation of a politically porous relationship:

"But Johnston was effusive in his public support of the Treasurer, the thrust of Government policy, and the appropriateness of the 'consultative independence' characterising the relationship between central bank and government. Johnston, "reserved his strongest commendation for the Treasurer Mr Keating, saying 'we feel privileged that we too are riding on the chariot'. In his view, it was the responsibility of the Reserve Bank to 'rub along with the Government so long as it is on the right track', and to resort to 'public tantrums' if it were being seriously thwarted by the Government, or if it considered the Government was on the wrong track"(*SMH*, 15 July 1989).

"The most painful thing that has happened is this questioning of the independence of the bank: in particular the assertion that the bank has been a party to manipulating interest rates.

It's very hard to rebut these things when they are said. I've tried to. I don't know whether people believe me. I can only say that I believe it to be. I think the most important thing is that it should be known that my successor hasn't been compromised at all in his freedom of actions.

There have been no passes sold anywhere by the Reserve Bank, to which a newcomer will say, Well I would act in this way or that way but I can't because my predecessor committed me to this or that" (quoted in The Age, 17 July 1989).

And Johnston was also to suggest a further step in the evolution of the Bank's formal accountability relationships, raising the possibility of a direct reporting relationship with the Parliament. In an interview with The Age reported on 19 July 1989 Johnston advocated a greater measure of transparency and accountability by way of a requirement on the Governor to testify before a Parliamentary Committee - along the lines of the reporting arrangements for the US Federal Reserve - suggesting that this would encourage more openness:

" ... the chance to testify to the legislature, under the glorious pain of oath, is another thing. It is often useful, in politics, to be seen to be compelled to say things that outside politics one would have been happy to shout from the rooftops.

Perhaps this way might our central bankers of the future find it possible to speak plainly and candidly, not to the political bosses who appointed them, but to the population to whom they are, through the Reserve Bank charter, responsible.

This is, after all, what happens in America, without any sign of it frightening the horses"(The Age 19 July 1989).

Fraser's appointment served to elevate the importance of 'central bank independence' as an item on the Australian public policy agenda, and as a subject of partisan contestation between the ALP Government and the Opposition. In a detailed review in the Australian Financial Review Michael Stutchbury observed that the Reserve Bank's multiple objectives constituted, "the most broad and most ambitious task confronting any central bank governor in the world", and that, in resiling from the use of money supply growth targets the Bank had suffered a 'credibility' downgrade in the markets, made all the more egregious by the vagueness of the checklist approach and greater discretion in policymaking. While acknowledging that the practice of central bank-government relations was, even within the most 'credible' of institutional arrangements, other than the strict autonomy suggested by statute reading, Stutchbury observed that:

" ... the perception of independence can be critical in convincing financial markets that particular central banks will not subvert the long-term goals of currency stability to the short-term election concerns of politicians ...

As Australia enters the 1990s, a strong case can be made that the ground rules for operating monetary policy in Australia are outdated and should be changed.

The 1945 charter and the Reserve Bank's lack of autonomy from the Government of the day were established as a reaction to the Labor Party's deep distrust of central bankers ...

The problem with Australia is that everyone has come to believe that the central bank will never be serious about extinguishing inflation.

This means that the Reserve Bank would have to deliberately engineer a deep recession to tame inflation - which only reinforces the credibility gap. And there is no constituency in Australia - be it the voters, the farmers, the miners, the retailers, the builders, the manufacturers or the unions - which wants to get rid of inflation that badly.

This is Bernie Fraser's mission impossible"(AFR, 19 July 1989, emphasis added).

The Stutchbury analysis is clearly apposite to the matters traversed in preceding chapters, and anticipates much of the discussion that follows. Recast in terms of what has come before, Stutchbury, in effect, suggests that notwithstanding the strong theoretical (rational economics) case in favour of greater central bank independence the constraints imposed by historical precedent - in turn informing an institutional culture within the ALP - and the absence of a societal coalition in favour of an alternative focus for monetary policy, underpinned by a new set of institutional arrangements, combined to militate against institutional reform. And, Stutchbury notes, those in favour of such reforms were not required to cast far afield for a model:

"One possible reform model is New Zealand. Reforms being passed through Parliament will require the Government to set an inflation target and will leave the Reserve Bank of New Zealand with the sole responsibility of achieving the target..." (AFR, 19 July 1989).

Stutchbury would develop this line of argument in a further article, sympathetically reviewing the thrust of Coalition policy - which increasingly would allege a growing credibility gap, and recommend an institutional solution along the lines of the New Zealand model - but expressing reservations about the prospects of any government willingly carrying the economic and political costs that would accrue from a hard nosed deflationary programme:

"The bottom line of this monetary policy credibility gap is that no one believes that any Federal Government would tolerate the wave of business bankruptcies

and job retrenchments that would be required to **crunch** inflation out of the Australian economy.

Or would a Liberal-National Party Government accept the doubling of unemployment that New Zealand's Rogernomics has found to be the cost of cutting down inflation?"(AFR, 30 August 1989).

In August 1989 the debate was very much joined within the political domain. At a speech to the National Press Club John Hewson indicated that an incoming Coalition government would consider legislating to increase the independence of the Reserve Bank. Paul Keating, for his part, suggested that having a central bank outside of the final direction of the government of the day would be unworkable, and reasserted the efficacy of the formal relationship between the Bank, the government of the day, and the Parliament:

"The central bank is not beyond the control of democratically elected Government but the central bank has every right and opportunity to put its case, with the final arbiter being the Parliament and hence the electorate" (quoted in the AFR, 13 September 1989).

The debate continued in the press by way of an exchange between the Sydney Morning Herald's Max Walsh and Treasurer Keating, the former suggesting that Keating's reluctance to embrace greater formal independence for the Reserve Bank of Australia betrayed the fact that, "[a]n independent central bank concerned, as it should be, with reducing inflation and stabilising the currency would be an Australian Treasurer's nightmare"(SMH, 14 September 1989).

In a detailed reply, published on the 22 September 1989, Keating defended the institutional status quo, and attempted to explain an earlier comment to the effect that the Reserve Bank 'did his bidding':

"These matters of mine are not new as I have always said that monetary policy is a matter agreed between myself and the Governor of the Reserve Bank. At my press conference for the January balance of payments figures held on February 16 this year, I said just that, although my comments were misinterpreted. At that press conference, I was rejecting the specific notion put to me that the Government had no control over the conduct of monetary policy ...

But I had a wider purpose in drawing attention to the appropriateness of the current Act. Dr Hewson, the Shadow Treasurer, assisted by some in the media such as Max Walsh, has been pushing the fiction that Australia's inflation problems could be solved by amending the Reserve Bank Act to require it to focus exclusively on achieving price stability and by removing the board entirely from any vestiges of control by the Parliament or the Government of the day...

Amending the Reserve Bank Act and thinking that inflation will disappear in a relatively painless way is the height of naivety or straight quackery" (SMH, 22 September 1989).

Moreover Keating was concerned to properly differentiate the 'labourist' approach from its 'monetarist' alternative:

"If Mr Peacock and Dr Hewson are saying that they would put the monetary supply at the centre of the fight against inflation, then we would be back in a world believing that wage increases were determined by inflation expectations and that inflation expectations were determined by expectations about the future growth of money supply. In other words, we would be back to the failed dogma of high monetarism" (SMH, 22 September 1989).

In his reply Walsh suggested both that the Accord had reached the limits of its anti-inflationary impetus, and reprised the dynamic inconsistency and 'public choice' informed cases for central bank independence:

"The political imperative of governments to highlight the favourable while dissembling, dismissing, misrepresenting or ignoring the more fundamental unfavourable aspects of our economic situation means the required corrective action is postponed until the arrival of the unavoidable crisis.

That is why the Reserve Bank should be given both greater practical independence and a non-political charter which unambiguously gives it responsibility for maintaining price stability and protecting the integrity of the currency...

... the successful economies do recognise the overriding necessity of getting inflation right before anything else is possible" (SMH, 25 September 1989).

In October 1989 John Hewson provided more detail on the kinds of legislative changes that an incoming Coalition Government would consider, including the appointment of external executive directors to the Bank board, and a mandated focus on price stability, albeit one expressed in terms of comparability with rates of inflation below the average of Australia's trading partners, and not a quantified price stability target such as that entertained by the New Zealand arrangements. Hewson also suggested that under a Coalition Government the Reserve Bank Act would be amended such that the Secretary of the Treasury would come off the Bank Board.

It was in the context of a warming domestic political debate that, on 30 November 1989 Bernie Fraser gave his first speech as Reserve Bank Governor.³ Not surprisingly, and for reasons that will be more closely examined in a following chapter, the speech

³ Chris Higgins was appointed Secretary of the Treasury, and joined the former Secretary on the Reserve Bank Board.

focused on the issue of central bank independence.⁴ The speech was a vigorous defence of the Bank's independence, within the context of a set of institutional arrangements and a policy mix which Fraser defended as appropriate. Fraser rejected calls by the Federal Opposition for legislated independence for the Reserve Bank of Australia, argued that it was entirely possible for the Reserve Bank to be both independent and co-operative, affirmed that elimination of inflation was a prime objective of the Bank, but was also strongly supportive of a coordinative approach to realising that objective, with the policy load shared between monetary, fiscal, structural reform, and, in particular, wages policy. The 'Accord', Fraser argued, was a particularly appropriate means of achieving the required measure of policy coordination.⁵

Recession policies - from the current account to price stability

As we noted in the last Chapter, over the course of 1988 and 1989 monetary policy had been tightened in a series of 'snugging' movements. In the final quarter of 1989 the Australian economy contracted (a reduction in output of 0.2 percent for the December quarter 1989 was confirmed on 21 March 1990; see Tingle, 1994:80). Bernie Fraser, as we noted in Chapter 6, had, from his position as Secretary of the Treasury, argued for a much greater reliance on fiscal and wages policies, and the avoidance of a credit squeeze. By the end of 1989 Fraser was at the head of the Reserve Bank, and was arguing the case for a reduction in interest rates with his Board, and with his former department. Edwards reports that there were a variety of assessments of the 'turning point' in the economy and the timing of any adjustment in interest rates:

"Bernie wanted to knock them [interest rates] off in November of 1989, Paul recalled. He hadn't agreed; he'd wanted to wait until after Christmas. But he did want to get them down, he said, before history revealed itself...

Bernie had said, 'Let's put monetary policy to bed for a while', a view that the Bank expressed in a press release; then there was a big blue with the Bank, the only one Keating ever had, and then there was a long gap from April to August before the cuts resumed. It was the gap that did the damage, Paul now thought

⁴ Michael Stutchbury would describe the speech as "the most uncentral bank speech given by the head of a central bank" (AFR, 6 December 1989).

⁵ In reviewing this speech The Australian referred to a consistent theme in Fraser's approach, citing comments by Fraser in an earlier speech given in April 1989. In that speech Fraser had identified the problems associated with an over-reliance on monetary policy:

"We could really slam on the monetary brakes and before very long that would really bring the economy to a halt and we would see lower inflation and current account deficit...

But I have observed how wasteful and costly those approaches can be in giving sever jolts to confidence, their impacts of profits and investment, closure of factories and the displacement of large numbers of employees"(quoted in The Australian, 21 December 1989).

- the gap as the board of the Bank, and of course Treasury, resisted. Paul had given Bernie a blast across the table after that press release, a full blast in which he said that the Bank had tried to cut off his options for bringing rates down more quickly. He told the assembled group of Bank officials that they should all go and get jobs somewhere else if they wanted to behave like that. But he had to say for Bernie that mostly he was fighting alone, or alone with just Kelty against the board and the Treasury. The department was fighting it so hard that at one point Chris Higgins had actually voted at the board against a recommendation to ease. Bernie was fighting in Sydney while Keating fought on in Canberra and not the least against the Department of Prime Minister and Cabinet" (1996: 378).

This recollection is important for a number of reasons. It suggests a diversity of views within the Bank, within the Board, and within the official family. If the recollection reported by Edwards is accurate it also illuminates a process of decision making at the Board level which was, at times, other than consensual, and a degree of freedom for the Secretary of the Treasury - Chris Higgins - to exercise his vote on monetary policy in accordance with the views of the Treasury, and not those of the responsible Minister, the Treasurer. It also suggests that, despite attempts to pressure the Bank into reducing interest rates more quickly, and the presence of a Governor who sympathised with the case, the Government of the day was unable to exercise any determining influence over the central bank. In short, Australia's central bank exhibited all the hallmarks of an independent institution.

In December of 1989 Bernie Fraser had recommended an easing in monetary policy to the Reserve Bank Board, a recommendation which the Board were not of a mind to accept, preferring instead to wait (Tingle, 1994: 72). On the 15 January Fraser wrote to members of the Board recommending a rate cut. Tingle records that,

"The only factor - but a substantial one - in the Governor's view militating against an easing was inflation. Inflation, he told the Board, was 'excessively rapid', and there had been 'only a limited improvement in inflation ... winding back inflation should remain the primary concern of all arms of policy', Fraser wrote, and was 'a reason for proceeding cautiously'" (Tingle, 1994: 73).

Tingle reports that Fraser had suggested agreeing to an interest rate cut by way of telephone conference, but the Board itself requested a meeting, concerned that policy decision-making could be viewed as being subject to political influence in the lead-up to the election (Tingle, 1994: 73). On the 23 January 1990 an easing in monetary policy was announced, and a second easing was announced on 15 February following a Board meeting on 6 February.⁶ Whatever the political and economic consequences of the interest rate reductions - which Tingle suggests had the effect of being a 'circuit breaker'

⁶ Prime Minister Bob Hawke announced on 16 February that the Labor Government would go to the polls on 24 March 1999 (Tingle, 1994: 75).

- the fact of monetary policy changes being formally announced by the Bank was a significant further development in the informal reshaping of the institution of central banking in Australia, the announcements breaking the policy and pattern of the past in which the Bank had chosen not to explicitly announce changes in policy settings. The change in policy, which represented a significant departure from past practice, was welcomed by the Australian Financial Review, which commented that the new found 'glasnost' on the part of the Bank represented a 'declaration of independence':

"The idea of a sensitive, reactive banking system which must depend on subtle and unstated variation in Reserve bank policy and the sometimes conflicting statements of politicians who are trying to play a double game, is ultimately untenable...

Mr Fraser's actions undoubtedly have political implications now that we are in the midst of an election campaign.

Whatever government is voted to power on March 24, it will be difficult for its Treasurer to demand, either openly or behind the scenes, a return to the old system of nods and winks" (AFR, 1 March 1990).

On 13 March Paul Keating suggested that with the slowing of the economy interest rates should be lowered, a comment which left the Reserve Bank open to accusations of political intervention. Keating qualified his comment by suggesting that a further easing would have been appropriate if not for the election campaign, but that such an easing would follow discussions with his own advisers, the central bank and its board - "[W]e don't get the central bank to do things that are generally not done in election campaigns" (in Tingle, 1994: 79).⁷

In April there was a further cut in interest rates, but there were to be no further cuts between April and August. The ALP Hawke Government was returned to power in the election on 24 March, but the policy debate was to continue, within the official family, and without. At the end of March Treasury Secretary Chris Higgins sent a paper to the Treasurer in which he argued that, "monetary policy should be avowedly set and conducted in a medium-term context with the objectives of restrained growth in domestic demand and reduced cost and price pressures" (Edwards, 1996: 382). Padraic McGuinness, writing in The Australian in April, again commended the New Zealand model to his Australian audience, suggesting, somewhat ironically that rather than seeking to emulate that model the option of monetary union could be considered, with the task of maintaining the stability of a common Tasman currency given to the Reserve Bank of New Zealand. Towards the end of April 1990 Bernie Fraser reinforced

⁷ Which, it could be argued, did not deny the possibility of the central bank and board being asked, only the inappropriateness of the timing of such a 'request'.

the importance of bearing down on inflation, but rejected any unilateral action on the part of the Bank to announce a medium term objective for price stability, and reaffirmed the form of 'consultative independence' that advocates of the international orthodoxy - evidenced in the clean demarcations of the New Zealand model - found particularly disturbing:

"Nor is it appropriate for me to be indicating here today views which the Bank might have about the kinds of monetary and other policy measures - including possible 'circuit breakers' - that would help to develop workable strategies to achieve the transition from high to low inflation without recession.

These are matters which should properly be discussed in the first instance with the Treasurer and his official advisers: the Bank is keen to do that."(quoted in the AFR, 20/4/90).

An editorial in The Weekend Australian of 21/22 April, under the head-line "Bank targets inflation - and then cops out", was critical both of the defence by Fraser of the multiple objectives in the Bank's charter, suggested that the 'new' Reserve Bank of New Zealand Act provided an appropriate model, and cautioned Fraser against deferring to the Government in such policy matters:

"He is right in warning of the dangers and harm of inflation. He is wrong in thinking it is his duty to wait for the Treasurer to tell him what to do about it. Mr Fraser has started a debate, and expects criticism. He cannot complain if he is the first target of it" (The Weekend Australian, 21-22 April 1990).

The contraction in the Australian economy that had been detected in the December quarter 1989 national accounts did not carry forward into the March quarter 1990 numbers released on 30 May 1990, the data indicating a 1.8 per cent increase in GDP for the quarter. The respite was however to be short-lived, and by the time the data for the June quarter of 1990 were released, they would confirm that the Australian economy was in recession. It would stay in recession through the balance of 1990, experience a very mild recovery in the first half of 1991, and then contract again sharply in the latter part of 1991.⁸ The recession would have the effect of attracting a much higher level of scrutiny to the actions of the Reserve Bank, and the other members of the official family. Monetary policy that had initially been directed to securing external balance, would increasingly be justified by reference to gains on the inflation front. However the Bank would largely escape the political opprobrium generated by the recession. Treasurer Keating's claim that the recession was one that Australia 'had to have' would sheet responsibility to the government of the day (although Keating would seek to hold business, the banks and the Victorian State Government

responsible at various points). For the Reserve Bank, the recession provided an opportunity to win back some of its lost credibility, and it would do that by proving that, when gains on inflation were there to be had, the Bank would seek to secure those gains, and to lower inflation expectations.

In July relations between the Bank and the Government were strained following a speech by the Bank's Deputy Governor, John Phillips. While the speech simply reiterated points that had been made in successive Reserve Bank Annual Reports, the press reported Phillips' advocacy of low and stable inflation as the primary medium term objective for monetary policy as a new departure. Phillips also raised doubts about the key element of the policy orthodoxy in suggesting that monetary policy was not an effective weapon with which to address the current account constraint. Treasurer Keating's response was intemperate and hostile, the assumption having been made that in the Governor's absence overseas Phillips was administering some policy retribution for having been 'passed over' for the position. In a series of commentaries in the Sydney Morning Herald, Ross Gittins was critical of Keating for having turned a 'mildly embarrassing molehill into a policy-divide mountain', noting that the Keating reaction risked confirming in the minds of the market that the Government was 'soft' on inflation and would resist any attempt by the central bank to prosecute the objective. Keating's over-reaction had, in short, undermined the credibility of the central bank. Other commentators took the opportunity to support a more independent role for the Bank in the development of macroeconomic policy more widely. An editorial in the Canberra Times suggested that,

" [a] strong independent Reserve, willing to disagree publicly with the government of the day, would add something rich and valuable to the economic debate. It should not be the job of the bank to ponder the industrial implications of reform, or the potential popularity of a specific course. It is the bank's job to present options for getting inflation down. It is the government of the day's job to sell the idea to the people" (Canberra Times, 10 August 1990).

The Treasury had opposed any cut in interest rates before the 1990/91 Budget, whereas both Bernie Fraser and Paul Keating wanted a one per cent reduction in early August, a cut that was agreed to at a Reserve Bank Board meeting on 31 July.⁹ Treasury Secretary Chris Higgins voted against the recommendation of the Governor at this meeting. Edwards reports that,

⁸ The political economy of the recessions of the early 1990s is detailed fully elsewhere (see Kelly, 1992, Tingle, 1994, Edwards 1996).

⁹ Tingle suggests that through 1990 the Reserve bank had been increasing its inflation rhetoric and had been pushing for the Treasurer to make inflation and not the balance of payments and the current account the focus of policy. It was confirmed the day after the Board meeting that inflation had declined, thus justifying a reduction in interest rates (see Tingle, 1994: 95).

"Higgins opposed the cut with Keating, opposed it with Fraser, and opposed it on the Board of the Reserve Bank, of which he was a member by virtue of his office as Secretary of the Treasury. It was a serious step for a public servant to act so clearly against the wishes of his minister ... " (1996: 385).

However Tingle suggests that a 'deal' of sorts was done between 'Canberra and Sydney' over the August cut in interest rates, with Fraser agreeing to a one per cent cut in rates on the grounds that there would not be a further cut for some time, thus enhancing the credibility of a central bank that would not appear to have been panicked into making monetary policy decisions (Tingle, 1994: 96). The Budget was delivered on the 21 August 1990, and the June quarter national accounts released on Budget night showed a significant contraction in the domestic economy (Tingle, 1994: 99). On 2 October the Reserve Bank Board held its regular meeting, and Tingle reports that two days later Keating rejected pleas by farming and business groups for a big cut in interest rates, suggesting - as per the Treasury assessment - that the economy was slowing in line with forecasts and there was no risk of a full scale recession (1994: 105). On 15 October interest rates were reduced by a further 1 per cent, a reduction that Tingle claims was once again resisted by the Treasury.

Independent advice

On the same day as he announced the decision of the Bank Board to reduce rates Bernie Fraser suggested in a speech that further reductions in inflation could not be entertained using monetary policy, given wage pressures, and recommended that the Government give consideration to a wages-tax trade-off. Tingle reports that this independent advocacy of a change in the policy mix was not welcomed by the Treasurer.¹⁰ Others however were encouraged, and the Canberra Times took the opportunity to applaud the Bank's independence, and Fraser's advocacy of a policy change:

"He suggested that another wage-tax trade-off would be a good idea. What he said was of moderate importance, but the fact of his saying it was even more important. If this signals a new will by the Reserve to act more independently from the Government, the Treasurer and the Treasury, it is welcome. However it is one matter for the Reserve to assert independence and another for the Government to allow it to pursue that assertion"(Canberra Times, 18 October 1990).

¹⁰ Tingle suggests that, "Keating was not impressed with at the Governor's intervention, dismissing the suggestions quickly the next day, and muttering privately that things were not really helped by 'Bernie wandering around like Little Boy Blue' talking about inflation" (Tingle, 1994: 107).

The following day The Age supported the greater openness on the part of the Bank and argued in favour of more of the same:

"If anything we need an even more outspoken Reserve Bank. Not one that deliberately delights in making life difficult for the Government. But one which can argue a case about what is best for the economy in public, one which is publicly consulted about major economic trends and one which also has to publicly defend its actions on monetary policy (i.e. interest rates).

But just as Fraser talks about the need for Australia to develop an anti-inflationary culture, we should also be prepared to encourage a culture which places a high public regard on the words of a central banker - and accepts that in the interests of sound economic management that this may involve some occasional public differences with the Government of the day. In fact, this week's speech - almost a year after that speech on independence - represents an important step forward for central bank frankness. Previous speeches have raised the need to do something more about inflation than just rely on monetary policy and mentioned the importance of wages policy but this went a step further by actually suggesting a specific policy action.

The intellectual arguments for a more independent central bank, more consistently focused on inflation, one which does not - as Keating has boasted - do what he tells it to - are gaining currency. Fraser himself who has been criticised in the past for being, 'soft on inflation' has now felt the need to make a more specific public contribution to the inflation debate.

Recessions come and go, but the outcome of this debate on the role of the Reserve Bank will be critically important to the long-term strength of the Australian economy" (The Age, 19 October 1990).

Fraser's speech provided further evidence of a growing capacity on the part of the Australian central bank to independently contribute to the ongoing policy debate - the independence of the central bank extending to an authority to comment on aspects of policy, outside its direct control, but apposite to its charter objectives. But despite the greater openness of the Bank, the greater transparency in the conduct of policy, and the Bank's on-going advocacy of the benefits of low inflation, arguments in favour of a change in the formal institutional arrangements would continue to be advanced. An editorial in The Australian in November 1990 suggested that the electorate had not yet been offered a credible, independent anti-inflationary policy:

"There are overseas models to emulate ... The board would have a clear charter to seek price stability. It could have an inflation target to pursue over three to five years. The sanction for failure might be dismissal of the board ... Mr Keating would be better able to defend his Budget surplus and anti-inflation gains, and demand greater flexibility from the wages system, had he the external discipline of an independent monetary policy" (The Australian, 12 November 1990).

On 6 December 1990 Treasury Secretary Chris Higgins died suddenly. The day after Higgins' death Keating spoke at a Parliamentary Press Gallery annual dinner. In what was to be a defining moment in modern Australian politics Keating used the speech to criticise what he perceived to be deficiencies in the leadership style of the incumbent Prime Minister, and claimed that he himself enjoyed the confidence of the financial markets, the central bank, the unions, and the Treasury (Edwards, 1996: 389). And in a comment that would add further support to the argument that the Reserve Bank was under political control and direction, the media reported that Keating had, in his speech, offered the observation that, "I've got the confidence of the financial markets, I've got the central bank, I've got the support of organised labour and I've got the confidence of the Treasury and the policy-making centres in Canberra" (quoted in Kelly, 1992: 622; see also Tingle, 1994: 113; Edwards, 1996: 388-9). It was the kind of comment that, once reported, particularly in off shore financial centers, would serve only to further depreciate the credibility of the central bank, of its conduct of monetary policy, and of the conduct of macroeconomic policy in particular. The Bank's adoption of a more transparent approach to the 'bias' being imparted to policy at any given point in time, and the new practice of announcing changes in interest rates as they were made had allowed some recovery of credibility lost. Keating's 'off-the-record' observations, reported out of context, would cause a further widening of the credibility gap.

Breaking the stick of inflation

The new year was to be a politically volatile one for the Government. On 3 June 1991 Paul Keating would resign as Treasurer and return to the back-bench having failed in a leadership bid against the incumbent Prime Minister, Bob Hawke. Edwards suggests that, while the members of the official family had not predicted the recession, both Treasury and the Reserve Bank wanted to take the opportunity to get inflation down to a sustainably low level:

"In past months they had both proposed that the government adopt a formal target for inflation, say 3 per cent, as a guide to policy. They had resisted interest rate cuts, arguing that the cuts already made should be allowed time to work. They wanted to make further cuts on 'history', that is, actual recorded deterioration in production or declining inflation, rather than forecasts for deteriorating production or declining inflation" (1996: 403).

Given the debate that would ensue in the following 24 months over the merits or otherwise of inflation targets, it is interesting to note Edward's recollection that both the Bank and Treasury favoured the Government's adoption of a formal target.¹¹

Edwards reports that in a speech written for an Economic Planning Advisory Council meeting on 22 February Keating argued that Australia was "snapping the inflationary stick" (1996: 405). The speech, penned by Edwards, "helped to shift the debate over economic policy objectives away from the current account deficit ... towards an objective that was both attainable and truly important, and to which Keating had in one way or another been striving since 1983" (1996: 405).

In the first half of 1991 Keating pressured the Bank to reduce interest rates, with support at one point from the Treasury (Edwards, 1996: 404). The extent of the Bank's focus on its new price stability target is reflected in the fact that it preferred to link any rate reduction to an improvement in the CPI, with the data for the March quarter due in mid May. However the Reserve Bank Board did agree to a cut, and on the 4 April the Bank announced a reduction of half a per cent, bringing the cash rate down to 11.5 per cent. A further reduction of one per cent would be made in mid May, following the announcement of the CPI for the March quarter. The episode confirms that despite the rhetorical flourishes from both sides of Australian politics - that supported a view of the central bank as a dependent entity operating within politically porous institutional arrangements - the record suggests that the Bank was not of a mind to codify political preferences into Board policy decisions, and that Fraser, in particular, was concerned to protect the integrity of the Bank's decision making processes.¹²

Over the course of 1991 the debate over the relative merits of the institutional status quo and the New Zealand styled reforms advocated by the Coalition continued. Reviewing that debate in June 1991 the Australian Financial Review couched an analysis in terms of the 'threat of independence' suggesting that the Hawke Government, and indeed the community at large, would perceive an 'independent' central bank tasked to deliver price stability as a threat, given the short-run adjustment costs associated with a deflationary strategy. Moreover Bernie Fraser's perceived lack

¹¹ A formal target would be adopted by the Bank in 1993, and then imported into Government policy, and the final Accord agreement - see the discussion in the following Chapter.

¹² The distance between Fraser and Keating on such matters is captured in an exchange reported by Edwards. In March 1991 the Treasurer, Reserve Bank Governor, Secretary of the Treasury and officials met to consider the economic situation:

"'This is like a board meeting', said Fraser, remarking on the formality as the officials and the Treasurer gathered in the room. 'The real one, not the play one,' replied Keating" (1996: 407).

of anti-inflation credentials were seen as compromising the credibility of any more resolute policy stance on inflation:

"In spite of these efforts, the anti-inflation hawks are still suspicious of Bernie Fraser and his intimacy with the Government. Although the cuts in interest rates under his governorship are seen as justified, his attempts to talk down the Australian dollar two weeks ago suggested he was going soft on inflation.

There is probably some ground for suspicion. The Reserve Bank is aware there may be limits to the Australian community's willingness to pay the price for eradicating inflation" (AFR, 17 June 1991).

The Bank's Annual Report for the year ended 30 June 1991 heralded the Bank's success in reducing inflation:

"The past twelve months have seen major progress in lowering inflation. For the first time in many years Australia's inflation rate fell below the OECD average and inflationary expectations took a large step down ...

Last year's Report, with its theme of inflation, reflected the Bank's belief that a consistent framework throughout the whole of the economic cycle would be necessary to lower inflation decisively ...

To reduce inflation in a structural, permanent way - as distinct from a temporary, cyclical improvement - requires the prevailing inflation psychology to be fractured...

The main task for monetary policy in 1991/92 is to peg the progress which has been made on inflation over the past year, preparatory to winding it back further. Cyclical falls in inflation - where prices slow in response to weak activity - have occurred in the past, most recently in the early 1980s recession when inflation dropped from around 12 per cent in 1982 to a little over 5 per cent in 1984. On that occasion much of the gain was lost within a couple of years, an outcome which policy-makers are determined to avoid on this occasion" (RBA Annual Report, 1991).

The Report was welcomed in an editorial in the Australian Financial Review, which suggested that the Bank should go further in nominating a New Zealand styled medium-term inflation target, and reduce the use of monetary policy as a 'swing' instrument:

"A clear and articulated aim would help raise the Reserve Bank's credibility and shift the public debate away from its obsession with interest rate fine tuning. With the sights more focused, the debate could shift to the more pressing issue of how to limit the costs of getting inflation nailed down" (AFR, 27/8/91).

Kerin, Fraser, the Treasury, and the Bank

In August 1991 inflation fell to an annual rate of 3.4%, the lowest annual rate in 21 years. However an interest rate reduction in September 1991 resulted in further criticism of the Bank and its Governor by the Leader of the Opposition, Dr John Hewson. Bernie Fraser responded by suggested in that, "[w]e need some growth too. Helping achieve an acceptable blend of both objectives is the relevant challenge for monetary policy" (The Australian, 5 September 1991). Hewson continued his attacks on the Bank, the Government, and the new Treasurer, John Kerin, suggesting that there had been complicity between the Treasurer and the Governor in seeking to influence private banks lending policies vis a vis housing and business financing. The Weekend Australian, normally sympathetic to the general thrust of Liberal-National Coalition policy was critical of Hewson, observing that:

"It is curious that the party which wants to remove the Reserve Bank from politics is so obsessed with embroiling it in political controversy ...

If the bank were more independent, then Dr Hewson as prime minister would have to live with this decision in silence, just as he would have to live with decisions to keep rates high at politically inconvenient times.

The irony of Dr Hewson's position is that its effect is to undermine the institution which he says he wants to enhance. The Reserve Bank along with every other central bank around the world in the late 1980s was guilty of serious monetary policy miscalculations. This, in turn, has provoked a substantial rethink within the bank, a far greater emphasis on medium-term settings to achieve price stability and growing support for a more independent bank. Mr Fraser, in fact, is reflecting these precise trends in his speeches and behaviour as Governor. If Dr Hewson is upset about monetary policy his argument should be taken up with the Government not with claims that the Reserve Bank's advice is inspired by politics, not economics.

While Mr Fraser continues to endure attacks from monetary purists for being a monetary policy dove, the Reserve, under his governorship, has maintained one of the tightest monetary policies in the world. It is so tight that our economy is in its deepest post-war recession"(The Weekend Australian 7-8 September 1991).

In reply Hewson reprised Liberal National Coalition Policy suggesting that the deficiencies in the conduct of monetary policy and the institutional arrangements could be remedied if the Bank was tasked to deliver a price stability objective set down for them by the government, and if there were greater transparency and accountability attendant upon the Bank's, and the government's performance.

From the back-bench former Treasurer Paul Keating had added a new dimension to the policy and political environment with his advocacy of a quicker reduction in interest

rates. Whereas Keating and Bernie Fraser had developed a very effective working relationship, the same could not be said of the relationship between Fraser and Kerin, the latter tending to rely more on the Treasury and the Department of Prime Minister and Cabinet for advice. Writing in The Australian Laura Tingle suggested that Keating's,

"regularly aired analysis of the state of the economy and of interest rate settings is in accord with the Reserve Bank's diagnosis at a time of falling inflation ... What has emerged instead is that Reserve Bank chairman (sic) Bernie Fraser, backed by the senior officers of the Reserve, was the leading force in determining interest rates, despite resistance from Canberra, and was prepared to cite the bank's statutory independence and use sheer dogmatism to ensure the monetary policy outcome he wanted" (The Australian, 8 October 1991).

At the time Tingle suggested that the tension between Kerin and Fraser reached a point where Fraser indicated a preparedness to invoke the disputes procedures provided in the Act - provisions not ever used by either the Bank or a Treasurer. The sequence of events suggests that the conflict was over issues of timing, process, and the quantum of any rate cut. Treasury, under its new Secretary Tony Cole was keen to anticipate a rate cut and announce it in the Budget. For his part Bernie Fraser declined to agree to a policy decision being made without reference to the Bank Board. Tingle reports that on the 26 August Treasurer Kerin had phoned Bernie Fraser to pressure him to convene an early Board meeting with a view to having an interest rate cut announced before a crucial ALP Caucus meeting. On the 28 August Fraser was invited to a meeting in Canberra, attended by the Treasurer, his staff, Treasury and Department of Prime Minister and Cabinet Officials, and staff from the Prime Minister's Office. Fraser refused to bring the rate cut forward, and argued in favour of a full one per cent cut, in the face of a recommendation from Treasury and the Department of Prime Minister and Cabinet that the rate cut be 0.5 per cent:

"Kerin asked Fraser what would happen if he insisted on the smaller cut. The Governor replied by saying this would involve the unpleasantness of Parliament becoming involved, a reference to the fact that the Reserve Bank legislation provides for any disputed monetary policy decision between the bank and the Government to be resolved by the two sides tabling their assessments in Parliament. If this course were to be pursued, Fraser said, the Prime Minister should be directly involved. A three-way conversation over a speaker-phone in the Prime Ministers Office between Hawke, Kerin and Fraser followed, at which the Governor dogmatically set out the Bank's reasons for insisting on a 1 percentage point cut in interest rates, including more up-to-date, and not so optimistic, data on building approvals, and secured the agreement of Hawke, Kerin and their advisers" (Tingle, 1994: 142).

The Bank Board meeting was convened earlier than normal, and made the decision to cut rates by one per cent.

"Fightback!"

November 1991 was to see a dispute of major proportions between Bernie Fraser and the Liberal-National Coalition. On the 21 November the Liberal and National Parties (LNP) released their "Fightback!" proposals on Taxation and Expenditure Reform. While the political focus was largely on the Opposition's intention to introduce a 'New Zealand-styled' Goods and Service Tax, other elements of the Opposition's proposals reflected central elements of the New Zealand policy mix, and a 'commitment to price stability' was the first element in the "Fightback!" 20 point plan. The Coalition committed itself to a co-ordinated anti-inflationary strategy which, inter alia, included a commitment to "policies aimed at the medium term goal of reducing inflation to below two per cent, and keeping it there." (LNP, 1991a:37) Implementation of the strategy was to involve amending the Reserve Bank Act:

"We will legislate to give the Reserve Bank effective independence and a clear mandate to achieve medium term price stability. The Governor will be required to be more accountable for his actions, including regular testimony before Parliamentary Committees. The Government and its agencies will continue to comment on the setting of monetary policy and its relationship with other policies. The Reserve Bank will continue to consult with the Government on those settings. But all changes to monetary policy will be decided by the Bank Board and announced by the Governor after consideration of what is needed to achieve the Government's mandate." (LNP, 1991a:38)

The policy was couched in terms of ensuring the independence of the Bank, the suggestion being that relations between the Bank and the Government had lacked integrity - "The Reserve Bank-Hawke Government link has been a sorry saga of compromise and influence. Interest rates have been manipulated for short-term political ends" (LNP, 1991b:129). The Coalition suggested that the actions of the Bank had been less than transparent, and the Bank not held publicly accountable for its actions (1991b:130).

In a series of interviews with Sydney Journalist Craig McGregor, mention of which has already been made, Fraser offered up his own assessment of the merits of the Opposition's policy prescription. Fraser's assessments would literally be front page news, the RBA Governor observing, in reference to the proposed Goods and Service Tax that,

"... we've got inflation down, and we've got people thinking inflation can stay down. I think it would be blowing those expectations to come forward with a consumption tax at this stage which is going to kick those expectations up by 4 or 5 percent or whatever",

and, in reference to the Opposition's intention to amend the Reserve Bank Act:

"It's not that easy to change the charter of the Reserve Bank,' Mr Fraser said. I won't go just to appease some dickhead minister who wants to put Attila the Hun in charge of monetary policy'"(SMH, 23 November 1991).

Response to the Fraser comments was mixed. An editorial in The Australian suggested that:

"... there is little doubt that the interview with Mr Fraser reflects the naivety of the governor in dealing with the media and will only intensify the suspicion in which he is held by the federal Opposition.

Mr Fraser is not alone in his concern about the timing of Dr Hewson's various reforms. But here we come to the core of the issue - the critical role the Reserve Bank must play during the first term of a Hewson government. With a deregulated labour market, a recovering economy and a degree of fiscal policy flexibility having been sacrificed to compensate Australians for his new tax, Dr Hewson would probably have to rely on the Reserve - empowered with a charter to pursue price stability - to contain inflationary expectations. It may be that Mr Fraser will be obliged as governor to conduct a firmer monetary policy than he might otherwise like. If instead he tried to frustrate a Hewson charter, he would not simply be opposing a 'dickhead minister', as he put it, but the will of the Australian electorate"(The Australian, 26 November 1991).

In his column in The Australian the same day, Alan Wood, an otherwise enthusiastic supporter of the Coalition's policy prescription, was defensive of Fraser, suggesting that while his comments may have been unwise and indiscreet, he (Wood) was only aware of one instance of direct political interference in interest rate setting, and that before Fraser's term as Governor. Some ten days later, following a speech by Fraser that had included a resolute defence of the Bank's multiple objectives, and of the form of consultative independence practised by the Bank, Wood rehearsed the merits of the Opposition's package of proposed reforms, suggesting that an incoming government with a mandate for these changes would present Fraser with a clear choice - "get on with the anti-inflation job or get out" (The Australian, 3 December 1991). The Sydney Morning Herald took a more cautious approach, indicating merit in both Fraser's, and the Coalition's positions:

"There are advantages to specifying inflation targets. They can be self-fulfilling to some extent: if people believe that the targets will be met, they will pitch their wage demands and commercial contracts accordingly. However, even a Government with a very strong commitment to eliminating inflation will also be concerned with growth and employment and will want the flexibility to cushion economic shocks. As Mr Fraser says, the cost of cutting inflation can be cut without big reductions of output and employment, and these opportunities should be seized. There are also times when even very large cuts in output and employment will produce only slight reductions in inflation. Inflation targets should be used selectively"(SMH, 3 December 1991).

In early December the Reserve Bank's Deputy Governor, John Phillips, announced his retirement. Phillips, viewed as an inflation 'hawk' was expected to use his departure to reassert the primacy of fighting inflation. Interestingly he expressed his reservations about tasking the Bank to deliver a quantified price stability objective, and the merits of the New Zealand model. While the New Zealand model was described by Phillips as an 'interesting experiment', he raised concerns about the adoption of a target unless it was very well framed:

" I would not say it is wrong but I think something like this ... needs to be watched over for more than one year. It is interesting that, without a target, we have got inflation down about as far as New Zealand.

The question is which will stick better - ours or theirs" (The Age 5 December 1991).¹³

In December an important development in the Reserve Bank's 'accountability' relationship with the Federal Parliament occurred that went largely unremarked. On 18 December the Bank took up an opportunity that had existed since the preceding year to appear before the House Committee on Banking, Finance and Public Administration to speak to, and be questioned on, the Bank's Annual Report.¹⁴

On 19 December 1991 Paul Keating replaced Bob Hawke as Prime Minister, Ralph Willis, who had succeeded John Kerin as Treasurer under Bob Hawke, was moved to the Finance portfolio, with John Dawkins taking over as Treasurer. The new year was

¹³ In a farewell speech and subsequent media interviews Phillips would elaborate on his views. In an interview with The Australian's Laura Tingle published on the 12 April 1992, Tingle reports Phillips as suggesting that:

"I think it would be more accurate to say my sympathy lies at the moment with changing the charter rather than leaving it,' he says - but not changing the charter from one that emphasises both inflation and unemployment to one looking at inflation.

'Charters can be written in a number of ways. I thought that the Bundesbank example was closer to my idea of a good charter because it says the central bank should take notice of the policies of the government but not to the point where it cuts across the central bank's primary function, which is to promote price stability and get inflation down.

'I think that is the right balance. It's not that I think the central bank shouldn't have other objectives. I think it's proper for Parliament to give an indication to the central bank as to how it ought to go about that.'

Formal inflation targets impart ' a degree of inflexibility which can be counter-productive at times. My own experience with quantitative targets of one type or another, which I think would apply just as much, if not more, to inflation targets, is that at times they will force you to do stupid things just to meet the target ... some of those things you just can't afford to do"(The Australian, 12/4/92).

¹⁴ Commenting subsequently on that appearance Bernie Fraser remarked that the meeting was attended by only three Committee members - the ballot for the leadership of the Labor Party was to take place the following day.

to see a continuation of the tensions between Fraser and the Opposition. In March 1992 both Fraser and the Opposition's shadow Treasurer Peter Reith were present at a meeting of the Asian Pacific Bankers Club - an exclusive group attended by the chief executives of banks in the region, including the largest banks in Japan and Australia. Reith accused the Reserve Bank of being politicised, and Fraser, who was in the audience, was invited to respond when he rose to speak later. Fraser is reported to have stated that, because Reith's comments were made before foreigners, he wanted to record the fact that the bank was "very independent and not subject to political interference" (The Australian, 19 March 1992). A report in The Age suggested that Fraser had indicated to those present that he, "normally would not worry about such nonsense and Mr Reith's representations come into that category" (The Age, 20 March 1992).

John Phillips' 'farewell speech' in March 1992 was anticipated as providing some comfort to those anxious to see changes along the lines of those proposed by the Coalition. Phillips however defended the track record of the Bank, and raised serious reservations about the adoption of a quantified price stability target. The Australian Financial Review headlined the speech as its front page lead under the headline - "RBA deputy rejects Libs' inflation plan" :

"Mr Phillips' rejection yesterday of both the Opposition's 0-2 per cent inflation target - and his rejection of claims of a lack of central bank 'independence' - carried extra weight because he has been seen as the Reserve Bank's chief anti-inflation 'hawk'. And, particularly after being passed over by Mr Keating for the Reserve Bank Governor's job, the Opposition cannot accuse him of being a government 'mate'" (AFR, 26 March 1992).

John Phillips' successor as Deputy Governor, Ian Macfarlane - viewed as sharing with Phillips a 'hawkish' predisposition towards inflation - would also face the ire of the Opposition when, in a speech in May 1992 he suggested that high inflation in Australia was over, not just in remission. Opposition Leader John Hewson accused Macfarlane of putting his arguments, 'very selectively'. Media reaction to the Macfarlane speech, and the Opposition criticism of it, was mixed. Alan Wood, writing in The Australian, suggested that Macfarlane had been acting in a manner consistent with the Opposition's preferred model of institutional best-practice, the New Zealand arrangements:

"His objective in making the speech is transparently clear: he is attempting to favourably influence inflationary expectations, a very respectable task for a central bankers and precisely the sort of behaviour you would expect under the Hewson model of central banking.

It is just the sort of thing the Governor of the Reserve Bank of New Zealand does regularly, for example, and New Zealand's central banking policy has had a strong influence on John Hewson.

In its most recent report on Australia the OECD clearly favoured such changes and was only stopped from advocating a Hewson-style inflation target by Treasury intervention in its report."

Claiming that inflation will jump again with recovery is a remarkably short-term political ploy, and to represent a serious attempt by a senior central banker to make the case for sustained low inflation as mere partisan politics is both offensive and silly" (The Australian, 26 May 1992).

The Australian Financial Review adopted a similar stance, but Tim Colebatch, writing in The Age was critical of the Macfarlane speech, but for a completely different set of reasons:

"Australia suffered worse because policy-makers like Ian Macfarlane got it wrong. They exaggerated the risk of high inflation; they ignored the far more serious risk of high unemployment. One may argue interminably over how much damage inflation does. There can be no argument about the devastating effects of high unemployment. It destroys its victims morale, their self-confidence, their financial well-being, their ability to enjoy life. It leads to crime, domestic violence, poor health, even suicide.

Thanks to the Reserve, Australia now has 'an internationally respectable inflation rate'. It also has a million people unemployed, more than 300,000 who have been out of work for a year or more, and 500,000 more unwillingly working part-time. Most disturbing of all, one in six of its children are now growing up in homes where neither parent has a job. Blame Martin Place" (The Age, 2 June 1992).

Over the period through to the Federal election on 13 March 1993, the merits of the Coalition's plans for the Reserve Bank, and its incumbent Governor, were canvassed at length in the Australian press, and with differing degrees of enthusiasm and support. On the 3 July John Hewson indicated that under a Coalition Government ACTU Secretary Bill Kelty would not be reappointed to the Board (Kelty's performance had in the previous week been defended by Bernie Fraser), and, if necessary all Board members could be replaced. Alan Wood, writing in The Weekend Australian, suggested that the Coalition's obsession with Kelty was becoming a dangerous political liability, and that, in the event of the Coalition coming to power, support (particularly in the Senate) for changes to the Reserve Bank Act could be lost if the motivation was seen as being informed more by vengeance, than the desire for a credible institution (The Weekend Australian, 4-5 July 1992). An editorial in the Canberra Times defended the record of Bernie Fraser, and the contribution of ACTU Secretary Bill Kelty as a Bank Board member, and suggested that central bank independence raised some important issues of both institutional design and constitutional probity:

"The idea that the broad conduct of the central bank should be independent of day-to-day political fiddling is worthy. That it should be beyond the power of ultimate political control is, however, raising monetary policy too high. Monetary policy is not pure art or purely technical, it is not removed from values, broader policies and principles; but it does have the power to have a massive impact on people's lives. Politicians must take ultimate responsibility for the way it is conducted, and would be abdicating that responsibility by legislating it out of their control. The smart politician would eschew regular intervention but would retain a reserve power" (Canberra Times, 7 July 1992).

Writing in The Australian Alan Wood was critical of attacks on Bill Kelty, suggesting that, "contrary to the Opposition's assertions, he has not apparently sought to push a line on monetary policy, nor been 'soft' on inflation, nor behaved as a de facto Cabinet member of the Labor Government" (The Australian, 7/7/92). Wood was however supportive of a restructured Reserve Bank board arguing for the appointment of full time directors, and the removal of the Secretary of the Treasury. This line of argument was also pursued in an editorial in the Australian Financial Review in which it was suggested that,

"... if the role of the Reserve is to be narrowed down to inflation containment, is there still a need for such a range of interests to be represented. A smaller group, with narrower technical expertise might well be more effective - perhaps full-timers, as occupy the boards of the central banks in Germany and the US.

In New Zealand, whose anti-inflation priority is a model for Dr Hewson, the Governor is contracted by the Government to work towards a narrow target. The board acts in effect as advisers to him, rather than as the bank's senior decision makers.

What then is the bottom-line for board members? To what extent do they represent, at meetings, their sectoral interests? To what extent do they subordinate these for a broader conception of the national interest? ...

The notes may be signed by the Governor, the value of them in part determined by the board, but the bank is owned by the electors" (AFR, 9 July 1992).

A similar position was taken in an editorial in The Age:

"It is also arguable that the board would be more effective if its seven part-time appointed members, drawn from academia, business and the ACTU, were replaced by fewer full-time members. Given the high stakes for the nation, it may be desirable to have full-time members focusing more closely on the controversial, complex judgements that confront the bank.

Unhappily these issues have largely been lost in recent debate generated by the Opposition over Reserve Bank independence ... To be credible, the Opposition should say how it would alter the independence provisions of the Reserve Bank Act, and how it would reshape the bank's functions and board structure" (The Age, 13 July 1992).

On 22 July it was announced that Bill Kelty had been re-appointed to the Board for a further five year term, and this appointment was followed by those of Janet Holmes a Court and Solomon Lew in August. For his part Bernie Fraser continued to defend key defining features of the ALP programme, and the Accord in particular, observing in a speech that the Accord had been "a substantial contributor to the low rate of inflation we now see in Australia" (AFR, 19 August 1992).

In October Opposition Leader John Hewson confirmed further details of the Coalition's plans for the Reserve Bank and the Reserve Bank Act, including the intention to remove reference to full employment from the Bank's charter, and to provide the Bank with a mandated and quantified price stability target of an annual rate of inflation between 0 and 2 per cent (the New Zealand Policy Target at the time). Dr Hewson also indicated that the dispute procedures in the Act would be removed, the intention being to constrain both the Federal Government and the Parliament from having any control over monetary policy decisions (The Australian, 1 October 1992). Editorial reaction to this clarification of policy was mixed, the Sydney Morning Herald suggesting that the Coalition's plans constituted a 'dangerous vision':

"The Federal Opposition is not planning to change the charter because it is out of touch with economic reality. Dr Hewson wants to change the charter because he does not believe that a central bank should even try to influence the level of economic activity ...

But although the idea of a more independent and accountable Reserve Bank is superficially attractive, there are real dangers in Dr Hewson's vision. An inflation rate of between 0 and 2 per cent is a extremely narrow range: few countries have ever managed to remain within this band for lengthy periods of time.

There's a very good reason why most central banks - with the exception of NZ - have a deliberately vague charter, which refers to nebulous concepts like the general welfare of the population.

Such charters give central banks the ability to react to particular situations. They can choose between a tough anti-inflationary stance to cut inflation quickly and a less severe approach that aims to bring down inflation in the medium term ...

The practical difference is this. What would be the Reserve Bank's response to a scheme that cut inflation to zero tomorrow, but which pushed the unemployment rate to 25 per cent?

Under the existing charter, the Reserve would not implement the scheme of the grounds that 25 per cent unemployment was a ridiculously high costs, and it was responsible for that.

But under Dr Hewson's charter, the Reserve Bank could well decide that Unemployment was not its problem and that in concentrating single- mindedly

on inflation it was just doing what it had been told to do" (SMH, 5 October 1992).

In The Age David Walker noted that, despite being an institutional 'recidivist' Australia's inflation performance compared favourably with both New Zealand and Canada, and suggested that, in the case of New Zealand, the inflation performance had been purchased more by way of an economic slow-down than any action by the Reserve Bank, concluding that, "Orthodoxy hasn't quite won the battle yet" (The Age, 9 October 1992). For its part The Australian editorialised that the government, and not the Reserve Bank should hold the reins, supporting the removal of the full employment objective from the charter, but the retention of a charter objective directing the bank to maintain 'economic welfare and prosperity'. The editorial noted that, quite independently of formal institutional, and specifically statutory provisions, financial markets exercised an 'independent' discipline on the central bank and the government of the day. And while the editorial indicated support for a more robust reporting regime for the Bank, there was no support for either a quantified price stability target linked to an exclusive focus on inflation, not for absolute independence:

"On the 'technical' aspect of a formal zero-to-2 per cent inflation target in the bank's charter, the argument is weighted against Dr Hewson's proposal ... Now that inflation has been brought down to low levels in Australia, the authorities can build on their newly established record, while maintaining policy flexibility. That will require more skill and courage than blindly sticking to (and easily achieving) an inflation target at the expense of the wider economy.

At the philosophical level is the question of who is actually running the country. Dr Hewson would leave the setting of interest rates to an unelected official, an undesirable innovation. Ultimately, it is the elected government that must be responsible and the public must understand that the Government is responsible. That means the ultimate power must rest with the Government, not the bank" (The Weekend Australian, 10-11 October 1992).

In late January and early February of 1993 tensions between the Opposition and Reserve Bank Governor Fraser spilled over in a very public dispute over the Reserve Bank's intervention in foreign exchange markets. On the 20 January John Hewson accused the Bank of intervening in foreign exchange markets to prop up the value of the Australian dollar, and ventured the observation that the intervention had run down the central bank's reserves to a "precariously low level" (The Age, 20 February 1993). On 25 January Fraser wrote to the Federal Treasurer, John Dawkins, expressing his concern that Dr Hewson's comments,

"... which could hardly have been made in total ignorance of their potential impact on foreign exchange markets, attracted a good deal of prominence in overseas markets ...

In current circumstances, where weakness in the world economy and commodity prices are creating a difficult climate for the Australian dollar, it is clearly unhelpful for people who might be expected to know better to be unsettling the market with such claims" (The Australian, 3 February 1993).

Treasurer Dawkins released the text of the Governor's letter, and of his reply in which he admonished the Leader of the Opposition, and asked that, "in future you refrain from making comments which are likely to result in financial market instability" (The Australian, 3 February 1993). Editorial responses were mixed, the Sydney Morning Herald suggesting that, while Dr Hewson's comments were politically motivated and exaggerated, Treasurer Dawkins was, "stretching a long bow in claiming that the Opposition Leader should make no further remarks on the grounds that they 'are likely to result in financial market instability'" SMH, 4 February 1993). An editorial in The Age was more critical of John Hewson, suggesting that his remarks were wrong and inappropriate, but also suggesting that Bernie Fraser might consider stepping down in the event of a Coalition victory:

"Apart from undermining the reputation of the Reserve Bank, the Hewson-Fraser fracas could make it very difficult for Mr Fraser to coexist with a coalition government. As a statutory officer, the governor of the Reserve Bank cannot be readily sacked, and Dr Hewson has long insisted that the Reserve Bank should be independent of the Government. It would be best, however, if Mr Fraser were to step down if he felt at odds with a Hewson government and its economic policy. Meanwhile, Dr Hewson should be more careful with his facts and more restrained in his comments" (The Age, 4 February 1993).

In an interview published two weeks later Fraser rejected suggestions that he would find it difficult to work with a Hewson led government. While continuing to defend the relevance of what, in later years he would refer to as the 'institutional pillars' underpinning the conduct of monetary policy - at that time a charter going to multiple objectives, policy making vested in a board including full-time and part-time members, a consultative relationship with the government of the day, and a pluralistic approach to policy in which monetary, fiscal, wages, and structural reform policies worked in concert - Fraser suggested he could work with a Hewson government:

"As for a change of government, I would sort of continue with what I'm doing now, pursuing what is emblazoned on the wall down there as our objectives, and trying to do what one can to deliver on those objectives" (SMH, 18 February 1993).

One week out from the Federal election Bernie Fraser took the opportunity of a speech to warn both the major parties that they may have to abandon their taxation and expenditure promises after the election for the sake of fiscal responsibility and lower interest rates. And while both parties denied that the warning was directed to them,

the speech was received as evidence of a growing independence on the part of the Reserve Bank. An editorial in The Age observed that,

" when the governor took the opportunity to assert his independence and economic judgement in warning that both parties could be imperilling the national interest, it was right and proper for him to do so. The Reserve Bank should have the prime responsibility for monetary policy, and monetary policy should be set without any regard to short-term political expediency.

Whether or not Mr Fraser remains its head after the election - and there is no good reason for him to go - the Reserve Bank must not be afraid to speak out and do what it believes to be correct. Treasury can advise, but as a public service department, it must defer to Government policy. When need be, the Reserve can say: 'No Prime Minister!'"(The Age, 6 March 1993).

But the speech also provided a subtle re-assertion of the appropriateness of the Bank's charter objectives, and a defence of its record on prices, Fraser commenting, in reference to the latter that, given appropriate policies Australia could remain in the low inflation club. But Fraser suggested that with inflation under control, "unemployment is clearly our most pressing macro-economic problem", and that, in part, the solution lay in an improved growth performance for the Australian economy:

" ... we need greater emphasis on stronger, sustainable growth. Such growth, based on new investment and export opportunities, will help with budgetary and savings problems, and it will generate more jobs. Sensible macro-economic policies and further structural reform must, therefore, remain at the top of the policy agenda, whichever party wins office on 13 March" (RBA Bulletin, March 1993).

Two days out from the election Prime Minister Keating indicated that under an ALP Government there may be some prospect of changes in the reporting and accountability arrangements for the Reserve Bank. Keating suggested that such changes were more likely to be negotiated with the Bank than imposed through legislative changes:

"I think that it may be possible to design a different system of monetary management in this country - one where the accountability is clear and one which also takes account of the needs of sensible monetary management"(AFR 12 March 1993).

The Labor Party won the 'unwinnable' election, although the seeds of its subsequent loss to the Liberal-National Coalition in 1996 were arguably sown in seeing the 'victory' in those terms. Others preferred to view the election in terms of the Coalition's loss of an 'unloseable' election (see Edwards, 1996). In attributing the blame for that loss the Coalition would focus on issues of leadership, and policy - Alexander Downer succeeding John Hewson as Leader of the Liberal Party and of the Coalition, and a number of changes being made to policy. The proposed Goods and Service Tax would

be dropped from the platform - then rehabilitated in 1998 - and the "Fightback!" plans for significant changes to the Reserve Bank Act would also be a casualty, foreshadowed in Downer's announcement on the 3 June 1994. In the sense of changes to the formal institutional status of the Reserve Bank, Downer's announcement constituted the effective closure of the partisan political contest over the Bank.

However within the wider policy community debate over aspects of the formal institutional arrangements, including central bank independence and accountability, would continue. Two weeks after the 13 March election Bernie Fraser took the opportunity to comment on a number of aspects of monetary policy. Rehearsing the case for the Bank's existing charter, Fraser again indicated his opposition to inflation targeting per se:

"... I am rather wary of inflation targets. A case for targets can be made where inflation is out of control and no credible anti-inflation policy is in place. In those circumstances, a target which the authorities were seen to be totally committed to could help to establish credibility and thereby push down price expectations. Even in those circumstances, however, the evidence suggests that price expectations are shifted more by actions than by words.

To my knowledge, no country has reduced its inflation by incantation, rather than by creating some slack in the economy. My reading of the evidence is that Australia reduced inflation at least as effectively (in terms of the trade-off between inflation and lost output) as countries like New Zealand, which have an inflation target ...

An inflation target of the narrow '0 to 2 per cent' variety would, I believe, do us more harm than good" (RBA Bulletin, April 1993)¹⁵.

However in the same speech Fraser, in effect, foreshadowed the articulation by the Bank of its own inflation target, commenting that the Reserve Bank attached a high priority to price stability, noting that the Bank's role as the guardian of low inflation was all the more important in the absence of a strong natural lobby for it in Australia (a matter to which we return in subsequent chapters), and noting also that Australia's, "re-entry to the low inflation club has not brought out large numbers of cheering fans", Fraser observed that his own view was that, "if the rate of inflation in underlying terms could be held to an average of 2 to 3 per cent over a period of years, that would be a good outcome" (RBA Bulletin, April 1993).

¹⁵ So far as the relative performance as between Australia and New Zealand, in December 1991 the New Zealand economic forecasting group, BERL, noted that over the ~~decade~~ 1981-1991, "while inflation has fallen in both countries, Australia's low inflation has been achieved with 1.4 million jobs being created in the economy between 1983-1991, an amount equal to the total employment in New Zealand. Sadly for New Zealand, our low inflation has been achieved with a loss of 93,000 jobs between 1985-1991" (BERL, 1991: 12).

In the same speech Fraser took the opportunity to comment on central bank independence and accountability, noting in passing that since 1992 the Bank had appeared before a Parliamentary Committee to speak to and answer questions on its Annual Report, and indicating his support for enhancements to the accountability arrangements for the Bank:

"Recent talk of accountability for the Bank ... at least carries with it the inference that the Bank is independent and has something to be accountable for! ...

The Reserve Bank cannot (and does not) expect to have independence without accountability ... The Bank should be required to explain what it is doing and why: such accountability is part and parcel of good governance" (RBA Bulletin, April 1993).

Fraser went on to support appearances before Parliamentary Committees by the Governor, but stopped short of supporting the release of detailed minutes of Bank board meetings: "the preparation and publication of detailed minutes which reported individual members' positions would run a real risk of impairing the Bank's decision making" (RBA Bulletin, April 1993).

Over the balance of Fraser's term as Governor the Bank's inflation target would become imported into Government policy, initially by the Keating Government, and in a more codified form, by the Howard Government. In a speech in August 1993 Fraser would again suggest the adoption of a goal of 2 to 3 per cent underlying rate over time. In a speech delivered on 26 September that nascent goal was given further life, but with the important proviso that such a target needed to accommodate fluctuations over the business cycle. Fraser observed that,

"... the notion that monetary policy has no effect on output can only be a throwback to textbook constructs of self correcting forces which keep the economy in some kind of equilibrium - including, in their modern guise, perfect foresight and rational expectations. It is clearly wrong over any time horizon relevant to policy makers. Changes in monetary policy might not do much to raise the economy's 'long-term' growth potential, but they certainly affect output and employment over the course of the business cycle ...

our aim is to maintain price stability while doing what we can to smooth the business cycle.

In our judgement, underlying inflation of around 2 to 3 per cent is a reasonable goal for monetary policy" (RBA Bulletin, October 1994).

That same speech also contained some remarks about the vexed issue of 'credibility', remarks which are clearly apposite to much of the discussion in Chapters 2 and 3, and to much of what follows. Fraser noted that the issue of credibility,

" ... arises in the context of the authorities' perceived (lack of) credibility with the financial markets. Having credibility in that quarter is important to all central banks, not least in countries like Australia which have sizeable budget and current account deficits to fund. But that is not the only relevant quarter ... credibility with wage and price setters would help to control inflation. Then there is the issue of the Bank's credibility in terms of its obligation to the broader community to do what it can to sustain economic activity and employment" (RBA Bulletin, October 1994).

In terms of the distinction we introduced in Chapter 2 as between credibility with financial markets in particular (and other price setters), and the broader legitimacy of policy and institutions, Fraser captures the dual imperatives associated both with independence and accountability in this observation.

Returning to the Bank's inflation target, it is interesting to note that the vehicle through which the target was to make the transition from Bank to Government policy was the Accord Agreement. Over the course of the 1993-1996 Keating Government two further Accord agreements were to be negotiated, Accords VII and VIII. Like all the preceding agreements Accord VII was couched in terms of the dual objectives of employment growth and price stability. But the last of the Accords, Accord VIII Agreement, 1995-1996 was to import the Bank's price stability target:

"The Accord partners remain fully committed to the maintenance of low inflation, regarding this as a desirable social outcome. The 1990s have seen a threshold change in inflation and inflationary expectations, which is essential for interest rates remaining at levels conducive to continuing healthy economic and employment growth. Great weight is given to the significance of this achievement and to the difficulties inherent in establishing a low inflationary environment once lost.

The union movement and the Government are able to influence the level of unit labour costs and price inflation, although it is clear that there are many other contributing factors. The Accord is based on and consistent with maintaining an underlying rate of inflation of 2 to 3 per cent on average over the cycle. This will help to maintain our competitive position and the real income of workers.

This does not mean that when underlying inflation exceeds 3 per cent for a short time corrective action is always desirable. It does imply, however, that on-going inflation at the level requires a policy response which targets the cause of the problem" (ACTU, 1995).

Having been conceived as a policy instrument designed to generate economic growth, maximise employment, and deliver stable prices, the last of the Accord agreements was to reflect these on-going themes.

Consolidating 'the Australian model'

The Liberal-National Coalition's 1991 "Fightback!" package had elevated price stability, and New Zealand-styled reforms of monetary policy institutions, to the apex of the agenda for the then government in waiting. The loss of the 'unlosable' election by the Coalition was to result in a revisiting of policies and personnel, with a public resiling from the "Fightback!" package, and a series of leadership changes. While Alexander Downer's announcement the Coalition was resiling from its earlier policy - in effect support for New Zealand styled institutional reforms - closed one chapter, it was not to be the end of the story. The 1945 legislation had shown itself to be capable of accommodating an environment that few, if any, would have anticipated, and it would accommodate further reforms, albeit of a more evolutionary kind. By the time of the 1996 election the Coalition was under the leadership of former Treasurer John Howard, with the shadow Treasury portfolio held by Peter Costello. The policy that the Coalition took into the election on the 2 March 1996 was however consistent with the changes announced by former leader Alexander Downer in 1994. That policy included a "commitment to a low inflation environment", with the Coalition indicating an intention to, "support the Reserve Bank objective of maintaining underlying inflation within a range of 2-3 per cent over the economic cycle" (LNP, 1996), and introduce complementary policies designed to increase competition and productivity. The Coalition also committed itself to ensuring greater transparency and accountability in taxation, monetary and fiscal policy generally, (the latter by means of a Charter of Budget Honesty not dissimilar to the New Zealand Fiscal Responsibility Act). In reference to the Reserve Bank the Coalition undertook to:

"... respect the Reserve Bank's integrity and independence, and encourage it to further develop its information dissemination strategy:

we will not change the Bank's Charter

we support the Bank's inflation target" (LNP, 1996).

In the course of three years the Coalition policy had changed from one premised on, at best, politically porous, and at worst, chronically corrupt institutional arrangements, to one predicated on respect for the Bank's integrity and independence, and one accepting of a price stability target developed by the Bank itself.

The period from 1993 to 1996 saw no changes in the formal institutional arrangements for the conduct of monetary policy.¹⁶ Reserve Bank Governor Bernie Fraser would

¹⁶ Shortly after the 1993 election Paul Keating did request an 'options' paper on central bank independence from the Department of Prime Minister and Cabinet. This paper, which may have been part of the stock-take at the start of the government's new term, appears not to have proceeded any further than an initial consideration by the Prime Minister.

continue to advocate his support for the Bank's statutory charter, the Bank's governance arrangements, and the relationship of 'consultative independence' between Bank and government. In his first speech after the 1993 election Fraser provided a reprise on his earlier comments on central bank independence, foreshadowed the development of an inflation target, while at the same time rejecting a New Zealand styled, 'hard target', and extended his, and the Bank's observations to include the relationship between independence and accountability. But the speech manifested an additional aspect of the Bank's independence with its observations on fiscal policy, and the dangers of a long-term structural deficit in the government's accounts:

"Whether we like it or not, the reality is that even perceptions of large on-going budget deficits and borrowing requirements risk major instability in financial markets, which is in no-one's interests. We have had several reminders over the past year of how such perceptions, which were not always well founded, have destabilised both bond and foreign exchange markets" (RBA Bulletin, April 1993, emphasis in original).

Fraser's speech was perceived as constituting a blunt warning for the new Government, and its new Treasurer, John Dawkins. Alan Wood, observed that, "neither the bank nor Treasury believe the Government's present policies will do enough or that the Government is sufficiently focused on the problem [of the deficit]. Unless the Government begins to take his warnings more seriously, those who think that Bernie Fraser is just a Keating acolyte may be in for a surprise" (The Australian, 1 April 1993). An editorial in the Australian Financial Review echoed these sentiments, suggesting that the speech by Fraser constituted a "powerful challenge to the Government's fiscal complacency. It is a rejection of the Government's claim that the economy will grow fast enough to solve the problem of the medium-term Budget deficit" (AER, 1 April 1993).

Within the 'official family' Ted Evans was appointed to the position of Treasury Secretary in March, replacing former Keating staffer Tony Cole. Of Evans, an article in the Australian Financial Review would note that he, "is a graduate of the Bernie Fraser school of economic officialdom - both are quietly spoken but tough-minded pragmatists rooted in a commonsense approach to economic management ... " (AER, 23 March 1993). Like Fraser, Evans was from a working class background, had started his working life as a telephone technician, studying economics part-time, eventually graduating with a first class honours degree and joining the Commonwealth Treasury. Evans was a member of the so-called group of four within the Treasury united in a shared view of the world, - a mix of economic rationalism and policy pragmatism - and all of whom enjoyed a close working relationship with Paul Keating. Evans' relationship with Keating developed through the former heading up the Treasury

Taskforce which produced the ill-fated 1985 tax reform proposals. On the relationship between Evans and Fraser the Australian Financial Review commented that:

"Like Fraser he will bring to the job a formidable intelligence, mental toughness and a strong commitment to rational economic policy.

But like the Reserve Bank Governor, he will also combine this with a genuine sympathy for the ordinary people who feel the impact of the decisions made in Canberra and Martin Place.

This more earthy approach, their commonality of policy view, and their close personal relationship will ensure that Treasury and the RBA, the two institutional pillars of economic policy, will work more closely than they have in many years" (AFR, 23 March 1993).

That closeness however would be one that would see differences between the two, and their respective institutions, over the emphasis of policy, and the timing of policy decisions.

Fraser's sometimes strained relationship with the Coalition was further in evidence in September when he suggested, in an interview with the Australian Financial Review, that politicking over the Federal Budget - which had encountered difficulties in its passage through the Senate - had served to de-stabilise financial markets. In response to these observations the National Party Leader Tim Fischer commented that Bernie Fraser was no longer deserving of the measured respect generally accorded to Reserve Bank governors:

"Mr Fischer alleged Mr Fraser made 'outrageously partisan and frankly unintelligent comments' and declared open season on him. 'I say to Bernie Fraser, butt out, because each and every utterance of a partisan political nature you make from this point on will be treated as just that and will be dealt with robustly by the Coalition'" (AFR, 6 September 1993).

While the relationship between Bernie Fraser and the Coalition was, on balance, somewhat less acerbic following the 1994 Coalition leadership and policy changes than in the period immediately prior to the 1993 election, the post election period was to see Fraser and senior Opposition shadow Minister Peter Reith clash in the course of the formers appearance before the House of Representatives banking committee in October 1993. Underpinning the clash was Reith's advocacy of New Zealand styled reforms to the Australian institutional arrangements. The Australian Financial Review reported Fraser had noted that,

"Australia's success in drastically cutting inflation had been achieved in a less costly way than New Zealand ... Mr Fraser also rejected suggestions that the bank was a cat's paw for the Keating Government, saying it operated with 'a high degree if independence'. 'We choose to operate that independence in

consultation with the Government - we don't see anything improper or untoward or wimpish about that" (AFR, 29 October 1993).

Fraser's continued advocacy of the institutional status quo, and in particular his explicit and vocal support for the Accord arrangements would inject a measure of tension into his relationship with the Coalition through until the 1996 Federal election, and the Coalition's representation in 1995 of Australia's economic performance as 'five minutes of sunshine' elicited a public rebuke from the Reserve Bank Governor. Addressing an audience of media representatives in Melbourne in July, Fraser suggested that, "[d]iscerning listeners among you will know that, even allowing for some 'catch-up', five years of 3 to 4 per cent growth has a different ring to it - and certainly a truer ring - than hollow sounding throwaways, like 'five minutes of sunshine'" (RBA Bulletin, August 1995). The same speech also contained a ringing endorsement of the Accord, increasingly a signal point of policy differentiation between the incumbent ALP Government, and the Federal Opposition:

"People in financial markets do not appear to give much thought to the Accord, perhaps because incomes policies do not feature prominently in other countries' economic armouries these days. Or, if they do think about it, they tend to dismiss it as being incompatible with their view of the way 'market economies' should work. Some other commentators seem intent on maintaining the scepticism they have displayed from the outset - notwithstanding that, in the Accord process, Australia has had an incomes policy for more than a decade which actually works. It has contributed, significantly, in my view, to sustained moderation in wage increases, and to engineering a more productivity-focused industrial relations culture, without Darwinian consequences for the weaker members of the workforce.

As in the past, the growth in wages in the years ahead will have a major bearing on how successful we are in keeping inflation under control. More specifically, it will be critical in helping to keep underlying inflation at 2 to 3 per cent, and in ensuring that any breaches of that objective that might occur are temporary. To my knowledge, Australia is the only country where a union movement has formally committed itself to pursuing wage increases which are consistent with delivering the central bank's inflation objective" (RBA Bulletin, August 1995).

Fraser's endorsement echoed the objectives of those that had first proposed an Accord - a capacity to deliver to prices and incomes.

But any simplistic assessment of Fraser as being inappropriately 'dove-like' in his orientation to monetary policy was called into question by the actions of the monetary authorities over the period from 1993 to 1996. On 30 July 1993 the Governor announced what was to be the last in a series of interest rate reductions, with interest rates reduced by 0.5 per cent to 4.75 per cent. The announcement was couched in the terms typically used for interest rate reduction, the action having been taken following, 'recent deliberations of the Board, and consultations with the Treasurer'. The

policymaking template suggested by the charter was also in evidence, the Governor reporting that,

"[i]n the Board's judgement, the combination of a sluggish rate of recovery, relatively high real interest rates and low inflation warrant a further modest fall in cash rates" (RBA Bulletin, August 1993).

However on 17 August 1994, five consecutive years of monetary policy easing came to an end, with the Governor announcing an increase of 0.75 per cent in cash rates, following 'deliberations by the Board over several months, and consultations with the Government'.¹⁷ The increase was justified by the need to sustain non-inflationary growth, 'that being the best guarantee of further increases in jobs and reductions in unemployment'. The statement highlighted the determination of the Bank, "to demonstrate to all groups in the community that the authorities are determined that Australia remain a low inflation country in what seems certain to be a low inflation world. Today's action is intended to help keep underlying inflation around 2 to 3 per cent over a long period" (RBA Bulletin, September 1994).

Rates were again increased on the 24 October (by 1 per cent to 6.5 per cent) and on the 14 December (by a further 1 per cent to 7.5 per cent), and would remain at this level until 31 July 1996, after the 1996 Federal election, and before the first Coalition Budget. The preparedness to increase rates, to justify rate increases, in part at least, by reference to an inflation target, to hold those rates through a Federal election, and to reduce rates in advance, rather than as a consequence of a Federal Budget, all suggest a certain measure of central bank independence.

The 1996 Liberal-National Coalition Government

With the defeat of the Keating Government in March 1996, a Liberal-National Coalition Government was elected to power under John Howard. Peter Costello was appointed Federal Treasurer. Given the incoming Government's stated policy, the expectation was that the Reserve Bank Act would not be revisited. Within a week of the election however the complexion of the Bank Board, tasked with policymaking and governance, changed with the resignation of ACTU Secretary Bill Kelty. The ACTU had been represented on the Board throughout the thirteen years of the 1983 - 1996 ALP governments, but had also been represented under governments of other

¹⁷ The reference to consultations with 'the Government', as opposed to consultations with 'the Treasurer' may be indicative of both Prime Minister Keating and Treasurer Dawkins involvement in those consultations.

persuasions, former Prime Minister Malcolm Fraser having appointed Bob Hawke to the Board when the latter was ACTU President. Kelty resigned within 48 hours of the election, advising the new Prime Minister of his resignation in a letter in which he indicated he could no longer reconcile the central bank's low inflation target with his union role. Under the Accord arrangements,

"it was reasonable and feasible for the ACTU to support the Reserve Bank's 2 to 3 per cent inflation target ... With the abolition of the Accord processes, and a renewed emphasis on 'market forces' in wage matters, I do not see how I can satisfactorily reconcile my union and board responsibilities" (AFR, 5 March 1996).

Kelty subsequently observed that, while under the Coalition a formalised Accord agreement was absent, his presence on the Board of an institution tasked with enforcing an incomes policy risked creating the appearance of a defacto 'accord', placing the ACTU in an invidious position, and, not the least, bring the Reserve Bank as an institution into disrepute:

"I would have brought the institutions into disrespect because you are a union official without an Accord ... I am on the Reserve Bank, a Reserve Bank that has a monetary target, a wages target, an inflation target, and even though I am there as an individual, I carry the ACTU, I have a reputation with the ACTU - the electorate has just said they don't want an Accord - but de facto they would have an accord, and I would have to come out and say that I am committed to that - to that wages target, I am committed to that inflation target, and therefore the wages outcomes had better be this or that ... so I can't be committed, and once I am not committed I can't do anything other than resign. I can't stay on - if I try to stay on and have an independent position, then I bring the whole institution into disrespect ...

if I get involved in a wage dispute, then the first thing that I get asked is, 'is this consistent with your membership of the Reserve Bank ? ... what do I say ? - is it an accord defacto ? - you can't have an accord de facto with people who don't want to have one, so there was no choice. If I had tried to stay the Bank itself would have paid a price for that, because there are some loyalties there ... I would have put all the other members of the Board under enormous pressure , the Governor of the day, and the Bank itself would have been under pressure - it would have caused harm ..." (personal interview, 1997).

And while fervently rejecting the principle and the economic wisdom of a set of institutional arrangements in which the Bank is faced with the prospect of using interest rates - effectively unemployment - to discipline both the Industrial Relations Commission, and wage negotiators, Kelty emphasised that the decision reflected, in part, the esteem in which he held the institution:

" ... the institution does matter - I was on it for over eight years ... it was a matter of pride for me to be on it" (personal interview, 1997).

Commenting at the time on Kelty's resignation, Tom Burton suggested that the key message was, "an unambiguous declaration that the ACTU was ready to participate in [Prime Minister] Howard's new market-driven industrial relations era ... For 13 years the ACTU acted as the nation's de facto wages cop, reining in unions that sought to break beyond the wage and inflation targets of the Accord" (*AFR*, 5/3/96).

In late March a former Reserve Bank Official, Adrian Blundell-Wignall suggested that, as a second-best alternative to legislative changes, the Government and the Bank could agree on an unambiguous inflation target each year. Commenting on this proposal in *The Australian*, Alan Wood, commended it to the new Treasurer, suggesting that it, "has the advantage of not requiring any changes to legislation, giving much more precision to the Reserve Bank's inflation target and giving greater transparency to monetary policy ... It is an important contribution to the debate and one that Costello should consider taking up, since it would have the effect of pushing the bank further in a direction it is already travelling" (*The Australian*, 2 April 1996).

For his part, the new Treasurer was very circumspect in his post election comments on the Reserve Bank, and the conduct of monetary policy more generally. In May 1996 the new Treasurer attended a meeting of OECD finance ministers in Paris. In the course of a press conference on 22 May the Treasurer was asked about the prospects for an interest rate cut in Australia, and in replying made one of his few post election comments on the Bank, and monetary policy:

"We have a very independent Reserve Bank, and it's charged with the conduct of monetary policy and it set a target of keeping underlying inflation between 2 and 3%. The Government is determined to play its part to keep inflation low and that's why we're talking about fiscal consolidation. If we can achieve fiscal consolidation, we take pressure off interest rates and the Bank will consider all those elements but I don't speculate on interest rate movements in Australia. All I do, is I make sure that we set the right economic parameters for it" (Transcript, The Hon Peter Costello, 22 May 1996).

Bernie Fraser, whose term as Governor was due to expire in September 1996, had indicated that he intended to retire from the position at that point, and the process of selecting his successor had commenced.¹⁸ The announcement of his successor was made on the 14 August 1996.

¹⁸ One respondent, concerned at the performance of Fraser, and the need to institute reforms to the Bank's charter and its governance arrangements, indicated that he had advised the Coalition that former Governors' Coombs and Johnston had both tendered their resignations to incoming governments (which, in the case of both, were not accepted), and that Bernie Fraser might be reminded of this precedent. There is however no indication, that either publicly or privately, Fraser was invited to consider his tenure by the incoming Government.

In the course of the preceding weekend the Treasurer foreshadowed an intention to codify a set of agreed understandings between Fraser's successor as Governor, and the Coalition Government, the letter to include an agreed commitment to realising the Bank's informal inflation target. The announcement coincided with the release of John Edward's biography of Paul Keating, and the latter took the opportunity to make a rare post-election comment, suggesting that the exchange of letters would constitute the 'antithesis of independence' for the new Reserve Bank Governor:

"The governor, whoever he or she might be has the right to take instruction from the Act of Parliament and for the governor and the board to interpret. To be signed up by the Government to only focus on price stability is really code for saying 'we're back to inflation first and that growth and employment won't matter in the future' ... And I think some of the business people reading the Financial Review and thinking sagely about nominated inflation targets should really read that for being back to 2.5 per cent growth and low profits. That's what it really means" (*AFR*, 13 August 1996).¹⁹

Media reports also suggested that the move was warmly applauded by Reserve Bank of New Zealand Governor, Dr Don Brash, who told ABC radio that a target set out in an exchange of letters would "make it clear to everyone where they stand" (*The Age*, 13 August 1996).²⁰

The response from the ALP Opposition was immediate, the Leader of the Opposition, Kim Beazley, suggesting that the letters,

"... have a focus which does not represent the breadth of the tasks that the Charter requires the Reserve Bank Governor to observe. When we were in office we regarded growth and employment as important as inflation. And we set flexible targets ... we believe that the Reserve Bank Governor's attitudes in the area of employment are going to be critical to get us on the job growth path again. Therefore, if Mr Costello's exchange of letters produces an inflexibility which is not there at the moment then the changes will be very much detrimental to the interests of the people of Australia who need and want work ...

I think it's likely to mean New Zealand-style targets which are nought to 2% ... in which case the exchange of letters will both have an impact on the independence of the Reserve Bank Governor, but also an impact in a direction which will mean no job growth in this country or no substantial job growth and, therefore, no capacity to reduce levels of unemployment" (Transcript, Leader of the Opposition, 12 August 1996).

The ensuing debate, in advance of the release of the letters to be exchanged between the Treasurer and the Governor-designate was couched as much in terms of the merits or

¹⁹ The same article reports a spokesman for the Treasurer as describing Mr Keating's comments as unfortunate, and stating that the Reserve Bank's statutory charter objectives were to remain unchanged.

²⁰ An additional report quoted Dr Brash as observing that the New Zealand 'exchange of letters' had, "a downside from a personal point of view in that with an objective very clearly spelled out the accountability for not delivering that is also clear" (*AFR*, 13/8/96).

otherwise of 'the New Zealand model' as it was in terms of the constitutional probity of what was intended. The Shadow Treasurer, Gareth Evans, suggested that what was planned either formalised the existing position, or signalled a dangerous move to an inflexible target, opining that, "I don't think that we have much to learn at all from the New Zealand experience, but this Government seems to be besotted by it" (AFR, 13 August 1996).

The Opposition indicated its intentions to seek legal advice on the course of action proposed by the Treasurer, a press release from the Leader of the Opposition venturing the observation that an exchange of letters might be ultra vires the Reserve Bank Act, and foreshadowing the option of referring the matter to the High Court, with a view to that Court requiring, "the Government to abide by all the provisions of the RBA Act" (Press Release, Leader of the Opposition, 13/8/96).

Editorial writers from The Australian and the Australian Financial Review were somewhat more welcoming of the Treasurer's plan, an editorial in the former endorsing the proposed exchange of letters, and the need for changes in the composition of the Bank's Board:

"Mr Costello's initiative, together with the opportunity to appoint a new governor and, in about 12 months time to appoint new board members, is a further chance to bolster the new monetary regime" (The Australian, 13 August 1996).

An editorial in the Australian Financial Review commended the Treasurer's planned course of action as, 'good policy sense', and endorsed the prioritisation of the price stability objective above the other elements in the Banks statutory charter:

"The Australian Financial Review believes strongly that the emphasis must be put on holding down inflation and that this goal can best be served by setting a medium-term target, although this might be better set at 1 to 2 per cent rather than the current 2 to 3 percent. At the same time the RBA should, as at present, have the flexibility to let the underlying inflation rate rise above the target range in the short-term if the only alternative would be to induce excessive contraction in economic activity.

The emphasis for the RBA, however, must be on fighting inflation. In setting policy goals for the bank the Federal Government should thus resist the temptation to try to target anything else, or soften its commitment to fighting inflation when the going gets tougher. Provided the RBA is given reasonable flexibility, focusing on inflation offers the best chance of getting the other policy outcomes right" (AFR, 13 August 1996).

For its part the Sydney Morning Herald was less effusive, noting the relevance of the Bank's multiple objectives, the independence afforded by the Act, and the importance of a credible track-record in underpinning institutions and policies:

"Price stability is obviously an important objective of the bank. Indeed it is the primary objective. But it is not the only objective ... It is the Reserve Bank's record on containing inflation, rather than paper targets on which it should be judged by money markets. While the record of the Reserve Bank has been a good one in the past few years, that message has been slow to sink in overseas. It is now starting to do so, however. Mr Costello should be concentrating on finding a successor to Mr Fraser who will equal, and even better, his record, and who will not be afraid to assert the independence which is already afforded by the Reserve Bank Act" (SMH, 14 August 1996).

Alan Wood, writing in The Australian, while enthusiastic at the prospect of an exchange of letters, tempered this in identifying a 'problem' with the structure and composition of the Board:

"Most of the private [part-time] members are a grace-and-favour gaggle of Labor mates appointed by Keating, whose only contribution to monetary policy is to constantly want lower interest rates. Yet under the Act it is the board, not the governor, that is responsible for the conduct of monetary policy" (The Australian, 13 August 1996). The solution, Wood suggested, lay in public service appointments to the Board to shift the balance in favour of the 'full-time' members (the Act requires that of the seven part-time members, five shall not be officers of the Bank or the Australian public service), and in the appointment of the Governor:

"The skill, determination and integrity of the governor are ultimately more important than any legislation or exchange of letters" (The Australian, 13 August 1996).

The announcement of the new Governor-designate, and the release of an exchange of letters between that person and the Treasurer was made on 14 August 1996. The Governor-designate was to be Ian Macfarlane, one of the Bank's Deputy Governors, a Bank 'insider' with seventeen years experience at the Bank. A series of media profiles published in the days following his appointment variously described him as 'engaging, personable, intelligent', a 'very friendly colleague', 'tough experienced, and widely respected', an 'ideas man', and someone who had encouraged a culture of intellectual rigour through his encouragement of 'quality people' within the Bank. Most commentators agreed that Macfarlane had a well deserved reputation as an anti-inflation 'hawk', some venturing the observation that Macfarlane might be somewhat more disposed to affording priority to the price stability objective in the Bank's charter, and that, in the words of one headline, inflation was to become the 'new priority' under Macfarlane. A number identified a capacity for independence in thought and action, and suggested that the Bank would certainly be no less independent under Macfarlane

than it had been under his predecessor. The essence of the assessment was captured by one profile which suggested that Macfarlane would be 'firmer but still compassionate'. Significantly the appointment appeared to enjoy bi-partisan support, with the Shadow Treasurer, Gareth Evans, remarking that the Opposition made no criticism of the appointment.²¹ The Governor designate was to take up his appointment on 17 September 1996.

Two other announcements were made contemporaneously - the details of the exchange of letters foreshadowed by the Treasurer the previous weekend, and the name of the person appointed to succeed ACTU Secretary Bill Kelty on the Bank Board. While the text of the exchange of letters was viewed as a codification of existing Bank policy and practice, it was, nonetheless, the single most important institutional initiative taken since the floating of the dollar and financial deregulation.²²

The rationale behind the exchange of letters, and the reasons for the Government and its advisers preferring this option over a more formal revisiting of the Reserve Bank Act are canvassed in the following Chapter. Targeted, in the main, at an overseas audience, the 'Statement on the conduct of monetary policy' reaffirmed the Bank's independence, including the 'consultative independence' suggested by the Act, reaffirmed the Bank's statutory charter, and the Bank's inflation objective (of a rate of 2 to 3 per cent over the cycle), recorded the view of the Bank and the Government that price stability was a 'crucial precondition' for sustained growth in economic activity and employment (arguably thereby providing an implicit prioritising of the Bank's charter objectives), and committed the Bank and the Government to an enhanced set of accountability arrangements, specifically the release of six monthly reports by the Bank, and the appearance of Governor before the House of Representatives Standing Committee on Financial Institutions and Public Administration to speak to these six monthly reports.

²¹ Commenting on Macfarlane's appointment, Barry Hughes, the Chief Economist for the CS First Boston group, and former economic adviser to Paul Keating, welcomed the appointment, suggesting that Macfarlane's performance in the markets had been impressive:

"I was at a London briefing for 30 or so major fund managers last October, a week after Macfarlane had made a speech there. This was at the height of the fashion for New Zealand styled central banking and the low point of RBA denigration as mere political puppets.

By common consent, Macfarlane put up a spirited defence of the bank's policies and its room for independence, enough to stop the cynics in their tracks ... It was a different story on my return this April. By then it was Kiwi-style, inflation-centred central banking that had become the disappointment, with cynicism turning to a grudging admiration for the RBA" (*Canberra Times*, 15 August 1996)

²² The document is attached as an appendix.

The exchange of letters having been telegraphed, and welcomed in the editorial pages in advance of the release of the 'Statement', the combination of a Governor-designate and an agreed position on some of the key aspects of the Bank-Government institutional arrangement was in turn, well received. The Canberra Times questioned the wisdom of an agreed position on the Bank's inflation objective, suggesting that to make the objective part of a bi-lateral exchange effectively reduced the Bank's goal independence (Canberra Times, 15 August 1996). And the Sydney Morning Herald suggested that, because the exchange of letters essentially codified existing policy and practice, it was largely superfluous. However the editorial suggested that, if

"the statement contributes to a better understanding of Australia's financial system - here and (particularly) overseas - that will be a good thing. It may, for example, repair some of the damage caused by the comments made by the former Prime Minister, Mr Keating, when he was Treasurer, about how the Reserve Bank did what he told it and how he had the bank 'in my pocket'" (SMH, 15 August 1996). And, as the discussion below confirms, it was the symbolic import of the exchange of letters and its impact on overseas financial markets in particular, that would be most advantageous. A number of acts of political theatre - played out largely by the former Treasurer Paul Keating - had served to militate against much needed credibility in off-shore markets. A new act, no less theatrical, but scripted by the Bank and the new Government, would again engage an overseas audience, but the reviews would be more sympathetic.

At a press conference announcing Macfarlane's appointment, the Treasurer clarified the relationship between the statutory charter, and the text of the agreed statement:

"The requirement to the Bank comes from the statute. And the statute always overrides anything else. Let me make that entirely clear, that is the legal requirement. The statute has the threefold objective; - the stability of the currency, full employment and the prosperity and welfare of the people of Australia. We are not proposing to change the statute, that's a policy position that I announced on behalf of the then Opposition before the election, and nothing in this can change that position.

What we do, however, I think more as a matter of public explanation, than anything else, is we explain how the first two objectives leads to the third. And the way in which price stability contributes to the employment and the economic prosperity of the people of Australia. And we lay down the importance of that, we attest to that objective. Now, the Bank itself, and I want to emphasis (sic) this point, the Bank itself set the 2-3% underlying inflation objective"(Press Conference Transcript, 14 August 1996).

Moreover the Treasurer affirmed that, while he hoped that the target would be a 'firm' one, he was comfortable with the target range being exceeded at times, so long as it was brought back within the target range over the course of the business cycle.

In justifying the negotiation of the joint statement embodied in the exchange of letters, the Treasurer suggested that the publication of the statements would redress the damage done to the Bank's credibility by virtue of comments made by Treasurers past:

"And when you go overseas you are still questioned; 'do you have the bank in your pocket' as was once claimed by one of your predecessors? That probably, regardless of what the reality was, that probably did more damage to perceptions than any other comment" (Press Conference Transcript, 14 August 1996).

And the Treasurer suggested that the arrangements agreed with the Reserve Bank of Australia were superior to those that prevailed under the New Zealand statute:

"I thought the full New Zealand model was too inflexible. I think this in an advance in Australia, but it preserves enough flexibility. New Zealand is a formal contract. New Zealand has the 0-2 per cent target, and recently when that target was breached and nothing happened, people were scratching around saying, well what was the purpose of that contract. I think this is more realistic..." (Press Conference Transcript, 14 August 1996).

For its part the Federal Opposition, which had indicated a preparedness to refer any contracting out of the Bank's statutory charter objectives to the High Court, suggested that the agreed statement in the exchange of letters represented a resiling from the 'hard target' approach foreshadowed by the Treasurer earlier in the week, and a step back from the New Zealand model. Subsequent advice to the shadow Treasurer confirmed that the exchange of letters would not be viewed as ultra vires the Reserve Bank Act, and that, as a device to 'buy' a reduction in the US/Australia bond rate differential (the restoration of credibility in the eyes of off-shore financial markets) the exercise had been successful. However on the matter of the appointment of a successor to former Reserve Bank Board members, ACTU Secretary Bill Kelty, the ALP was less than sanguine.

Kelty's replacement was to be Hugh Morgan, the Chief Executive Officer of Western Mining Corporation (WMC) Limited, who had previously served on the Board from 1981 to 1984, but had been replaced by then Treasurer Paul Keating, at the end of his term. Morgan was a founding member of the H.R.Nicholls Society, a club established to lobby for labour market deregulation and to oppose the continuation of institutionalised arbitration in Australian wage fixing. Morgan was also an outspoken critic of the ACTU and Australian unions, and of other aspects of Australian public policy, including Aboriginal policy (SMH, 16 August 1996). In 1991 Morgan had given a speech to the Business Council of Australia in which he advocated a 'free banking' solution to what he perceived as Australia's monetary stability problems. The Federal

Opposition was critical of the appointment, Shadow Treasurer Gareth Evans suggesting that Mr Morgan was, "not known for his sympathy, empathy or experience with working Australians, and it's very important that the board have that working Australian voice on it" (Canberra Times, 15 August 1996). Writing in the Sydney Morning Herald, Geoff Kitney observed that, "Morgan's presence could also contribute to a potentially important shift in the balance of thinking on the Reserve Bank board to a more hard-line, anti-inflation position ... a shift by the bank to a greater focus on inflation would be consistent with the policies of conservative governments elsewhere - and with the harder-line position the Coalition took in Opposition" (SMH, 16 August 1996).²³ The extent of any shift is a matter that we examine in the following chapter in evaluating the Australian institutional regime.

Conclusion

The period under review in this chapter was one in which the Bank and successive governments were the subject of charges of politicised policy making reflecting institutional arrangements that were, it was alleged, at best politically porous, and at worst, corrupt. The absence of central bank independence, it was argued, justified an institutional remedy - changes to the Act to provide for a mandated and quantified price stability objective, governance arrangements directed to the delivery of that mandated objective, and a much more independent relationship from the government of the day, and indeed other actors within the official family. In the context of the policy debate from 1983-1994 the desired alternative was viewed as being most clearly evident in the New Zealand model. The case for the prosecution was helped by the at times intemperate and misjudged observations of the Treasurer Paul Keating - comments which, with the benefit of hindsight, must surely have been acknowledged as contributing to a credibility deficit. Moreover first-hand accounts that attribute to Keating and his personal advisers the responsibility for the conduct of monetary policy also serve to create the impression of an environment in which Canberra, not Martin Place, took the decisions. But so far as evidence of politicised behaviour is concerned, there is very little, despite the best efforts of the media (and at times politicians) to provide it. Even those most supportive of the institutional remedies advanced by the Coalition over the period from 1991-1993 suggest that there is little, if any evidence of

²³ For his part the Treasurer commented that, had Kelty not resigned he would have continued on the Board, and the Government would have been 'quite happy with that situation'. But he indicated that the Act did not require Board appointments to be representative of particular sectors, and that the guiding criteria in making future appointments would be a capacity to understand the Bank's statutory objectives and contribute to decision-making in relation to those objectives.

politicised policy making under Bernie Fraser's stewardship of the Bank. Moreover, even though, within the ranks of the serious economic and political commentators there was some support for institutional reform, including reforms consistent with the New Zealand model, there was a measure of reluctance to embrace a single target, and a concern to ensure that, however independent, the Reserve Bank of Australia remained accountable to the Parliament, if not to the government of the day. By late 1996 there is a sense of settlement on matters of institutional form.

That settlement is underpinned by the post-War Coombsian scheme, but it is one modified by environmental changes - most importantly the floating of the Australian dollar and financial liberalisation - and by evolutionary reshaping within the overall parameters given by the Coombsian scheme. Within the state directed policy network the Bank itself had directed its attention to remedying the credibility deficit. The bias of monetary policy was now explicit, and announcements timed to follow regular meetings of the Bank Board' the Governor (and his senior staff), at the initiative of the Bank, were now appearing on a regular basis before a committee of the Federal Parliament; the Bank had developed its own inflation target - the 'two point something' target over the business cycle - and this target had been accepted by successive governments, and codified into an agreed statement on the conduct of monetary policy (an Australian variant of the New Zealand Policy Targets Agreement) between the Governor (on behalf of the Bank Board) and the 1996 Coalition Government. Credibility, at the very least diminished, had been regained, and the legitimising elements of the Coombsian settlement remained intact.

The personality of Fraser is one of the dominating elements in the political and policy landscape over this period. Like his predecessor (and his successor) Fraser defended the Bank against accusations of political interference. Fraser's first speech on becoming Governor was directed to the issue of central bank independence, and his final speech as Governor would return to that same theme. Some would suggest that Fraser's defence of the Bank was borne out of a partisan allegiance, but this would imply that others imposed a particular policy approach on him, whereas it is entirely possible that Fraser may have been the architect, and others the policy builders. Moreover if the accusation of partisan allegiance is to have any substance, the fact that Fraser came very close to invoking the formal disputes procedure against a Labor Treasurer would require some explanation. The fact that Fraser was wary of the power of interest rates arguably made him more open to the opportunities presented by an Accord - specifically access to a plurality of policy instruments including wages policy, and the social wage. Whether, as some have suggested, Fraser's public pronouncements, his (within international finance markets at least) somewhat unorthodox views on central

bank charters and relationships with governments, and his advocacy of somewhat unfashionable incomes policies, conspired to produce a credibility deficit, is a matter to which we return. In the climate of greater openness and transparency associated with Fraser's stewardship of the Bank there were clearly greater opportunities for a public debate over the merits or otherwise of policies and institutional arrangements, opportunities which Fraser, notwithstanding his reputation for reservedness, responded to. And so towards the close of this period reviewed in this chapter there is, through a series of speeches made by Fraser on behalf of the Bank and the Board, the articulation of a model viewed as accommodating the challenges posed by the applied art of monetary policy making and implementation. It is an institutional model which analytically is best illuminated, and in normative terms, is suggested by the political economy model we have articulated. This is a matter to which we return in the concluding Chapter. In the penultimate Chapter we examine the trajectory of institutional reshaping in Australia over the period from 1989-1996, focusing in particular on the retention of key elements of the Coombsian institutional settlement - charter objectives and governance arrangements in particular - on the perceived merits of the New Zealand alternative, and on the extent to which the evolving Australian arrangements satisfy the test of 'central bank independence'.

Appendix

STATEMENT ON THE CONDUCT OF MONETARY POLICY

THE TREASURER AND THE GOVERNOR (designate) OF THE RESERVE BANK

(Issued on 14 August 1996)

This statement records the common understanding of the Governor (designate) of the Reserve Bank and the Government on key aspects of Australia's monetary policy framework. It is designed to clarify respective roles and responsibilities.

Monetary policy is a key element of macroeconomic policy and its effective conduct is critical to Australia's economic performance and prospects. For this reason, and given the appointment of a new Governor of the Reserve Bank, it is appropriate and timely for the Governor (designate) and the Government to set out clearly their mutual understanding of the operation of monetary policy in Australia.

It is expected that this statement will contribute to a better understanding both in Australia and overseas of the nature of the relationship between the Reserve Bank and the Government, the objectives of monetary policy, the mechanisms for ensuring transparency and accountability in the way policy is conducted, and the independence of the Bank.

RELATIONSHIP BETWEEN THE RESERVE BANK AND THE GOVERNMENT

The Reserve Bank Act gives the Reserve Bank Board the power to determine the Bank's monetary policy and take the necessary action to implement policy changes.

The Government recognises the independence of the Bank and its responsibility for monetary policy matters and intends to respect the Bank's independence as provided by statute.

Section 11 of the Reserve Bank Act prescribes procedures for the resolution of policy differences between the Bank and the Government. The procedures, in effect, allow the Government to determine policy in the event of a material difference; but the procedures are politically demanding and their nature reinforces the Bank's

independence. Safeguards like this ensure that monetary policy is subject to the checks and balances inherent and necessary in a democratic system.

In addressing the Bank's responsibility for monetary policy the Act provides that the Board shall, from time to time, inform the Government of the Bank's policy. Such arrangements are a common and valuable feature of institutional systems in other industrial countries with independent central banks and recognise the importance of macroeconomic policy co-ordination.

Consistent with its responsibilities for economic policy as a whole the Government reserves the right to comment on monetary policy from time to time. However, the Government will no longer make parallel announcements of monetary policy adjustments, when the Reserve Bank changes the overnight cash rate. This will enhance both the perception, as well as the reality, of the independence of Reserve Bank decision making.

OBJECTIVES OF MONETARY POLICY

The framework for the operation of monetary policy is set out in the Reserve Bank Act 1959 which requires the Board to conduct monetary policy in a way that, in the Board's opinion, will best contribute to the objectives of:

- (a) the stability of the currency of Australia;
- (b) the maintenance of full employment in Australia; and
- (c) the economic prosperity and welfare of the people of Australia.

The first two objectives lead to the third, and ultimate, objective of monetary policy and indeed economic policy as a whole. These objectives allow the Reserve Bank to focus on price (currency) stability while taking account of the implications of monetary policy for activity and, therefore, employment in the short term. Price stability is a crucial precondition for sustained growth in economic activity and employment.

Both the Bank and the Government agree on the importance of low inflation and low inflation expectations. These assist businesses in making sound investment decisions, underpin the creation of new and secure jobs, protect the savings of Australians and preserve the value of the currency.

In pursuing the goal of medium term price stability the Reserve Bank has adopted the objective of keeping underlying inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short run variation in underlying inflation over the cycle while preserving a clearly identifiable benchmark performance over time.

The Governor (designate) takes this opportunity to express his commitment to the Reserve Bank's inflation objective, consistent with his duties under the Act. For its part the Government indicates again that it endorses the Bank's objective and emphasises the role that disciplined fiscal policy must play in achieving such an outcome.

TRANSPARENCY AND ACCOUNTABILITY

Monetary policy needs to be conducted in an open and forward looking way because policy adjustments affect activity and inflation with a lag and because of the crucial role of inflation expectations in shaping actual inflation outcomes. In addition, with a clearly defined inflation objective, it is important that the Bank report on how it sees developments in the economy, currently and in prospect, affecting expected inflation outcomes. These considerations point to the need for effective transparency and accountability arrangements.

In recent years the Reserve Bank has taken steps to make the conduct of policy more transparent. Changes in policy and related reasons are now clearly announced and explained. In addition, the Bank has upgraded its public commentary on the economic outlook and issues bearing on monetary policy settings, through public addresses and its regular quarterly report on the economy. In furthering the arrangements already in place the Governor (designate) will support the release by the Bank of specific statements on monetary policy and the role it is playing in achieving the Bank's objectives. It is intended that these statements will include information on the outlook for inflation and will be released at roughly six monthly intervals.

The Governor (designate) has also indicated that he plans to be available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Financial Institutions and Public Administration.

The Treasurer expressed support for these arrangements, seeing them as a valuable step forward in enhancing transparency and accountability in the Reserve Bank's conduct of monetary policy - and therefore the credibility of policy itself.

The Government and Bank recognise that outcomes, and not the arrangements underpinning them, will ultimately measure the quality of the conduct of monetary policy.

14 August 1996

Chapter 8

Evaluating the Australian Model

Introduction

Australian policymakers rejected the New Zealand model, and for reasons that had as much to do with its substantive weaknesses, as with the symbolic import of resiling from the charter objectives contained in the Coombsian institutional scheme. In this penultimate chapter the objective is to advance an evaluation of the Australian model, one informed by the assessment of a variety of institutional stakeholders - many of whom, in the context of the model that has informed this research, are presently or have in the recent past been situated within the state-directed policy network that has sustained the continuity of the Australian model.

To rehearse the essential features of the argument to date, we have argued that the equilibrium condition for the institution of the central bank is one that maximises endowments of both credibility and legitimacy. Within the political economy credible policy will be policy that satisfies the test of dynamic consistency. The rational economic literature would suggest that satisfying this test will be expedited by an exclusive focus on price stability, and by governance and accountability mechanisms that provide the central bank with operational independence. Legitimacy, on the other hand goes to the economics and the politics of central banking - inasmuch as it is argued that the 'art of central banking' requires, at the very least, that the short run adjustments costs associated with the conduct of monetary policy (the fact that the short-run Phillips Curve is not vertical) be taken into account, and that governance and accountability mechanisms ensure that on both procedural and substantive grounds the needs of the wider community within which the central bank is located are accommodated.

The New Zealand model, the design of which was very much informed by the rational economic literature survey in Chapter 2, and which in turn featured large in the debate within the Australian community over the merits of the post War Coombsian scheme, clearly addresses the need for institutional and policy credibility. But we would contend that the incremental pattern of institutional reshaping within the Australian context - an institutional dynamism within the parameters of the Coombsian scheme - has allowed an emerging credibility deficit to be addressed, while at the same time ensuring that both institution and policy have satisfied the test of legitimacy. The

existence of a bi-partisan settlement on matters of institutional form and policy process is strongly suggestive of an equilibrium condition in which endowments of both credibility and legitimacy have been maximised.

In this penultimate chapter we use the analysis and narrative of the preceding two chapters as a basis for a more detailed examination of the dimensions and qualities of the Australian model as it is presently constituted. For much of the period reviewed by this research, that model has been a somewhat unfashionable one. Two elements of the formal institutional arrangement in particular have offended against the institutional prescription suggested by the rational economics literature - a charter directed to multiple objectives, and a system of governance in which power resides in a Board, moreover a Board of which the Secretary of the Commonwealth Treasury is a member. This Chapter focuses on policy objectives and the governance of the central bank, and seeks to more fully illuminate the reasons for the retention of core elements of the original Coombsian scheme, albeit in a wider institutional context and policy environment that is now significantly different to that which existed when the original institutional scheme was first codified into statute. The discussion turns first to the question as to why in 1996 the incoming Coalition Government chose not to go down the path of statutory reform along the lines of the New Zealand model.

Legislative change and the exchange of letters: why was a statutory remedy not pursued?

Alexander Downer's accession to the leadership of the Liberal Party was indicative of both a symbolic, and a substantive shift in Coalition policy - a shift which signified the primacy of politics and of practical policymaking, over economic theory. Those involved with the policymaking process with the Coalition suggested that the policy became one of enhancing the central bank's independence, as opposed to enforcing independence by way of statutory change. While, respondents reported that there was significant disagreement with, and political disquiet resulting from Bernie Fraser's pronouncements on aspects of Coalition policy, so far as the policies adopted by the Bank were concerned, and the outcomes attendant upon those policies, there was little disagreement, if any, with the substance of policy - particularly over the period after the election of the 1993-96 Keating government. One respondent suggested that the Bank had adopted a defacto focus on inflation notwithstanding its charter objectives (a variation on the argument that Fraser, contrary to the approach expected of the orthodox central banker, tended to act tougher than he talked). It was pointed out that

in 1994 the Bank had tightened monetary policy notwithstanding that this resulted in an increase in unemployment.

Within the Coalition, while there was some debate over the relative merits of amendments to the Reserve Bank Act, and, changes to the Bank's charter objectives in particular, the decision not to proceed down the legislative path reflected a number of factors - the fact that the Coalition had decided to focus on fiscal measures, and in particular reducing government expenditure, the fact that the Bank itself had developed its own inflation target and that outcomes were within the target range, that market expectations had been lowered, and that public opinion more generally was accepting of the benefits of a low inflation environment. In effect, most of the benefits that might accrue from legislative changes were already being captured. One respondent suggested that in the present institutional framework the degree of central bank independence depended largely on the personality of the Governor, and how he conducted himself. Moreover the politics of the situation recommended the status quo. The symbolic import of amending the Reserve Bank Act to shift the focus from the multiple objectives to an exclusive focus on price stability was viewed as electorally problematic. One respondent suggested that monetary policy and the institutional arrangements within which that policy was determined and implemented, were seen, within Coalition ranks as being of a 'second order', the 1993 election debacle having demonstrated the political folly of taking a technically correct position on such second order issues - changing the Bank's charter would have precipitated a political debate over whether the Government had been elected to do something about unemployment.

However a key factor, from the perspective of those tasked with the provision of both policy and political advice appears to have been the lack of certainty associated with the absence of a Government majority in the Senate. Within the 'official family' there was a concern to avoid opening up the Reserve Bank legislation before the Senate, and a risk that the final result of any attempt to proceed down the legislative path would be not just a second-best outcome, but one decidedly inferior to the institutional and operational status quo. Treasury, for its part, recommended against the legislative route in preference to a less formalised path.

Those responsible for furnishing the Treasurer with political advice were concerned to ensure that the wording of the exchange of letters was consistent with the Reserve Bank Act, having correctly (with the benefit of hindsight) anticipated that any inconsistency between the two risked any extra-legislative initiative being challenged on the grounds of it being *ultra vires*.

Certain risks inherent in this approach were however acknowledged by those involved in the debate over the Coalition's position, with one respondent indicating some concern that in the absence of any statutory change, there was the risk that the Bank would, by virtue of the mix of personalities and the 'institutional mood' within the Bank, drift back into the practices and policies of the 1980s. If the Act were to be amended, it was argued, the risks of the informal arrangements 'falling over' would be reduced. Moreover while there was some comfort in the present arrangements for those concerned to accommodate exogenous shocks to the economy, the fact of the Bank's multiple objectives left open the danger that, in the guise of responding to a shock, the Bank could focus, to an inappropriate degree, on the employment objective. This risk was however seen as being offset against the possibility of the inflation target being incrementally reduced, 'by stealth', with a revised target being incorporated into a subsequent exchange of letters. To date there has been no revisiting of the agreed text released in August 1996.

Economic and political commentator, Alan Wood, suggested that 'politics' had been the determining factor:

" ... the Liberal Party's view has been more towards the New Zealand model, and they were pretty overt about that in the 1993 election, which they lost. And then they became a lot more cautious about a range of economic policy, including monetary policy, and so they were no longer strongly pushing that view, but they still had an inclination to want to make it much clearer that the Bank's primary concern was with inflation, and that the Bank was independent in the decisions it took about that, and that is basically what the letter is about...

... they didn't want to do it by re-writing the Reserve Bank Act, and the reason for that is that they didn't know what would come out of ... although it likes independence and so on and it would be nice to have it written into the Act - the political realities are such that the risks were too great - if you tried to re-write the Reserve Bank Act and put it through that Senate that we've got at the moment, you could come out with a much worse Act than the one we've got, so it wasn't worth the legislative risk or the political fight that would have been involved, to try and do it legislatively. And so the way to go was the exchange of letters - it was just a *modus vivendi* really to get around the politics of re-writing the Reserve Bank Act, and its objective, as I say, was to give effect as far as possible within that framework, to make it clear that inflation was the primary objective, although not the only one, and that the Bank was responsible for monetary policy, both of which are quite desirable I might say ...

I do think it was more political than anything else - a recognition that they had lost that game in the 1993 election, and they were just setting themselves up for another hiding if they persisted along the lines of, 'these people don't care about the unemployed', etc etc ... it was more political pragmatism than anything else, and once in government, Costello would certainly have had the problems pointed out to him of trying to amend the Reserve Bank Act - again which was

very much a political argument, although there was also a policy content in the sense that you could have lost rather than gained"(personal interview, 1997).¹

Within the Bank, including from the vantage point of the Board, proceeding down the legislative path was seen as having little to commend it, but the opportunity to send a circuit breaking message to the markets was seen as one to be taken. The Bank's inflation target had been imported into the last of the Accord agreements, and accepted as an element of Government policy in other statements by Treasurers in the Keating Government.² From the Bank's perspective, any vehicle that enabled the incoming Government to commit itself to the Bank's target, was viewed as a plus. Bank staff and the Board were concerned at the risk premium the markets had built into Australian bond rates - a premium evidenced in the bond rate differential - and saw an exchange of letters as an opportunity to reduce that differential. One Board member

¹ As an example of what might have occurred, Wood cited the dangers inherent in proceeding down the statutory path in giving effect to the Wallis Committee of Inquiry recommendations on changes to the institutional arrangements governing the prudential supervision of the banking and finance system:

"... its a bit like the Wallis Report now that has the gee whiz recommendations to change the prudential regulations, so that it is taken away from the Reserve bank in the case of banks, and put within this mega regulator that applies basically the same rules to banks, building societies and credit unions, and other deposit taking institutions ... I don't like that model any way because I think it extends moral hazard, but in just sheer practical terms you would have to re-write the Banking Act because the Banking Act makes the Reserve Bank responsible for the particular depositors - now there is ambiguity in terms of whether that means that all depositors are paid in full in any circumstances - the Bank argues that, no it doesn't mean that at all and so does Treasury, but the truth is that it has never been tested in the Court and there is a fair bet that if ever it was, the Court would rule that they were indeed obliged but I mean that is a separate argument - the fact is that there is a constructive ambiguity - its worked pretty well, it hasn't had a major test, but perhaps that is because it has worked pretty well- it hasn't cost the taxpayers money, and so on, but to change that system and implement the Wallis system you would have to rewrite the Banking Act to say obviously that it was no longer the [Reserve] Bank's responsibility it was this new body

now imagine putting that up to the Senate - its a free kick - you'll immediately enable them to stand up and say, 'this government is taking away the safety net for bank depositors' - its the politics that stop it, but as far as I am concerned, we are probably left with a better system than the one that Wallis recommended, and certainly one that would probably emerge if you put the Banking Act through the Senate, because my guess would be that the Senate would want to move amendments which would have the effect of making depositor protection far more explicit" (personal interview, 1997).

Wood's misgivings were not borne out, with the Coalition Government successfully prosecuting the legislation incorporating the Wallis Committee recommendations through the Senate.

² In a press release from the Treasurer on 17 August 1994, which paralleled the announcement by the Reserve Bank Governor of an increase in interest rates, the Treasurer states that:

"The decision was taken to ensure the maintenance of low inflation and sustained economic growth.

It reflects the commitment of the Government and the Reserve Bank to keep underlying inflation around 2 to 3 percent over the course of the economic cycle" (Office of the Commonwealth Treasurer, Press Release No. 96, 17 August 1994).

Treasurer Ralph Willis' Budget Speech of 9 May 1995 also made reference to the target, without elaboration, as if it was simply p[art of Government policy.

suggested that the exchange of letters provided the incoming Government with an opportunity to do something for the Bank. While Costello had been more muted in his criticisms of the Bank than his predecessor as shadow Treasurer, politically inspired comments suggesting that the Board (and the Bank) lacked independence had, in the words of one respondent, "annoyed the shit out of us". The onus on the incoming Government was to be party to an action that would restore credibility that the Coalition, while in Opposition, had, in part, been responsible for eroding. From the vantage point of the Bank and the Board, the exchange of letters was seen as simply codifying what had been Bank and Board policy and practice over the preceding four year period. By the time the incoming Treasurer met with the Bank Board over the May-June period, he was signalling a preference to proceed down the path of an agreed exchange of letters. There was no indication from any of those involved in these discussions of anything other than support for this proposed course of action.

While, in terms of its wording, the exchange of letters was positioned as being consistent with the Reserve Bank Act, some within the policy community suggested that the intention had been to rank the charter objectives, and to make the inflation objective paramount. Moreover, in terms of the policy 'logic' the fact that price stability was the main gift that a central bank could bestow over the long-run, and that, price stability would in turn contribute to the Bank's employment and economic welfare objectives, was viewed as 'logically sensible.' To the extent that the markets perceived the exchange of letters as representing an implicit prioritising of objectives, and that these perceptions were reflected in bond rates, it was not in the Bank's, nor the Government's interest, to contest such perceptions.

For those concerned to prosecute further reforms, the opportunity provided to the Government by new appointments to the Bank Board was viewed as holding out the prospect for a consolidation of a policy focus around the primacy of price stability.

The exchange of letters provided the markets, and in particular the overseas markets, with some of the theatre that, hitherto, Australia, had not provided, other than, in political terms, the theatre of the absurd. As one respondent observed, "the markets like a bit of theatre". The reviews, particularly those from the overseas audience, were positive. A number of respondents pointed to the fact that, following the release of the exchange of letters, the US/Australia bond rate differential narrowed significantly, and inflationary expectations continued to fall. Whatever the genesis of the 'credibility deficit' - a matter to which we return below - the exchange of letters provided the kind of circuit breaker that the Bank had been looking for for some time. And within the

ranks of those who had raised concerns about the potential for the exchange of letters to constitute a de facto revisiting of the Bank's charter objectives, increasingly the exchange of letters was seen as a vehicle to 'buy' a reduction in the bond rate differential, and, as such, if not to be actively supported, then certainly not made the subject of litigation through the High Court.

The day after the release of the agreed statement on the conduct of monetary policy, the announcement of Ian Marfarlane's appointment as Governor, and Hugh Morgan's appointment to the Board, retiring Governor Bernie Fraser gave what was, in effect, his valedictory address. The title of that address, to the National Press Club in Canberra, was 'Reserve Bank Independence', and in it, Fraser took the opportunity to rehearse the case for central bank independence, and reassert the appropriateness of the Australian institutional arrangements. Reviewing the allegations of a politicised approach to monetary policy Fraser argued that no hard evidence had even been advanced and that, "there is none". Fraser was also critical of those that had impugned 'sinister overtones' to his relationship with Paul Keating:

"Some went so far as to suggest that Mr Keating only had to get on the phone to me and I would do his bidding. As well as being malevolently ignorant, such stories were extremely offensive to the other Bank staff and Board members involved in all the Bank's decisions on monetary policy.

For the record, I always have been pleased to be counted a 'mate' of Paul Keating, in the proper sense of that term ... Commentators should not be surprised, not should they suspect intrigue, if a Treasurer and a Governor happen to see eye to eye on particular economic policies or strategies; and the Governor should not have to engage in public slanging matches with the Treasurer to demonstrate the Bank's political independence" (RBA Bulletin, September 1996).

Fraser also advanced a strong rebuttal of the 'rational economic' theoretical arguments in favour of an exclusive focus on price stability, suggesting that, while institutional changes informed by such theories constituted good central banking orthodoxy, to his taste, "equating independence with inflation targets alone is a form of Clayton's independence":

"Behind these subtle differences in taste are deep debates about trade-offs between inflation and unemployment. Without going into detail, it is generally agreed that no such trade-off exists in the long term; the policy implication which flows from this is that the best contribution monetary policy can make to sustained economic growth is to hold down inflation. The problem with this argument, however, is that the long term can be quite long indeed - five years or more. In the short term - that is, in the year or two ahead, which is clearly a highly relevant period for most people - trade-offs do arise" (RBA Bulletin, September 1996).

The Bank's multiple objectives, Fraser argued, helped to make those trade-offs explicit, and enable policymakers to balance price stability against the need for a sustainable level of economic activity:

"There is no doubt in my mind that had the Reserve Bank been charged with fighting inflation only through the 1990s, monetary policy would have made much less of a contribution to economic recovery than it actually did; interest rates would have gone down more grudgingly in the early 1990s, and up more enthusiastically in the mid 1990s" (RBA Bulletin, September 1996).

That 'balanced' approach, Fraser argued, was encouraged by the institutional 'framework' within which the Bank exercised its independence. The four pillars of that framework, Fraser suggested, were the Bank's charter, enjoining it to pursue multiple objectives, a flexible inflation target, a relationship between Bank and government characterised by 'consultative independence' (underpinned by a formal disputes procedure), and a Board bringing together a diverse range of interests, bringing a 'real-world' dimension to Board decisions, and adding authority to those decisions. Much of this framework, Fraser suggested, was reflected in the agreed statement on the conduct of monetary policy released the day before:

"Considerable effort also appears to have been directed towards ensuring that the statement was consistent with the Reserve Bank Act. So long as that basic consistency is maintained, the statement would not cause me any particular difficulties. In fact, because it essentially formalises current practices, it has a rather sweet ring to it for me. It suggests that we are all marching to the same tune now, something that seemed impossible only a few years ago when the Government was in Opposition" (RBA Bulletin, September 1996).

Fraser concluded his speech by drawing attention to the dangers inherent in a central bank not possessing sufficient independence from financial markets: "It would be ironic if one form of influence were to be substituted for another: if the short-termism of politicians were to be replaced by the short-termism of the financial markets" (RBA Bulletin, September 1996). Drawing on the rational choice assumptions which informs the theoretical case for greater central bank independence from political authorities, Fraser suggested that the advocacy of the primacy of price stability reflected the interests of financial markets:

"Most financial market participants rate low inflation ahead of the Reserve Bank's other objectives. This reflects a number of factors, but the financial harm done to holders of bonds when inflation and interest rates rise is the main one. We see their (understandable) priorities in market reactions to different economic indicators: weak economic activity and employment numbers, for example, are generally welcomed because they imply lower inflation and higher bond prices, while strong numbers are generally frowned upon because of

concerns that they will be followed by higher inflation and interest rates down the track" (RBA Bulletin, September 1996).

And in a comment which resonates with the political-economy developed in Chapter 3, and which anticipates our revisiting of this theoretical literature in the concluding chapter, Fraser advanced a distinction between two types of 'credibility', or, to recast his argument in terms of the theoretical model developed in Chapter 3, between credibility (with financial markets) on the one hand, and legitimacy (within the broader community) on the other:

"A lot of what is written about the Reserve Bank's 'credibility' is in the narrow context of the Bank's credibility with the financial markets for delivering low inflation. This is important, but to actually deliver low inflation the central bank needs credibility in labour and other markets more than in the financial markets. To build this broad community support for its anti-inflation objective, the Bank also needs to build credibility in relation to its other objectives" (RBA Bulletin, September 1996, emphasis added).

The charter

The rational economics case for an exclusive focus on price stability is theoretical and, in terms of the conduct of monetary policy, strategic. Insofar as the former is concerned, we rehearsed the arguments in Chapter 2. In part the preference for a focus on price stability is a function of the theoretical inadequacy of classical Phillips Curve formulations of policy trade-offs - in the absence of an exploitable Phillips Curve over the long-run, it makes little theoretical or technical sense to direct monetary policy to an objective which it is not able to deliver. In part the preference reflects the constraints imposed by the NAIRU and the logical inconsistency of directing monetary policy at objectives which, in the event of the rate of unemployment being below the NAIRU, would operate in a mutually contradictory fashion. Below the NAIRU, it is argued, lower unemployment may only be purchased at the expense of an increasing rate of inflation. Moreover, in a strategic sense, if the design of monetary policy institutions is to impart a measure of credibility, based on optimal degrees of transparency and accountability, a single quantified target enables performance to be measured. With multiple objectives, it is argued, there will always be as many excuses as there are objectives additional to price stability. Accordingly, accountability is optimised where a central bank has one target, preferably quantified, and where policy outcomes can be used to assess performance against that target.

Clearly this issue is not confined to the institutions of monetary policy, although the case of central banks and multiple objectives is an illustrative one. One of the seminal

works on Australian public administration notes the problematic quality of multiple goals:

"Multiple goals or subgoals raise their own problems. An agency may have a reasonably operational objectives set for it, but no clear guide to action when they conflict, or when all make claims on a limited budget. Suppose one were to define the aims of government economic policy as 'full employment plus stable prices plus an annual growth rate of five per cent'. Each is a roughly measurable objective; but no guide is given as to which should be sacrificed, and to what degree, in case of conflict ... It would be impossible to draft a formal policy-statement that went close to sorting out priorities. Goal setting in such cases often takes the form of a series of nudges - 'a little more of a, even at some expense (if necessary) to b'" (Spann, 1973: 26).

The preceding chapter indicated a measure of support for the kind of institutional/legislative changes that would direct the Reserve Bank of Australia to focus exclusively on a price stability objective. Those arguments have, to a degree, been accommodated in the Costello/Macfarlane exchange of letters, although the extent of that accommodation depends on the extent to which the agreed Statement is perceived as being indicative of a prioritisation of the elements of the Bank's legislative charter. Within the ranks of the Government's political advisers there was a view that, increasingly the Bank had adopted a de facto focus on inflation, notwithstanding the provisions of its statutory charter. Those adhering to this interpretation cited the 1994 tightening of monetary policy, and the consequential increase in unemployment as evidence, and suggested a gap between the Fraser 'rhetoric' and the policy reality. To the extent that the vehicle of an exchange of letters was a second best solution designed to avoid the risks attendant upon a formal revisiting of the Act, some within the ranks of the Government's advisers suggested however that, in the absence of legislative amendments there is a risk that either the Bank and/or a future government could revert to a policy stance more accommodating of higher levels of inflation. However, as we noted above, the vehicle of an exchange of letters, embodying an agreed 'Statement on the Conduct of Monetary Policy' was both the Bank's and the Commonwealth Treasury's preferred option. Moreover, that preference indicated support for the Bank's existing charter. Treasury Secretary, and Reserve Bank Board member Ted Evans suggested that, while a theoretical case can be made for institutional arrangements which direct central banks to focus exclusively on price stability, and while the standard formal measures of central bank independence tend to 'penalise' those central banks directed to multiple objectives, the standard indices betray a degree of laziness on the part of those that design them, and an uncritical acceptance of the view that, over the long-run monetary policy is neutral in its effect on output. And notwithstanding the uncertainty of some of the empirical work, Evans suggested that short-runs do matter, particularly if policy is designed and implemented

in such a manner as to string a series of short-runs together. Academics and some central bankers, he suggested, failed to appreciate that economic policymaking demands a measure of pragmatism, and the Bank's statutory charter admits of that pragmatism.

And this view was also in evidence in the assessments of Bank staff and Board members. The view from within the Bank was that to equate central bank independence with an exclusive focus on price stability failed to capture either the substance of what it is that constitutes effective independence, or the fact that price stability constitutes an intermediate objective, with the principal objective of monetary policy being the need to engender sustainable levels of growth in the economy. Focusing exclusively on price stability, it was suggested, would risk a bias against growth and output. The 'sensible person', it was suggested was not going to pursue price stability in isolation from some consideration of the output trade-offs.

Board members suggested that the Bank's statutory charter provided a relevant and an appropriate template within which to generate policy. One Board member observed that a charter directing the bank to focus exclusively on a price stability target would equate with a narrowly economic rationalist agenda, and that it was vital in taking monetary policy decisions that the Board consider the impact of monetary policy on economic growth and employment. Moreover this same respondent indicated that at each Board meeting there was a clear sense of all three arms of the Banks charter informing debate and decision-making, and cited examples of discussion and debate within the Board as to whether a particular action would assist in reducing unemployment. Without the charter, it was argued, it would be entirely possible for the Bank to take decisions that would increase unemployment, with the attendant social and fiscal costs, without being required to take account of these implications in making decisions.

Another Board member suggested that, in his opinion, the theoretical literature on the institutions of monetary policy tended to be somewhat one-sided in assuming that all of the risks attendant upon particular institutional forms were inflationary, and not deflationary. That 'natural inclination' of central bankers, it was suggested, was to drive inflation out of the system, and, so far as central bankers were concerned, the Bank's charter reflected the need, "to make them think about unemployment, think about growth - they're not going to think about it otherwise". The challenge for those designing institutions, it was argued, was to require central bankers to acknowledge a range of factors - "you should be devising contracts that make them think about the

other objectives, other than inflation". This respondent suggested that one of the challenges of institutional design was to effect an appropriate balance between the needs and preferences of the wider society, yet at the same time providing a necessary measure of central bank independence - central banks needed to consider growth because society in general wants to think about growth, and about inflation - "that is one of the problems - how to achieve the kinds of things that society wants and yet at the same time keep the Bank independent." The importance of the Bank's multiple objectives was cited in the policy trajectory coming out of the last recession; in a situation in which inflation moved outside of the Bank's 2 - 3 percent target zone, this was tolerated over the short-run in order to facilitate an increase in economic activity. A focus on the long term trajectory for inflation, and a charter directing the Bank to multiple objectives allowed the Board to more explicitly address some of the trade-offs associated with monetary policy making. Moreover, this respondent suggested that if the Bank were to ignore the real economy implications of monetary policy this would invite the community to revisit the institutional arrangements within which monetary policy was determined and implemented - sustainable institutions required an approach to policy in which monetary policy was one element of what was described as a 'social welfare function'. Recasting this observation in the context of our model, policy is required to be both credible and legitimate.

Within business sector groups the balance of opinion favoured the effective dualism of the Bank's statutory charter. Todd Ritchie of the National Farmers Federation (NFF) suggested that, while the existing charter was somewhat anachronistic - written by 'naive' people in a kinder gentler age - while technically the principle of assignation suggested that there should be a correspondence between one instrument (monetary policy) and one target (price stability), and while the principal target for the Bank should be inflation, there would be times over the cycle when the Bank would be required to shift its focus back to 'aggregate demand', but only when the inflation target was not compromised. Clearly for the NFF the prioritisation of the price stability objective was appropriate, the exchange of letters welcomed, and the consequential reduction in the bond rate differential - reflecting the removal of an uncertainty premium - was also seen as a positive development. But while Ritchie welcomed the impetus given by the exchange of letters, he shared with others in the policy, central banking, finance, and business communities the view that the only thing that would get rid of an uncertainty premium was performance over time. Moreover Ritchie suggested that the so far as an inflation target was concerned, and while he was supportive of a New Zealand styled target, the choice of a target was less a matter of theory than a question of values - and in the context of the values choices within the Australian

community - 2-3 per cent was not a bad target to have, and Australia was on track to becoming viewed as a low inflation country.

Both Australian Business Limited (formerly the Australian Chamber of Manufactures) and the Metal Trades Industry Association (MTIA) indicated a clear preference for the Bank's statutory charter objectives, but a concern that any prioritising of the Bank's price stability objective risked militating against the primary requirement of facilitating the highest possible levels of sustainable economic growth³ - for Australian Business Limited the Bank's decisions on levels of activity were of equal importance to the focus on inflation, and in early 1997, the view was that there was an urgent need for a set of policies around a growth strategy designed to increase the rate of economic growth, while at the same time effecting a reduction in a rate of unemployment perceived as being too high - unemployment, it was suggested, provided the 'political handle' to industry growth. What was clearly of concern at this point was the sense that, within the policy community, and within the Reserve Bank in particular, the prevailing view was that the maximum rate of economic growth consistent with 'stable prices' was 3.5 per cent. For Australian Business Limited the urgent need was to develop a solid intellectual argument with which to crank up the debate on where the speed limits for the economy were - to contest the view that an annual rate of 3.5 per cent constituted a 'speed limit' on the economy, a limit enforced by the Reserve Bank through its conduct of monetary policy.⁴

³ Australian Business Limited is New South Wales based industry organisation with approximately 3,500 member companies which, in turn account for a total turnover of \$15 billion and employ approximately a quarter of a million staff. The Metal Trades Industry Association (MTIA) is a national business organisation and represents almost 7000 companies in manufacturing, engineering, construction and related industries.

⁴ In the early months of 1997 a number of peak industry and employer groups raised concerns about the 'speed limits' that the Reserve Bank was perceived as enforcing. In a pre-budget submission the Australian Chamber of Commerce and Industry suggested that it was:

"... imperative for the Australian economy is the need to regenerate a return to faster rates of economic growth, and in particular, faster rates of investment growth. The apparent willingness to accept 3 1/2 % as the maximum rate of growth achievable without serious inflationary consequences is itself one of the greatest obstacles preventing a major rise in employment and a large reduction in unemployment ...

loss of production is the apparently forgotten overall loss to the community of deliberately slowing economic growth to contain inflation ...

There is thus a large costs to be borne in lost production and lost incomes in fighting inflation. It may be worth the costs, but what must not be forgotten is that there is a cost" (ACCI, 1997).

Comparing two scenarios in which the economy grew at 3.5% and 4.5%, the ACCI argued that, "the difference in national output if the economy grew by one percentage point less than it would have because of high rates of interest is a difference in output levels of more than \$81.7 billion in constant 1995-96 dollars" (ACCI, 1997).

For its part the MTIA, which, as early as 1995 had raised in a paper entitled, "How fast can Australia

Questioned on the efficacy of the Bank's statutory charter objectives, Heather Ridout, Director of Public Policy for the Metal Trades Industry Association responded by observing that:

"I firmly believe that it is the right charter, firmly and totally and unequivocally believe that Australia has the best charter ...

I have absolutely no doubt that Australia's central bank target is absolutely the right one ...

I think that to drive inflation down to zero, the pain that it would inflict on the economy is hardly worth it - its simply not worth the effort. And there's a lot of economic evidence to support that. I think that the target set at 2 - 3% over the life of the cycle complements monetary policy which can take into account

grow?" (MTIA, 1995), suggested in March 1997 that,

"While inflation looks to be under control, activity may remain undesirably modest for too extended a period. Much will depend on the degree of caution exercised by the Reserve Bank. If its key policymakers take the view that the primary task is to consolidate low inflation, they may come to regard modest growth of the order of 3.5 percent as entirely acceptable. That would be a mistake. Under present circumstances of high unemployment and excess capacity, the Australian economy is capable of growing at 4 percent plus for an extended interval without compromising the inflation objective" (MTIA, 1997b: 13, emphasis in original)

In a speech by RBA Governor Ian Macfarlane to the Australia-Israel Chamber of Commerce on the 15 May 1997, Macfarlane categorically refuted any suggestion that the Bank was operating with a 'speed limit':

"We do attract criticism ... from people who think because we have an inflation target it means we are not interested in economic growth. This is not true - as I have pointed out on a number of occasions. In fact, the reverse is true: we are interested in sustaining a good inflation performance because we are interested in growth ...

Some people would characterise our approach to monetary policy as incorporating 'a speed limit'. In a very broad sense this is true ... However the concept of a 'speed limit' is unhelpful if we try to use it mechanistically. It has been claimed that the Reserve Bank has a rule that the economy cannot be allowed to grow faster than 3 1/2 per cent. I have seen this claim on a number of occasions, but can assure you that it is not true ...

While we do not wish to take too strong a view on what is 'too much' in any particular short period. We need to keep a reasonably sober perspective on what is likely to be feasible over the long run. A growth rate of 5 per cent, for example, is so far above our historical performance, that unless you can specify how improvements on the supply side of the economy have lifted the potential growth rate dramatically, it cannot be taken seriously" (RBA Bulletin, June 1997).

In an earlier speech to the Australian Business Economists Sydney Macfarlane's predecessor had observed that,

"In these days when it is fashionable to benchmark everything that moves, I think we would be doing quite well if, over the next three years, we could match the performance of the past three years. In that period, GDP growth averaged 4 per cent a year, and underlying inflation averaged 2 1/2 per cent ...

Is 4 per cent a sustainable growth rate for Australia, or should we settle more prudently for 3 per cent? The difference is not trivial; assuming that population continues to grow at about 1 1/4 per cent per annum (as it has in the past decade), 4 per cent growth would see living standards double in 26 years, compared with 40 years in the case of the lower figure. Faster growth would also deliver larger wind-downs in unemployment" (RBA Bulletin, April 1996).

employment - which is going to be the biggest issue over the next couple of decades - and the well being of the Australian people. What should be more important to a public institution set up to manage economics and interest rates than to have regard to those objectives?

... if you are controlling monetary policy you are controlling the pace of economic growth in the economy - its not just controlling inflation. I think this is where we get it all wrong - how can we go to the Australian people and say we've done a great job we've got inflation under control - they will say, so what, where are the jobs, where's the growth ...

If you asked people in Australia - economists in Australia about the objective of economic growth - it would be something to do with higher wages, salaries, driving a Porsche - its all to do ultimately with people, and that is why I think the Reserve Bank has to have it in its charter - its got to have a charter that introduces human issues, such as the welfare of the Australian people, to give meaning to controlling inflation.

I feel very firmly... we are not managing the economy to keep inflation down, we are managing the economy to look after business and Australians - their interests and the interests of their children and their families... and these financial intermediaries who are there all the time - you wait for it, Budget night 7.30 the screen will light up, the dollar will go up, the dollar will go down, bonds will go up, bonds will go down - its just ridiculous, and 2 hours later someone has sat down and had a good look at the information and given a more considered response ... but you can't manage economies to satisfy financial markets - a lot of people will disagree with that because capital is so important in the world economy and so mobile, but ultimately it is the real economy that is going to determine the fate of nations, and we have to get a better balance I think, than we have got at the moment" (personal interview, 1997).

A similar view was expressed by one time Reserve Bank Board member, Australian Council of Trade Unions Secretary Bill Kelty, who defended the appropriateness of the Bank's existing charter:

"I think that it is very important to have multiple objectives ... because we are dealing with the economy ... the economy is the real thing ... the monetary policy and the fiscal instruments are the means. It is the real thing that counts, getting people jobs, decent living standards and a distribution of income ... that is the real game in town, the rest is a side-show ... unless one has this absolutely religious belief, and one would need an absolutely religious belief, to say, 'low inflation is good, low inflation is good, low inflation is good' ... low inflation would have to produce all the other benefits by itself ... it's a science fiction chant - people will have written books about this in 50 years time - they will look back in 50 years time and think that these economic fundamentalists were crazy ...

... you have got to ask yourself about these institutions - 'what are they there for?' They are not there just for some indirect purpose, they are there as real institutions ...

I think the balance changes - if you say to me, in terms of the charter of the Reserve Bank, given those objectives, are there occasions where you will have a

higher priority on one than on another, and the answer to that is probably yes, there are occasions where you will place more weight on one rather than another ... that is what proper economic decision making is about

With Bernie Fraser as Governor of the Reserve Bank we got the balance pretty right ... in the previous period it was a high inflation environment trying to come down to a low inflation environment the reality is that monetary policy played some small part ... unless you have some sort of Machiavellian view that the recession was some kind of plot hatched in Australia, that we could generate to the world an international recession of which we could be part in order to lower our rate of inflation, ... I would say that played some part, the wage adjustments played some part" (personal interview, 1997).

Alan Wood, a one time advocate of an exclusive focus on price stability, suggested that it was unrealistic to task the Bank with one objective, when the reality is that central banks and central bankers tend to factor in the real economy implications of monetary policy decisions:

" ... all central banks are concerned with growth - they can't avoid being - whatever they say publicly they all keep an eye on what is happening with the economy because they know that the short term Phillips Curve ain't vertical ... so that if you look at the Bundesbank for example even their Act says that they are supposed to look at economic activity although concern with it shouldn't override their primary role of controlling inflation" (personal interview, 1997).

And Wood suggested that a concern with multiple objectives reflected, not only an awareness of the economic implications of monetary policy, but also of the political implications of contingent policy making:

" ... central bankers - at least the smart ones - also keep an eye on politics - and you can see that in Australia where the Bank has cut rates, it has said quite a bit about being concerned with unemployment. Macfarlane in a speech expresses the monetary target as achieving the fastest rate of growth possible without overriding the inflation objective - he deliberately shifted the focus to show that growth was a concern ... because he knows ... at some point he is going to have to put rates up probably when unemployment is still quite high and you don't want to be seen as the sort of bugger that ... the bank doesn't want to be seen as totally unsympathetic, to be one of these remote figures that don't care about what is happening out in the real world of people - they just keep putting up interest rates regardless, they don't care about unemployment and so on ...

... having gone through a stage where I thought they should have only an inflation objective ... as long as it is clear that the inflation objective is the primary objective, and it should be for a central bank - if they are not there to preserve the value of the currency, what are they there for? ... it is just idle to pretend that they don't operate with an eye on activity, nor should they ..." (personal interview, 1997).

Wood's view of the influence of 'political imperatives' also came to the fore in the context of comments on the utility of a growth objective:

" ... if you are talking in terms of putting a growth objective in the Act, its just not worth a candle ... and so that then comes down to how the Bank actually operates its policies, because whatever the Act says, we know that they are going to have an eye on what's going on in the economy ... if they allow the perception to develop that they will pursue inflation whatever it costs in terms of economic growth, then sooner or later the Banking Act (sic) will be revisited whether they want it to be or not because the politics will just beat them ... if, on the other hand it's clear that they are making a reasonable fist of it, and they haven't put inflation above economic growth and activity at all costs then they will retain support" (personal interview, 1997).

Wood suggested that in large part the amount of latitude provided to a Bank to pursue objectives other than price stability - either implicitly or explicitly - would depend on the stock of credibility accrued over time, and the preparedness of a central bank to test the speed limits:

" ... you can see in Greenspan a careful eye on growth ... but the sustainable growth rate is a long-term concept, and I don't think it tells you a lot about the short term operation of monetary policy. Greenspan hasn't let the US economy go outside what is generally regarded as the Feds view of what is sustainable because he hasn't had inflationary pressures to cope with, and we will do the same here..." (personal interview, 1997).

The view that a multi-purpose charter is both reflective of the pragmatic and the political realities facing policymakers was also articulated by the Sydney Morning Herald's Max Walsh who suggested that:

" ... it suits the bank to have a multi-purpose charter ... inasmuch as it can always call upon one aspect of the charter to justify what it is doing. If I was in the central bank I would be happier to have that sort of charter than the NZ one ... in that it provides a degree of flexibility that is not present in the NZ model" (personal interview, 1997).

Walsh suggested that, notwithstanding the Bank's statutory charter,

" ... in the present environment no central bank is going to downgrade the importance of price stability in its agenda ... so I don't think that the markets are uncomfortable with the present situation, they don't feel that the Bank is going to surprise them, they feel the Bank is pretty predictable" (personal interview, 1997).

Moreover Walsh also referred to the 'political' dimension of maintaining a degree of institutional independence:

"I mean the charter is there to justify what you are going to do - that is why you need a multi-purpose charter. I think that central banks are conscious that, at the end of the day, they are part of the political process ... they are not discrete from it ... unless they are conscious of their political role they will get rolled over by the political system - its always within the hands of the legislature to curb them" (personal interview, 1997).

But while Walsh advanced the view that it was most unlikely that any government would want to visit upon itself the political opprobrium attached to removing reference to full employment in the Bank's charter, he suggested that with the passage of time the appreciation of the specific historical circumstances that gave rise to the charter might become somewhat attenuated:

"At no stage all the way through in Australian politics could I see any one advocating removal of the full employment objective from the charter. It's one of those things that you play around with at your peril. But in Macfarlane you see you have a bloke untouched by the depression, and untouched by World War Two - that post war generation - and he's a very decent fellow - but his personal experience doesn't encompass the factors that made full employment so important. It's very much a generational thing I suspect, I was born in 1937 ... I have vague memories of the war but nevertheless I was brought up by a generation of people who had been really hurt by it ... so it was part of my agenda. It's only in recent years that in politics we have had that generation take over who have been unscarred by the depression" (personal interview, 1997).

For his part Bernie Fraser, while not of the same generation as Walsh, was acutely aware of the potentially deleterious effects of monetary policy on the real economy. In his valedictory address Fraser identified the Bank's charter as one of the four pillars of the Australian institutional framework. Interviewed a year following his retirement from the Bank Fraser recalled that there were a number of reasons why the charter had retained relevance for monetary policy makers. He recalled an episode early in his career as a public servant:

"... very early on before I became Secretary to the Treasury I became aware of the fact that on its own monetary policy was not going to deliver low inflation except at a very high cost. I joined the public service in January 1961 and in September 1960 there was, by those standards, an almighty credit squeeze directed towards inflation - unemployment shot up, and that almost unseated the Menzies Government. It took quite a while to recover from this onslaught of credit policies and it was a salutary lesson for me really. I had come in and began to get involved, or observe, at this early stage, how to grind inflation down - you could hit it with a sledge-hammer, and that would hit inflation, but it had a much more powerful effect on employment and activity ... from that time on, and there have been other episodes, whenever monetary policy on its own has tried to control inflation, its either been pretty ineffectual, because the inflationary pressure have arisen from things that monetary policy can't always get at, or when it has been effective it has had a pretty high social cost in unemployment" (personal interview, 1997).

In part Fraser's commitment to the charter's multiple objectives reflected the view that, as Alan Wood suggested above, that the short-run Phillips Curve is not vertical. But it also reflected a preference to use multiple policy instruments in a coordinated fashion:

"Once inflationary expectations became part of the reality, as they did, workers demanded compensation, they demanded wage increases... wages became an important part of the inflation scene, and wages policy became important, fiscal policy became important in terms of grinding down or restraining inflationary pressures, not just monetary policy ... so it was my view based upon both observation and experience that monetary policy on its own was a pretty blunt weapon, and a more sophisticated approach really needed coordination with these other policies ... there was this view that if you wanted to restrain inflation in an acceptable and sustainable way you had to rely on more than monetary policy, and you had to have regard to what was happening with activity and employment" (personal interview, 1997).

Moreover, Fraser confirmed the assessments - a number of which have already been cited - of those who have argued that securing a political commitment to a specific set of institutional arrangements requires credibility with financial markets, and a wider sense of political legitimacy within the wider community:

" ... to have a sustainable anti-inflationary policy that is accepted by the community given the kind of monetary policy that you need to implement from time to time, you need to be able to demonstrate some gains in terms of growth and employment" (personal interview, 1997).

And as Fraser remarked in his 1996 valedictory speech to the National Press Club, with the experience of sustained levels of high unemployment, there was a tendency to question the merits of institutional arrangements informed by the rational economics literature - "even in these places where they have had this great focus on independence and single objectives, people are questioning ... and I think this is understandable given the consequences of sustained high unemployment" (personal interview, 1997).

For Fraser the fact that, in his assessment, all central bankers, whatever the text of their charters, have reference to the real economy implications of their monetary policy decisions is sufficient justification for charters directed to multiple objectives:

"It so happens that we have in our charter formal reference to these objectives. People would say that even if you don't have the acknowledgment or formal reference to growth and employment of course central bankers have regard to these things; well that's fine, I just think that it is nice to have it up front there. In fact it is more than nice, in my experience it has been quite essential to what I would regard as a balanced approach to the pursuit of low inflation and its maintenance, having a concern, having one eye on unemployment" (personal interview, 1997).

Fraser cited a number of instances where having recourse to the Reserve Bank of Australia's statutory charter assisted in winning support for particular monetary policy decisions - in effect that it changed the asymmetric quality of the risks that we noted in Chapter 2:

"In my view, without the dual objectives in the charter, interest rates would have come down much more grudgingly in the early 1990s, and they would have gone up much more quickly in the 1990s" (personal interview, 1997).

In reference to the timing of the monetary policy easings in 1994 Fraser suggested that, in the absence of the charter objectives it would have been very much harder to lower interest rates, as it had been in the early part of the 1990s:

"... in retrospect everyone says that we should have done more, even though at the time every action was criticised. It was hard work, including winning enough support within the Bank to make those changes. And I believe that, if the people who were resisting some of these changes were able to say, 'look our sole objective is to keep inflation down', my task of wanting to do much more than that would have been very much harder. I was able to say, 'sure we've got to keep inflation down, but we are obliged to also do what we can to get some growth in the economy, and to get employment growth'. And similarly in 1994 when things started to heat up a bit, there was a lot of pressure inside and outside the Bank to get stuck into things, to preserve the inflation objective, but again it was helpful to say we have an obligation ..." (personal interview, 1997).

On balance, while these assessments indicate a variety of views on the efficacy of the Bank's present charter, the balance of assessment favours the retention of that charter with its multiple objectives. Clearly, for reasons canvassed above and in earlier chapters, a charter directed to anything other than an exclusive focus on price stability is inconsistent with orthodox models of institutional best practice. There continues to be a constituency for the kind of arrangements typified by the New Zealand model, although not within the political mainstream. And for some the Costello/Macfarlane exchange of letters has served to codify - albeit somewhat implicitly - a prioritisation of the statutory charter objectives more consistent with orthodox central banking policy and practice. But the assessments reported above suggest that support for the charter reflects three other related considerations - the primacy of economic growth over an exclusive focus on price stability, particularly where the latter is informed by a narrow target range; the political necessity of a set of institutional arrangements that meet the wider community's requirement that the conduct of monetary policy be informed by a synthesis of economic and social considerations (employment in particular); and thirdly, a preference to use multiple policy instruments in pursuit of multiple policy objectives (the use of fiscal and incomes policies to complement

monetary policy). In short, the Reserve Bank of Australia's present charter is generally perceived as being consistent with the kinds of considerations facing central bankers, whatever the specific tenor of their formal charters, and with the need to ensure institutional continuity by means of broad community support reflecting the credibility and the legitimacy of those institutions.

Governance and policymaking: the role of the Board

Whereas the theoretically informed institutional prescription for central bank charters is relatively clear, the theoretically informed prescription as regards central bank governance is somewhat less so. In part the normative prescription, to the extent that it is informed by agency theory and the need for optimal performance contracts is strongly suggestive of governance and accountability arrangements which centre on a contract between the central bank governor and his/her principal - a Minister, the executive branch of the government, or the legislature. The role of the board of a bank under this kind of institutional configuration is to act with the delegated authority of the principal in ensuring the agent's compliance with the terms of the contract. But agency theory also admits of the possibility of a board assuming the role of the agent - of a group being collectively tasked with the conduct of monetary policy. This is the case where monetary policy is determined by a monetary policy committee - as is the case, for example, under the new Bank of England arrangements, and with the US Federal Reserve's Open Market Committee (FOMC).⁵

To the extent that the standard measures of central bank independence reviewed in Chapter 2 factor governance arrangements into indices of independence, differential weightings tend to reflect the ease or otherwise by which board members and governors can be removed from office, their length of tenure, the existence of transparent disputes procedures, and the capacity of governments to directly influence bank policy and practice by means of the appointment of treasury/finance representatives to the bank board. The last of these is discussed in the following section. The theoretical assumptions informing the indices of central bank independence largely utilise public choice type assumptions about the motivations, and incentives, shaping the behaviour of elected politicians - in stylised terms politicians will seek to engineer electorally propitious short-term Phillips Curve trade-offs, resulting in a dynamic inconsistency in policy over time. Accordingly institutional design has placed a premium on insulating

⁵ Although whereas in the case of the Bank of England the Monetary Policy Committee is guided by a single inflation target, the US Federal Reserve is tasked with the responsibility of meeting multiple objectives.

the conduct of monetary policy from day to day political control. And while the political-economy accounts of central bank 'independence' reviewed in Chapter 3 do not carry the same normative import of the rational economics literature, they do resonate with the standard public choice literature in suggesting that interests and societal coalitions will seek to maximise returns to their constituencies by influencing the design of institutions, and by seeking to influence the governance of those institutions within particular institutional configurations. In the recent discourse of Australian politics and public policy it has been this variant of 'public choice' that can be detected in the suggestion that appointments to the Board of the Reserve Bank of Australia have served to advance the objectives of particular economic interests (for example manufacturing and retail) over others, such as the finance sector. Moreover there is also a resonance with agency theory and the notion of multiple principals and competing agents. For example, appointments to the Board may be seen as advancing the interests of one principal - the Treasurer - and weighting the balance of power against the full-time members of the Board who view their role as serving the interests of a somewhat more ubiquitous principal - 'sound economic management'.

In somewhat more popular terms, as the discussion in the preceding chapter suggests, Board appointments have been viewed as going to the need for governments to distribute political patronage, and not to the need for sound and reasoned policy making. Accordingly it has been argued in some quarters that appointments to the Board should reflect the requirement for a measure of knowledge and competence in issues of monetary policy, that the number of full-time members of the Board might be increased (as with the US Federal Reserve) that Board appointments should be made on a bi-partisan basis, and that the restraint on the appointment of banking and finance personnel to the Board might be lessened. And a not uncommon assessment has been that the Board (and in particular the 'part-time' members) - notwithstanding its privileged status in statute - has been dominated by the full-time members and the 'official family'.

As we noted above, in his 'valedictory' address to the National Press Club in August 1996 Bernie Fraser identified a Board bringing together a diverse range of interests and adding a 'real world' dimension to policymaking as one of the four pillars of the Australian institutional arrangements. Interviewed in 1997 Fraser reaffirmed the observations made in his 1996 speech. Fraser suggested that, during his term as Governor the Board played the role of a "very important examiner to the Bank, scrutinising what we were saying", with Board members providing input into the decisionmaking process based on advice from the Bank and their own anecdotal

sources. Fraser remarked that, in his experience, "anecdotal material can be more valuable, particularly when you are approaching turning points, than the statistical data" (personal interview, 1997). Moreover Fraser suggested that it was significant that the Board was formally vested with the power to take policy decisions, and recalled that this status, and the quality of the Board's advocacy had an appreciable impact on other members of the 'policy community':

"From time to time the Board would meet with the Treasurer - I've seen a discernible impact on a couple of Treasurers when they've actually sat down with the Board members at lunch, or round the table, and the Board members have come out with the kinds of arguments, with their own illustrations of the kinds of economic arguments that I've been trying to make to the Treasurer" (personal interview, 1997).

And on the issue that the Board tends to be dominated by the 'full-time' or professional members of the Board, Fraser remarked that the part-time members, "can be persuaded by good arguments, but they are not the sort of people who sit around rubber-stamping what is put in front of them ... people who have made their own way in the world, have their own view of things, aren't lightly persuaded to a viewpoint..." (personal interview, 1997). And, as Fraser noted - and as our analysis of the trajectory of policymaking in preceding chapters confirms - the assumption that any division at the Board level would always be between the part-timers and the professionals, was not substantiated on each and every occasion - "it's not always the professionals against the amateurs" (personal interview, 1997).

Reserve Bank Board members paint a picture of a Board that is acutely aware of its formal role in governance and policymaking. Board meetings vary in length, but generally last about four hours. While the assumption is that the members of the official family - the Reserve Bank and the Treasury - have a common view, and that any differences have been resolved before the Board meets, the assumption does not always hold, as the review in the preceding chapter suggests, any more than the assumption that the Governor and Deputy Governors will, in each and every case, represent a common position before the Board, or that part-time members of the Board will be in agreement. While the Secretary of the Treasury sits on the Board, there is no formal coordination with the Treasury before meetings of the Board, but there are internal meetings within the Bank. Board meetings are structured around presentations by Bank staff going to papers on economics, financial markets, and prudential matters.⁶ After the presentation of the first two papers, any recommendations from

⁶ With the Reserve Bank no longer having responsibility for prudential supervision it can be assumed that the Board no longer receives a report on such matters.

the Governor on monetary policy are discussed, and a vote taken, if necessary (acknowledged by a number of respondents as an infrequent occurrence).

Board members suggested that the capacity of the part-time Board members to bring additional sources of information to the policymaking process is one of the strengths of the Australian arrangements, since business people tend to have access to more immediate information. One Board member characterised policymaking as a 'marriage' between the economic data provided to the Board by the Governor and his colleagues, and information provided by Board members - a reality check by way of anecdotal evidence.

Former Board member and ACTU Secretary Bill Kelty suggested that the performance of the Board reflected its composition at any given time, and the personality and preferences of the Governor:

"[it] depends on who the Governor is, and to what extent the Governor uses the Board ... the outside Board as a countervailing power, as a countervailing source, or a complementary source of information" (personal interview, 1997).

Comments from a variety of respondents suggest that over the course of Bernie Fraser's tenure as Governor there were occasions where the Governor, combined with the 'outside' or 'part-time' members of the Board constituted the majority view, with different combinations prevailing at other times. As Kelty observes:

"... no institution is free of intellectual and actual assessment ... not free of those pressures, and the Board would play a part in that, contesting advice... there is not one institution with one single voice ... there are a whole lot of people, there might be an average to which they all tend - a herd mentality - but occasionally there's a few people outside the herd - they may be right or they may be wrong, but occasionally there are a few people outside of the herd even in that institution ... occasionally it might be the Governor outside the herd, and if he has the support of the Board members then they are the dominant group ... the lynch-pin is the Governor" (personal interview, 1997).

But while Board members identified episodes of 'strong disagreements' and 'vigorous exchanges' at the Board, the picture that emerges is of a functional entity characterised by a high degree of collegiality, and a positive relationship between full-time and part-time Board members. And while there may be limitations on the capacity of Board members to assess their own capacity to suspend any immediate sectoral interests in the name of a higher policy 'common', those assessments do suggest a capacity to effect some distance from any immediate interest. One Board member remarked that, "Board members tend not to advocate positions reflecting their sectional interests but can in

fact at times be party to a decision which may well not be in the short-term interests of their particular sectoral constituency ... retailers have at times voted to keep interest rates up" (personal interview, 1997).

Another Board member suggested that the Board is not a representative board as such but it does bring representative skills to the process of developing monetary policy, and that industry 'representatives' do suspend their sectional interests in contributing to policymaking. Moreover this same Board member suggested that it would be inappropriate for membership of the Board to be determined on the basis of the representation of particular interest groups. However this respondent did note that the resignation of Bill Kelty had weakened the Board - both in terms of the personal knowledge and skills that Kelty brought to Board deliberations, and the capacity of Kelty to effectively 'represent' the views of the trade union movement to the Board. In a situation in which monetary policy settings continued to be influenced by the Industrial Relations Commission's capacity to influence aggregate wage outcomes, the absence of a 'trade union' or ACTU perspective - an individual possessing "representative skills in the area of wages policy" - was viewed as problematic by a number of respondents.

The perspectives of those outside the Bank and the Board ranged from a profound concern with the role and composition of the Board - and the 'political' nature of the appointments process - to a view that the Board was and is largely irrelevant to monetary policymaking and implementation, to very positive support both for the Board's formal role in monetary policymaking, and the quality of that policymaking process. We noted in preceding chapters the arguments advanced for formal institutional changes to the structure and function of the Board, and media analysis of, and commentary on, those arguments. The case for change rests on the tendency for Board appointments to reflect the imperatives of political patronage, the absence of the kinds of competencies required for monetary policymaking, the limitations imposed by the prohibition on banking/finance sector appointments to the Board, the numerical possibility of the 'part-time' members of the Board outvoting the 'full-time' members, and the related problems of accountability as variously between the Board, the Governor, and the government of the day.

Alan Wood, who, as we noted above, modified his position on the issue of the Bank's charter, remains implacably opposed to the present policymaking and governance arrangements:

"... one of the arguments constantly raised if you say 'get rid of the Board here, it's not much use', is, 'oh no, it is very important to have it as a sounding board,

it represents different sectors'... well that's really nonsense, there [are] all sorts of ways you can get that, if that is what you really want, and the New Zealand model is one of them ...

... the problem with the Board here is that you tend to get people - they might have some background or use - but quite often they have no experience of monetary policy. They tend to be businessmen who almost congenitally want lower interest rates in almost all circumstances ...

... my impression is that the Board has gone from being a cipher in most circumstances, to having somewhat more of a role - a genuine role ... under the Act there is no doubt about it - the Board is responsible for monetary policy. I think that is a very undesirable feature of the Act, because if the Board ever woke up to the fact and wanted to assert its authority, it could overrule the Governor; the official (sic) members on the Board could be out-voted because they are in a minority" (personal interview, 1997).⁷

On balance, Wood suggested,

" ... it is not desirable that the Board has responsibility under the Act for monetary policy because of the nature of the Board - the majority of them, most of the time, are not au fait with monetary policy, and in fact the Act itself prevents anyone who might be - almost anyone, the academic is an exception - being appointed to the Board who knows anything about monetary policy. Because anyone involved in banking and finance in the traditional sense, is not allowed on the Board, which is a strange provision in an age where large corporations are in many cases, in effect financial institutions, and you get someone like (Sir Peter) Abeles from TNT who was on the Board, who has a lot riding on interest rates and exchange rates and who has very big financial operations; it seems a bit silly to put him on, and have him have access to all this information and assume that he won't do anything with it, and assume ... if you put a banker on it, even a retired banker, that somehow it pollutes the Board - I just think that is a silly argument" (personal interview, 1997).⁸

The argument that Board positions provide a form of patronage was also advanced by the Sydney Morning Herald's Max Walsh, who, while he suggested that there was no real evidence that members of the Board, for reasons of self interest, had sought to impose a policy position on the Board,

"increasingly it will matter - the whole approach to Board appointments will be seen as increasingly anachronistic, reflecting a time when we didn't have a deregulated financial system. It was one of those jobs of patronage and position, rather than policy and importance; but the reality of it is that monetary policy is going to be the principal arm of macroeconomic policy for

⁷ Wood noted that the Bank tended to be 'very protective of the Board' - "they don't like to talk about it - so I can't give you stories about who did this, and who did that at the Board - they are pretty careful about this stuff" (personal interview, 1997).

⁸ But Wood suggested that, "I don't think the Government would now take the Board issue on, basically because the Board positions are one of those things that governments, politicians love to have - it's a bit like, now that we don't have knighthoods, you can say, 'well, what can I do for my business mate, well I can put him (sic) on the Reserve Bank Board" (personal interview, 1997).

the foreseeable future, and that calls for a degree of professionalism on the Board that doesn't exist at the moment"(personal interview, 1997).

Walsh was particularly dismissive of the argument that Board appointments had resulted in an appropriate mix of expertise:

" ... they have built themselves a rationale for this by saying that these people bring particular expertise to the Board, which is a crock of shit quite frankly ... all of these appointments have been the subject of political patronage ... there's no particular reason to have retailers on, or manufacturers - I mean that the information you can get from these people is now quite accessible ... when I say that you need a greater degree of professionalism I am not talking about having professional bankers on the Board; I am talking about people who have a stronger grasp of monetary policy and its implications than ~~running~~ a construction company or a large retailer ... I mean there are some ~~running~~ large retailing companies who you would have a lot of faith in ... others you don't" (personal interview, 1997).⁹

And, in part at least, the Walsh argument reflected the view that the 'part-time' members of the Board quite appropriately, were potentially at least, a countervailing voice to that of the 'full-time' members - "you see I very much doubt that if you put people on who don't have that grasp of monetary policy, when faced with advice from the professionals in the Bank they will not act as that countermanding force" (personal interview, 1997).

Finance sector economist, and former academic and ALP adviser, Barry Hughes indicated that he had never regarded the Board as being much more than a rubber stamp, although they could be a useful sounding base - "I don't regard them as a major decision making body but conduits of opinions and so on, particularly in the days when the Bank was trying to get some idea of what was happening to activity 'out there' ..." (personal interview, 1997). And, consistent with the observations of a number of other respondents Hughes also saw the prohibition on the appointment of finance/banking sector representatives as having been overtaken by the structure of commercial corporations in which major business organisations in the manufacturing and retailing sectors possessed a significant presence, in their own right, in the finance sector. Not only did this serve to blur the distinction between banking and finance, and the other sectors of the economy, it also raised the prospect of the commercial interests of Board members being advantaged vis a vis their competitors.

⁹ One respondent suggested that former Governor Bernie Fraser did quite strongly resist, though unsuccessfully, at least one Keating appointment to the Board on the grounds that the kinds of commercial interests represented by the Board member were inappropriate for the Board of the central bank

Others within the manufacturing and farming sectors advanced a variety of views. Todd Ritchie of the National Farmers Federation suggested that the Board was not an overly important element in the practice of Australian monetary policy, estimating that 90% of the decision making power resided with the Governor and the Deputy Governors, 5% with the Secretary of the Treasury, and 5% with the balance of the Board, and remarking that the Board was 'more for show than for purpose'. However this view of the efficacy of the 'part-time' members of the Board notwithstanding Ritchie did confirm that the National Farmers Federation had been actively lobbying the Government with a view to remedying a situation whereby the NFF felt that it had been ignored in recent Board appointments.

For its part the Metal Trades Industry Association indicated a large measure of support for the existing arrangements, Heather Ridout commenting that the Board combined the right mix of technical expertise (Bank representatives and an academic economist) and industry representatives. Significantly Ridout suggested that there had been occasions where the manufacturing sector had actively lobbied the Bank, and Board members, to represent a policy position reflecting the needs of that sector:

"I remember one instance when we had a big burst of economic growth, we had one quarter that went through the roof, and we had all those blessed screen printers who want to put interest rates up ... you know the whole market control sort of thing, screaming 'you've got to put up rates' and it was going to happen, it was really going to happen, and the MTIA called on the Bank to stare the markets down and we put out a technical argument that the movement was a blip and (the interest rate adjustment) shouldn't happen. Now we know that our analysis - and it was reinforced by other publications - was brought to the meeting of the Bank and the industry people went hard, and the union representative at the time - Kelty - went hard, and it exerted an influence ... you've got to take a broad perspective, and to have a broad perspective, you have to have a broad perspective represented on the Board" (personal interview, 1997).¹⁰

Ridout also commented on the fact that the Bank continued to actively network with sector groups in the economy, and that, while in her estimation the Bank was somewhat more orthodox under Macfarlane than under his predecessor,

"at the same time I think it is balanced by the fact that the Bank is still very determined to get out there and mix it with real people. We have had Ian Macfarlane here ... he heard from real manufacturers what was going on in manufacturing, and he showed a real determination to listen and participate. I think in a sense while he might be a more orthodox central banker than Bernie Fraser was, he certainly is showing an equal determination to be a good listener and to be a participant in a broad debate..." (personal interview, 1997).

¹⁰ Other respondents also commented on Kelty's reputation as an advocate for the manufacturing sector on the Board.

Within the Bank there has been some consideration of alternative forms of governance. One respondent recalled a meeting at which then Assistant Governor Stephen Grenville canvassed options, including a board of technical experts, or a US styled arrangement in which a number of full-time governors would be appointed. This respondent advanced the comment that, "the objection to the American style is that you have all these regional governors with nothing to do but give speeches and cause problems ...", and that, the Australian arrangements possessed the advantage that, with fewer direct participants, the message tended to be somewhat more consistent, and characterised by a greater measure of transparency. But, "as to whether you should have a board of technocrats, you are coming down to democratic theory there ... in practice the technocrats run the Bank, but there is something to be said for tried and trusted men and women to sit there" (personal interview, 1997).

While in 1996 the incoming Coalition Government elected not to proceed with any statutory reforms to the Australian institutional arrangements, advisers confirmed that the Government was concerned to improve the quality of the Board, given the perception in some quarters that, unlike the boards of central banks like the US Federal Reserve, the Board of the Reserve Bank of Australia was viewed as a Board of amateurs. Accordingly, in making appointments the incoming Government was anxious to secure individuals who could make a serious contribution, including some with money market experience, and some knowledge of practical monetary policy and the economic cycle.

Another respondent with close links to the Coalition, suggested that the view within the Coalition was that the Board had been weaker than desirable, the weakness attributable to two factors - the absence of a core of Board members with professional experience as economists and/or within the monetary policy arena, and an element of political patronage in appointments whereby competence had been made secondary to partisan allegiance. 'Good' appointments, it was suggested, would, over time change the character of the Board. This same respondent suggested that in an ideal world, the locus of accountability would be between the government of the day and the Governor by means of a contract, and the role of the Board limited to an advisory capacity - in effect a New Zealand styled set of governance and accountability arrangements. Under the present arrangements, with the Board vested with responsibility for monetary policymaking, it was suggested that the potential existed for the Governor to be out-voted by the Board, with an erosion of any effective accountability between the Governor and the government of the day.

However Treasury Secretary Ted Evans was somewhat more comfortable with the present arrangements, observing that, while Board members were jealous of their role, they were equally realistic. Evans commented that, while the Board had been known to chide the Governor for presumptuous comments, this had not been taken to extremes, with the Governor accepted as occupying a pre-eminent position on matters of policymaking. The contribution of the part-time members, Evans suggested, included a capacity to bring some street front judgements, and a real world perspective to policy issues, and to provide a voice for individuals in touch with the economy.

The Coombsian settlement under pressure - the Hugh Morgan 'Affair'

The early appointment of Hugh Morgan to the Board of the Reserve Bank of Australia was viewed as being consistent with the objective of appointing individuals with an understanding of the theory and practice of monetary policy making. Morgan, who is the Managing Director of one of Australia's largest goldmining companies, WMC, had served on the Board under a previous Coalition Government.

In January 1977 the Reserve Bank Board approved a sell-off of Reserve Bank Gold reserves. The sell off was made public on July 3, and triggered a sharp sell-off on world markets. It was subsequently revealed that Mr Morgan's company WMC had shielded itself from the price slide by quadrupling its forward selling programme between September and March. Opposition politicians were critical of Morgan, and the Reserve Bank for a failure to ensure that Morgan absented himself from Board decisionmaking where a potential conflict of interest might exist. For his part, Morgan issued a statement on the 17 July in which he said that he had, "never used any information which I obtained in my capacity as Reserve Bank board member to benefit WMC or passed on any such information to any officer." (SMH, 18 July 1997).

Reserve Bank Governor Ian Macfarlane defended the actions of the Board in permitting Mr Morgan to be present for the board's deliberations and party to the decision - "It would make the board of the bank unworkable if members had to absent themselves from all discussion and decisions which potentially gave rise to conflicts of interest with their other activities" (SMH, 18 July 1997). Mr Macfarlane was supported in this view by former bank Governor Bernie Fraser, the latter suggesting that, while potential conflict of interest were always present, there were ways of handling these potential conflicts.

The Sydney Morning Herald suggested in an editorial on the 18 July that the Reserve Bank Board should be abolished:

"There is no perfect model for a central bank to which Australia can turn which would eliminate these problems. A board comprised entirely of, say academic economists and public servants would quickly be accused of being out of touch with the real world. Decisions left solely to the Governor and his deputies would mean reversing the recent small, but welcome steps taken by the bank towards greater accountability and transparency in its decision making.

Instead the Government should abolish the present board and replace it with an advisory council with similarly broad business and economic expertise which would help to overcome the potential conflicts of interest which Mr Macfarlane has conceded. Such an advisory council would guard against bank officials becoming too insular by ensuring they still have to face the discipline of defending, on a regular basis, their assessment of economic conditions against real world experience. It would also ensure public perception of the impartiality of the bank's procedures is never again put in doubt" (SMH, 18 July 1997).

This argument has distinct parallels with those typically advanced by the Australian Labor Party, and which were reviewed in some detail in Chapter Four. ALP Leader Kim Beazley suggested later that month that the presence of Hugh Morgan on the board,

"had given him 'pause for thought' about the board's role and powers. Mr Beazley said that ... whatever transpired in the Morgan case at the RBA meeting, it made an argument for directors to be purely advisory rather than directive. 'Perhaps directors of the board ought to be people disconnected from any particular economic activity,' he said. 'The problem with that in Australia is that the pool is very small and the best advisers probably come from business and not universities...'" (AFR, 28 July 1997).

The historical parallels were picked up in a piece by Max Walsh in the Sydney Morning Herald as the story of WMC's forward cover first broke. Walsh suggested that former ALP Prime Minister Ben Chifley would be 'spinning in his grave':

"He would be pointing his finger at WMC's chief executive ... To do so would be terribly unfair... I invoke the memory of Ben Chifley because he vehemently opposed the appointment of a board to a central bank because he simply did not believe businessmen (and in those days there were no businesswomen) were to be trusted...

The Liberal-Country Party, however, took the view that control of monetary policy by a Governor advised solely by officials was 'undemocratic' ...

The first Governor of the Reserve Bank, H. C. (Nugget Coombs) who was regarded as coming out of the Labor side of politics, had no objection to an outside board though he did persuade then Treasurer Arthur Fadden to include

a representative of the Treasury and two executives of the bank as board members...

What we have learned since then is that just about everybody who is asked to sit in the Reserve Bank board has a potential conflict of interest ...

The key question is, however, what those outside board members bring to the table when it comes to policy? It is a question I have, over the years, asked the career central bankers who have had to deal with them. The answer boils down to this. It's a system which has its shortcomings but these are outweighed by its advantages.

While the outside directors might be amateur central bankers they are seasoned in the ways of the world and provide the critical sounding board against which monetary proposals are tested" (SMH, 16 July 1997).¹¹

In August 1997 the terms of two ALP Government appointees to the Reserve Bank Board ended - neither Mrs Janet Holmes a Court nor Mr Solomon Lew were re-appointed - and in November 1997 there was speculation that another Board member appointed by ALP Treasurer John Dawkins, Mr Dick Warburton, would not be reappointed when his term expired in December 1997. Sean Aylmer, writing in the Sydney Morning Herald noted that, in the event of the Government choosing not to replace the outgoing members the number of private sector members of the Board would be reduced to four, and that this would be in breach of the Reserve Bank Act (Sydney Morning Herald, 4 November 1997). Warburton was however reappointed in December 1997 for a further term expiring in 2002. Further moves on replacing Holmes a Court and Solomon Lew were deferred pending the appointment of the boards of the two new regulatory agencies established as a result of the Wallis Committee of Inquiry recommendations. With the Australian Prudential Regulatory Authority assuming the Reserve Bank's prudential functions, and one of the Reserve Bank's deputy Governors (and Board member) appointed to head up the new Agency the Government decided not to fill the vacancy created with the expiry of Solomon Lew's term of appointment, but did appoint a replacement for Janet Holmes a Court.

That replacement was Ms Jillian Broadbent, who took up her position on 7 May. Broadbent was, until late April 1998 an executive vice-president with the merchant bank, Bankers Trust, but resigned that position in order to take up the appointment to the Reserve Bank Board. Broadbent's appointment was also noteworthy for the fact

¹¹ The Morgan affair may well have had the perverse effect of further reinforcing perceptions of the Reserve bank's independence. Questioned on the Morgan conflict of interest Prime Minister John Howard replied that,

"my Government has control over who's appointed. Once they are appointed they have statutory independence. And as far as I'm concerned you go and talk to them. I have no control over what happens at Reserve Bank board meetings. And I don't intend to answer questions on what happened at a meeting I wasn't attending. I have enough trouble answering questions about

that her appointment was the first of a former Reserve Bank employee to the Board. In announcing the appointment the Treasurer noted Ms Broadbent's extensive financial sector experience, and her involvement in business and the community. But the appointment was also significant for the way in which it provided the kind of competencies and experience that, it had been argued in some quarters, the statutory fetters on Board appointments precluded. Whether successive appointments to the Board will effect changes in perceptions of the Board from within domestic and financial markets, and/or changes in the approach that the Board takes to monetary policymaking remains to be seen.¹²

Treasury representation on the Reserve Bank Board

Common to most of the measures of central bank independence reviewed in Chapter 2 is that the existence of a 'government representative' on the board of a central bank is viewed as militating against central bank independence. Ipso facto, a central bank governed by a board which includes representation from a treasury or a ministry of finance will be scored relatively lower on an index of central bank independence than an institution without this kind of representation (see Bade and Parkin, 1988; Alesina, 1988, Grilli et al, 1991, Cukierman, 1992, Eijffinger and de Haan, 1996). Accordingly the Reserve Bank of Australia has tended to accrue 'demerit' points on the various measures of central bank independence. The fact that the Secretary of the Treasury is represented on the Board of the Bank has been deemed to imply a porous relationship between the Bank and political authorities.

Deconstructing the implicit assumptions behind this dimension of central bank independence, the causality would appear to be two-fold. Firstly there is the assumption that the preferences of incumbent governments conform to the Downsian model - governments will seek to engineer electorally propitious economic circumstances within an electoral cycle (and the related assumptions that voters will be myopic, and markets powerless to act in the face of political manipulation). Secondly it is assumed that it will be in the nature of the politics/administration interface, and the prevailing institutional and constitutional arrangements, that the preferences of an elected government will be represented by a 'government representative' on the board of

meetings I go to" (SMH, 19 July 1997).

¹² As at the 31 December 1998 the Reserve Bank of Australia Board consisted of the Governor, Ian Macfarlane, whose term expires on the 17 September 2003, Assistant Governor Stephen Grenville (30 November 2001), Ted Evans (Treasury Secretary), Alan Jackson (28 January 2001), Frank Lowy (26 June 2000), Hugh Morgan (28 July 2002), Dick Warburton (20 December 2002), Adrian Pagan (The Australian National University - 28 November 2000), and Jillian Broadbent (6 May, 2003).

a central bank - or to recast this assumption, that the relationship between the government and that 'representative' satisfies the principal/agent model.

But the discussion in the preceding chapter suggests that neither of these two assumptions holds. The historical record indicates that during Paul Keating's term as Treasurer, on at least one occasion, a Secretary to the Treasury represented a position to the Board of the Reserve Bank at variance with the stated policy preferences of the government of the day. Moreover that position, whether personal or institutional in its origins, was clearly more 'hawkish' than that preferred by the government of the day.

Current Treasury Secretary Ted Evans sees the role of the Secretary of the Treasury on the Bank board as being that of an individual acting in a professional capacity - providing a counter to the Bank's view. He recalled that there had been occasions on which views within the official family had differed somewhat. Where such a difference of approach is anticipated typically there will be talks between the Governor and the Secretary before a meeting of the Board to ensure that both are fully aware of each other's position. Moreover Evans confirmed that there had been occasions on which one or other of the deputy Governors had contested the view of the Governor. Evans confirmed that it was not unusual for matters to be argued out at the Board, and while most of the time there is agreement, the main issue on which disagreements had tended to occur had been on the question of turning points. For his part Evans recalled a situation in which he had argued against an easing on the grounds that forecasts indicated that inflation would move outside of the Bank's target zone.

Commenting on the situation in which Chris Higgins had recommended a course of action at the Bank Board at variance with that preferred by Paul Keating, the Treasurer at the time, Evans indicated that he was not at all surprised by the actions of Higgins, observing that this course of action was not unrealistic when one knew Treasury well enough, and that given any opportunity at all Treasury would follow an apolitical line on issues such as monetary policy decisions. However, responding to the hypothetical situation in which a Treasurer instructed the Secretary of the Treasury to vote at the Reserve Bank Board in a particular way, Evans acknowledged that the scope for political interference did exist, suggesting however that given that kind of scenario, it would be a question of degree - how significant the issue was that any directive related to - and, moreover, that it would be less institutional than personal; it would be a matter for the personal conscience of the Secretary as to what to do. That said, Evans acknowledged that in an environment in which the notion of a 'permanent head' no longer enjoyed a great deal of currency - with the tenure of senior public servants being

at the whim of the government of the day - there was at least the potential for some abuse. This notwithstanding, Evans suggested that the Australian arrangements were far superior to those in which politicians enjoyed the right to direct central banks, in circumstances totally lacking in any transparency.

Another respondent close to the Government suggested that, while the Treasury representative took with him to Board meetings the views of the Treasury and the Treasurer, the Secretary was but one among a number of Board members, all of whom carried a duty to the Reserve Bank in the final analysis. This same respondent suggested that the perception of a Treasury representative on the Board being dominated by the Governor had not been helpful, and advanced the view that, under Bernie Fraser's governorship, Fraser had tended to dominate the Board, including the Treasury representative.

A source close to the Federal Treasurer suggested that the Secretary of the Treasury's membership of the Board was not a matter that raised concerns - that people tended not to complain about it, and that, so far as the Government was concerned, there was no intention of trying to influence Bank policy through the Secretary of the Treasury, with the Secretary tasked with representing the Treasury's views, not the Treasurer's. Moreover, given the composition of the Board, even in the event of the Secretary of the Treasury representing a 'government' position, against the views of the Governor, in the event of a vote at the Board (by all accounts an infrequent occurrence) the former only exercised one vote. However the same respondent suggested that, in the event of it being anticipated that there might be a close vote on an issue the Secretary of the Treasury might conceivably be briefed on the issue, but also commented that relations between the Treasury and the Reserve Bank were characterised by a high level of cooperation with both organisations sharing a similar view of the economy.

Former ALP Treasurer Ralph Willis suggested that the Secretary of the Treasury does possess a degree of independence from his political masters, and that the Treasury develops what it sees to be an appropriate set of policies on any given matter - that being the case the areas of policy on which the Treasury might advocate a position at variance with that preferred by the Treasurer would not be confined to monetary policy. But Willis did acknowledge that differences between the Treasurer and the permanent head of the Treasury were somewhat different in a circumstance in which the Secretary of the Treasury had the capacity to go and vote for a policy. Willis characterised the role of the Secretary of the Treasury as being other than a government representative per se, but conceded that it was a 'grey area'. Willis recalled a situation

in which the Secretary of the Treasury had advocated a position of variance with the recommendation of the Bank. The fact of this difference was less of an issue for Willis than the fact that, as Treasurer, he claimed to have found out only after the event, and from a member of the Board.¹³

A Board member indicated that in his assessment the Secretary of the Treasury occupied a seat on the Board as the head of the Treasury and not as a representative of the government per se. Moreover this respondent suggested that, far from diminishing the independence of the central bank, the Treasury Secretary's membership of the Board served to increase it - "if the Treasurer wants to contest a policy of the Board, who is going to construct the case?". The Treasury Secretary's membership of the Board it was argued, combined with the force of the statutory disputes procedure, imparted a far greater measure of transparency to the Australian arrangements than to those in other jurisdictions where Ministers enjoyed the power to unilaterally overrule central bankers, without any public scrutiny.

ACTU Secretary and former Board member Bill Kelty was somewhat dismissive of the deterministic 'logic' of measures of central bank independence, suggested that in his experience, the Secretary of the Treasury -

"actually represents himself ... if there is Treasury view, and that is not his own view, then most of the time he represents his own view ... it comes down to behaviour, it comes down to judgements..." (personal interview, 1997).

From within the Bank it was observed that, while the literature suggested that, in theory, treasuries may be positively disposed towards policies that favour faster growth and revenue, in practice the Australian Treasury had typically taken a 'tough' stance on policy - and had been at least as tough as the Reserve Bank. So far as the role of the Treasury Secretary as a member of the Bank Board was concerned it was suggested that the Secretary of the Treasury was, in accordance with the principle of collective responsibility, obliged to carry out Bank policy - "obliged to look at his responsibilities under the Act and vote accordingly."

Outside observers of the Bank and of monetary policy, interpreted the Australian arrangements, in practice, as providing that the Treasury Secretary was a member of

¹³ Willis was at pains to emphasise that his source was not ACTU Secretary Bill Kelty - a Board member at the time. One Board member said that he could recall only one occasion on which a Board policy had been 'decided' by a vote, and that had been in a situation where Treasury Secretary Ted Evans and then Governor Bernie Fraser had taken a different view on the timing of an interest rate increase - on this occasion the Governor had prevailed, with only a single vote being recorded against his recommendation. It is entirely possible that these are one and the same episode.

the Board in his own right, and not as representative of the government of the day. Alan Wood suggested that the presence of the Treasury Secretary added value to the quality of policymaking:

"... whether we should have a representative from Treasury on the central bank Board - well I think probably yes actually - he's only one member of the Board, he's going to be a fairly well informed member of the Board, in a setting where you have got problems with the Board ... he is one more vote that is likely to be, I would say certain to be of a mind with the Bank in most instances on monetary policy and likely to resist any sort of populist tendency on the Board, so he is important in that sense ...

I think it is important that the Bank and the Treasury have some sort of structure to their relationship ... and it is useful to have more than one source of official advice, and one that is plugged into the process" (personal interview, 1997).

And Wood added his voice to those who tended to suggest that the Treasury, and its representative, have tended to be somewhat 'drier' on interest rates than the Reserve Bank itself, citing the present Treasury Secretary, Ted Evans, as a case in point. On balance, Wood observed, he did not have a problem, in terms of the issue of central bank independence, with the notion of Treasury representation on the Board of the Bank:

"I mean you would have to ask, how would he subvert the independence of the Bank - I don't think he can, particularly now that the Bank, because of the changes to the way the economy operates and so on, with more open markets and all that, that the Bank is now the more dominant institution ... its own institutional hubris is going to ensure that they don't buckle under to the Secretary of the Treasury ... and whether he is on the Board or not, he can still ring up the bank and hector them if he wanted to, as I say I think there is some advantage in having him in there putting the argument at the forum of the Board" (personal interview, 1997).

Barry Hughes suggested that the presence of the Secretary of the Treasury on the Board possessed the additional merit of facilitating a greater measure of policy co-ordination:

"... that view is not a popular view among the markets, but I think that the markets are wrong about that - the markets are seduced by the form, rather than by the substance - what's important is that you have some people of stature running your monetary policy who are prepared to say - who are prepared on the one hand to compromise, I think that that is the nature of the world - but who won't be rolled over ..." (personal interview, 1997).

For his part former Governor, and Treasury Secretary, Bernie Fraser recalled that, in the past, relations between the Treasury and the Reserve Bank - and their respective heads - had been characterised by a measure of tension:

" ... in the past there had been a lot of conflict and a lot of drama between both those institutions and the Secretary to the Treasury. I was told that it was not uncommon for earlier secretaries to reserve their position ... I felt that when I was a Board member of those institutions that I should be doing what was in the best interests of both those institutions and not trying to protect some Treasury position. And on occasions I happily went along with decisions that would have been regarded as quite contrary to Treasury positions, and quite contrary to what my Treasury colleagues would have briefed me on for a particular meeting. I felt that I was there as a representative of the institution rather than to ride shot-gun or keep tabs on where these other characters were up to ..." (personal interview, 1997).

Fraser recalled that, as Reserve Bank Governor he had worked with three Treasury Secretaries [Higgins, Cole, and Evans] - "I didn't have with any of those the times of conflict and drama of earlier times. And when I was on the Board as the Treasury Secretary, Bob Johnston and I got along very well too. People talk about personalities sometimes being important and I think that they sometimes can be ... there were no tender egos on either side, and things worked pretty well." (personal interview, 1997).¹⁴ And on the issue of the potential for some variance as between the policy preferences of the Secretary of the Treasury, the Treasurer, and the Treasury, Fraser remarked that, " it has often been the case that there is a Treasury position which sometimes goes on irrespective of what the Treasurer is suggesting or his thinking might be ... different secretaries pursue that Treasury position with different enthusiasm" (personal interview, 1997).

Fraser recalled that, as Treasury Secretary he was never provided with any 'guidance' from the Treasurer before a Reserve Bank Board meeting - "I don't know if Secretaries have had any guidance of this kind - I didn't when I was Secretary to the Treasury"- but the ongoing contact between Treasury Secretary and Treasurer ensured a measure of communication - "the Treasurer would know what my thinking was, and I would know his, we would try to avoid a public conflict"(personal interview, 1997).

This discussion indicates that the practice of Treasury representation on the Board of the Reserve Bank of Australia is both far more complex than the statute-reading indices of central bank independence would suggest, and that far from being a force for monetary policy laxity, the representation of the Treasury has been directed to quite opposite ends. One of the two key assumptions that we identified at the start of this section - an assumption that must be satisfied if the causality is as the statute readers have suggested - clearly is not satisfied. The Treasury representative clearly is possessed

¹⁴ And Fraser also remarked that most Treasury Secretaries, before and after his term, had shared a tendency towards being 'pretty orthodox'.

of a large measure of independence, and far from representing the preferences of the government of the day, or for that matter those of his department, has operated quite independently - to the point of advocating a position markedly at variance with that preferred by government. Moreover, the Australian Treasury, much like its counterparts in other advanced industrial economies, has been a force for monetary and fiscal policy rectitude. While at the margin such independence may have been tolerated in circumstances where the majority position on the Board was not under threat - and while the real test of the 'independence' of that representative might be provided where opinion was more finely balanced, the practice of Treasury representation to date has been one that has served to elevate the independence of the central bank, and not diminish it. Moreover, there are, as we note in an Appendix to this Chapter, sound reasons at law to question the assumptions made about the consequences for central bank 'independence' of Treasury representation on the boards of the antipodean central banks.¹⁵

Australian perceptions of 'the New Zealand model'

Implicitly, support for the Reserve Bank of Australia's statutory charter - which was quite widespread across the range of respondents interviewed for this study, and support for a model of policymaking and governance in which a board of directors (including a 'government representative'), and not a governor, is responsible - which enjoyed slightly less, but by no means an insignificant level of support, is indicative of, at best, a measure of disquiet about the utility of the New Zealand institutional arrangements. The New Zealand model, as we noted in the previous chapter, was at times championed within the Australian financial and business communities as an appropriate institutional benchmark which might be replicated in any revisiting of the Australian arrangements. In political terms the advocacy of the New Zealand model reached its zenith with the Liberal-National Coalition's 'Fightback!' proposals. However others have continued to advocate New Zealand styled reforms to the Australian institutional arrangements (see Kirchner, 1997).

The New Zealand arrangements have also enjoyed some support within international financial markets. Former Treasurer Ralph Willis observed that perceptions of the Australian arrangements as lacking in independence were informed by a clear preference for the NZ model, and during his term the Australian Government came

¹⁵ As we note in Appendix One to this Chapter, at common law there are constraints on the capacity of a director to be mandated by any interest external to the organisation, the governance of which he or she is tasked with.

under pressure to emulate that model, in particular from Wall Street. And the Reserve Bank itself was aware of the enthusiasm for the model in overseas markets - an enthusiasm borne of the Reserve Bank of New Zealand's record in producing a significant reduction in prices, but also reflecting the relative simplicity of the New Zealand model as compared to the somewhat 'fuzzy' Australian arrangements, and the absence of any sense of 'theatre' in the latter. In stark contrast New Zealand underwent a very public revolution, characterised as a big change marked by a big announcement, and with a lot of theatre. Viewed in this 'theatrical' light the Australian institutional arrangements suffered. And while the substance of the Australian arrangements was no different following the exchange of letters, the markets' appetite for theatrics was satisfied, and, in more substantive terms, by the beginning of 1997 the Reserve Bank of Australia was noting that the markets were rating Australian and New Zealand bonds at the same level.

In the sense that changes in the Australian arrangements had occurred incrementally or on an evolutionary basis, this compared unfavourably with the New Zealand predilection for revolutionary change, and the perceived conceptual and operational simplicity of the New Zealand model - in simple terms, under the New Zealand arrangements (pre 1996), if inflation exceeded the PTA target of 0-2% the Governor would be fired. However, in 1995 and 1996 New Zealand inflation breached the PTA target zone, and the Governor retained his position - a fact that a number of Australian respondents commented on in questioning the utility of the New Zealand arrangements (and which, as we noted above, was referred to by Coalition Treasurer Peter Costello as a reason for not pursuing the New Zealand approach). From within the Reserve Bank of Australia the assessment appears to be a benign one - that far from the breach of the PTA target range having been the result of a forecasting error, the fact that the target range was exceeded confirms that, notwithstanding the PTA and the Reserve Bank of New Zealand's exclusive focus on price stability, the Governor was influenced by 'real economy' considerations in, firstly allowing the target zone to be breached, and secondly, taking some time to get back inside the target range - a policy trajectory which, in Australian eyes provided a better path for the real economy. As one respondent observed - "we are more prepared to say that we do care about growth than Brash is - the truth is they care about growth too".

Bernie Fraser confirmed that in his experience the New Zealand approach had, "weighed quite a bit on the international money markets", but advanced a rejoinder to which we return in this and in the concluding chapter. Fraser commented that,

"I have tried to emphasise to those people who were preoccupied with inflation, and say, 'well that's fine, but you need community support to sustain a low inflation policy, and you are not going to get that community support unless you are mindful and sensitive to these other things like growth and employment'" (personal interview, 1997).¹⁶

Whatever the merits or otherwise of the specifics of the two institutional frameworks, Fraser identified the political sustainability of the Australian approach (informed by the four pillars to which we have already referred) as its principal advantage, citing the fact that whereas there had been some criticism within New Zealand of the RBNZ's approach, within Australia people had not tended to rail against the Reserve Bank for wanting to get inflation down. Moreover Fraser remarked, in 1997, that, notwithstanding the formal differences:

"I don't know that there is much difference in the approach, we've both been successful in lowering inflation ... We [the RBA] haven't been forthright in marketing our approach. We have been on the defensive saying that we have been pursuing our objectives rather than the New Zealand model" (personal interview, 1997).

For his part Treasury Secretary Ted Evans voiced reservations about the thrust of the New Zealand legislation that, in his assessment had resulted in the Reserve Bank of New Zealand giving a greater emphasis to the price stability objective than that taken by the Bundesbank. Evans suggested that there is a balance involved in the judgements made in making monetary policy decisions, and that these judgements have clearly exercised the minds of policymakers in New Zealand, and Reserve Bank Governor Don Brash in particular. In Evans' assessment, if Don Brash had been totally focused on price stability the Bank would not have exceeded its mandated target range, and interest rates would have been pushed higher than they actually were. Accordingly, whether the Governor of the RBNZ is prepared to acknowledge it or not, the evidence would seem to suggest that the Bank does indeed have a concern with the growth and employment consequences of monetary policy. Moreover Evans suggests that in factoring the real economy implications of monetary policy into the decision making calculus, this not only reflects a degree of realism on the part of central bankers (and an acknowledgment of the fact that there are trade-offs over the short-run) but also the fact that to do otherwise - to focus on price stability to the exclusion of all other considerations - would be to place at risk their institutional independence. Any central banker, Evans suggested, will have an eye on the real economy. Evans observed, in early 1997, that New Zealand's higher short-term interest rates (a negative sloping

¹⁶ Fraser also sided with those who have argued that the Reserve Bank of New Zealand knowingly exceeded the PTA target range in 1995 and 1996, and suggested that, "this is one of the consequences of having a hard edged target" (personal interview, 1997).

yield curve) reflected the Bank's bias suggested by its mandated objective, and commented that it was not obvious that that needed to be the case. In Evans assessment there wouldn't be anyone in the Reserve Bank of Australia who would want to go down the New Zealand route, notwithstanding that the model had been championed in various circles.

Invited to explain New Zealand's institutional set-up Evans suggested that it could be explained by a number of factors - a poor starting point which required drastic corrective action, some extraordinarily clear thinking politicians supported by good policy advisers, and the fact of a unicameral legislature. On balance however Evans was somewhat critical of the New Zealand model, suggesting that it was unnecessarily purist, and that the country had suffered because of it with continuing high interest rates and a higher than necessary exchange rate. Interestingly he suggested that addressing New Zealand's underlying economic problems had required a combination of monetary, fiscal, and labour market policy reforms, but the net effect of the changes had been evidenced, in part, in a reaction against the constitutional arrangements that had conspired to produce both the policy mix and the implementation time-frame. Viewed in this way, he suggested, the promotion of a new electoral system was, in part, a consequence of the trajectory of economic policy followed by governments over the 1980s and 90s, of which the Reserve Bank Act of 1989 was but one element.

Other RBA Board members expressed similar concerns over aspects of the NZ model, and in their assessments there are resonances with arguments already traversed - including the argument that, all central banks, whatever their mandated objectives will be influenced by real economy considerations, and that this influence will reflect in part at least, an acknowledgment that to do otherwise is to place at risk the institutional independence of the central bank. One Board member observed that he was,

" ... certain that there aren't any central banks in the world that are not interested in growth as well as inflation - including the New Zealand bank - there were a number of actions they took that, had they been interested solely in inflation, they would not have taken ...

... one of the reasons is that if you continue to ignore that, the political realities are such that the institutions will change - in fact I used to say this about New Zealand - you just can't keep on ignoring growth in the name of stopping inflation" (personal interview, 1997).

This same respondent suggested that the time-bound nature of the New Zealand Policy Targets Agreement in and of itself had the potential to engender a degree of instability into markets - if the PTA were to become effectively politicised on the basis that there

would be some renegotiation of it following a change of government. In this assessment the open-ended nature both of the Costello/Macfarlane exchange of letters and the RBA's own inflation target imparted a greater degree of stability, and encouraged a greater measure of community support. Over a five year period, it was argued, if there was not widespread community support for the PTA target, then there is a risk of the PTA becoming politicised and of this engendering a degree of nervousness in financial markets. However this same respondent acknowledged both that the circumstances of the New Zealand economy had demanded a dramatic remedy, and that the New Zealand model did reduce the scope for inside lags in monetary policymaking:

"I think that if you are after an immediate response, the New Zealand model is the best ... I think that over the longer term our approach is better than the New Zealand one" (personal interview, 1997).

Another Board member again reinforced the assessment that the principal limitation of the New Zealand arrangements was the fact that an exclusive focus on price stability failed to take into account growth and unemployment, and that, the New Zealand arrangements had lost credibility when the RBNZ exceeded the PTA target zone.

And while, as we noted above, the decision in 1996 by the incoming Coalition Government not to proceed with a set of legislative reforms reflected a number of variables, weaknesses in the New Zealand model were a factor in the incoming Government not seeking to replicate those arrangements within the Australian jurisdiction. A Coalition Government source cited the Reserve Bank of Australia's multiple objectives approvingly, suggesting that the expectation was that the Bank would increase rates if underlying inflation moved outside of the target range, but that there was also an expectation that the Bank would adjust interest rates in response to an increase in unemployment. By contrast, under the New Zealand arrangements the capacity to direct monetary policy to be directed to both price stability and output objectives was denied. However the real problem with the New Zealand arrangements was seen to rest in the Reserve Bank's failure to keep inflation within the mandated target range, producing a massive loss of confidence in the markets, evidenced in increases in bond rates. The New Zealand target, it was argued, was too hard, and risked an attendant loss of credibility if and when inflation moved out of the target range. The Reserve Bank of Australia's preference for a more flexible target - 2 to 3 percent underlying inflation over the business cycle - was viewed as preferable. That said, this respondent did confirm that, in his assessment, within overseas financial markets the New Zealand model is perceived as preferable - the simplicity of the model is attractive, with one target it is easier to monitor the Bank's performance, and

the institutional arrangements are perceived as providing the requisite measure of operational independence. And another respondent close to the official family suggested that, as compared to the New Zealand, the Australian target is too flexible, provides too great a measure of discretion for the Bank and policymakers, and could usefully be further tightened to a 0-2 per cent target range.

Outside observers offered a variety of assessments. Todd Ritchie of the National Farmers Federation suggested that, notwithstanding the support of the NFF (and its New Zealand counterpart) for 'rational economics', in his assessment the New Zealand approach was too prescriptive, with too great an emphasis on the price stability objective. Moreover Ritchie suggested, in common with a number of other respondents, that the trajectory of policy and policy outcomes over time - the track-record - was more important in shaping market assessments than the formal institutional arrangements.

For his part, Alan Wood, a one time supporter of the NZ model, suggested that 'smart central bankers' tended to keep an eye on the politics of central banking, and that meant conducting monetary policy with a focus on factors additional to price stability:

"... it's just idle to pretend that they don't operate with an eye on activity, nor should they ... I think in the case of New Zealand and Australia - New Zealand initially got much more credit for going the way it did with that charter among financial markets and among central bankers too; but looking at the experience I must say that my conclusion is that they made a mistake in terms of having too narrow a target range, and so you got instrument instability, and my guess is that Don Brash would be pretty happy actually that political circumstances enabled him to get a wider target without appearing to have to back down himself ... I think it is pretty clear that they were just unrealistically narrow ...

I think that there is a problem with the Australian formulation in that you can say it is a bit too vague and therefore lend itself too readily to slackness in policy in that it is achieved over an economic cycle, on average, but there is a lot to be said for it too, in that it does give some desirable flexibility to deal with shocks - it acknowledges that there will be shocks, and that there can be a very high cost in activity terms in attempting to bring inflation back within the target range too quickly" (personal interview, 1997).

And this a view shared by Max Walsh who, while initially "quite impressed with the New Zealand approach", observed that,

"... we arrived at our target by stealth inasmuch as the Reserve Bank quietly put it into the market place without the approval of the politicians, so they got the politicians to tick it afterwards, which was a very clever political exercise ... and the more I see the more convinced I am that it is the right way to go because there are too many cyclical variables out there which can push you off course

and the price you pay to pull yourself back on course may be too high to pay politically for a central bank to retain its legitimacy as you call it" (personal interview, 1997).

In Alan Wood's assessment, both in terms of its target and its management of the breach of that target the Reserve Bank of New Zealand 'got it wrong' politically:

" ... the New Zealand Reserve Bank played its politics wrong in that sense I have to say, in that you had publicly the Bank's line that it would not be allowed to go outside - if it goes outside it will be terrible and we will have to do all sorts of things, Brash may have to resign - they took a very hard public line on keeping it within the target whereas as I understand it, privately talking to other central bankers - they conceded - they knew it was going to go outside the target rang. So I don't think that was really smart politics - I presume they did it to reassure markets, but at the end of the day when it goes outside its not surprising that you get instability. The smart politics would be to say we think its going outside the target range but this will only be temporary and reflects no change in our commitment to the inflation target, and here's the reason its going to go outside temporarily - you explain it" (personal interview, 1997).

And Wood also suggested that 'politics' - evidenced in wider perceptions of a central bank's orientation - was an important determinant of the long-term sustainability of particular institutional arrangements.¹⁷ And this aspect of the argument was also cited by Max Walsh who proffered the assessment that the change to New Zealand's electoral system was evidence of some disenchantment with aspects of the pace and trajectory of reform, and the orientation of institutions like the New Zealand central bank:

" ... you see the whole thing about having the change to the electoral system - there was too much straight jacketing and discipline involved without reference to the democratic instincts of the society ... whether that is true or not I feel that that was part of the mix. And to that extent New Zealand is a good case study in what not to do. You do have to have checks and balances - you pay a price for democracy [with] the single party system and a few other features in New Zealand - while it is a small society, and an educated society - even it runs into reform fatigue very quickly" (personal interview, 1997).

¹⁷ Wood suggested that, in reference to the inclusion of a 'growth/employment' element in a central bank charter - "ideally I would have that secondary provision in ... I think that because of New Zealand's particular circumstances, its not worth the risk of re-writing the Act. The same applies by the way in relation to the Board, if you believe there was a case as I do that there was a case for changing the arrangements in relation to our Board it just wasn't worth the fight in the Senate to change the Act, so the Government's tactics basically will be that as each opportunity arises to put its own people on the Board" (personal interview, 1997).

Independence revisited

In the preceding chapter we noted how the post 1983 Australian political discourse - as it went to the institutions of central banking - focused largely on the issue of central bank independence. And whatever the bases for suggestions of a lack of independence on the part of the Bank, retrospective assessments of the trajectory of policy and practice, and the various influences of personalities and institutions, have tended to confirm the popular view of that, for much of the 1980s and 1990s, the Reserve Bank of Australia was a somewhat dependent institution (see in particular, Edwards, 1996).

In part the answer to the question as to whether or not the Reserve Bank of Australia is an independent institution is suggested by developments that have occurred quite independently of the formal institutional arrangements - the float and the financial deregulation of the early 1980s, the Bank's development of its own inflation target under Bernie Fraser, and, more recently, the Costello/Macfarlane exchange of letters. Respondents identified these kinds of changes in assessing the degree of independence enjoyed by the RBA. While legislation has remained unchanged, ideas about what monetary policy can and cannot achieve have. From the vantage point of the Bank, while the legal independence to determine policy had always existed under the Act, the transition to a policy regime focused one instrument, used entirely at the Bank's discretion - namely open-market operations targeting the over-night rate - have resulted in a situation in which *de facto*, as well as *de jure*, the Bank is an independent institution. Barry Hughes commented that, "the markets give the Bank independence", and suggested that the degree of scrutiny of the Bank's actions made it very unlikely that an incumbent government could ever succeed in an attempt to overrule the Bank:

"If they are going to be overruled I think that it is the politician who is going to come off second best. You don't have to ring up a journalist and leak this stuff - the journalists are for ever ringing you, and all you have to be is less than glowing, and your message gets out, and this place [the market] will crucify the politicians" (personal interview, 1997).

Commenting on the issues of independence Treasury Secretary Ted Evans noted the remarkable perceptiveness of those responsible for the 1959 legislation - the legislation provided the Bank with considerably more independence than it chose to exercise, until the extra-legislative changes of the early 1980s.

Max Walsh endorsed the view that the Bank's independence had emerged in an evolutionary fashion, suggesting however that this independence had evolved notwithstanding the formal statutory arrangements:

" ... it's an independent central bank now in terms of what you might call international central banking, in practice rather than talking about the legislative framework. It's more independent now than it has been previously in its history, and it's been largely an evolutionary process ... in a way it was fortuitous that we had a change of government and a change of governor. It ... enabled the Reserve Bank to move forward formally in its independence which it had been asserting, but in a pretty much exploratory fashion" (personal interview, 1997).

Board members, for their part, defended the Bank against the suggestion that it was and is anything but independent, while at the same time defending the 'consultative independence' that has characterised the relationship between the Bank and successive governments of a variety of persuasions. Board members suggested that, in a formal sense, the existence of a manifestly transparent disputes procedure in the Act provided a defence against any expedient attempt to politicise the Bank in any way.

Other respondents cited evidence of behaviour on the part of the Bank that suggested a measure of independence from the government of the day. One Board member suggested that decisions on the timing of monetary policy changes had been quite consciously informed by the need to act, and be seen to act, in a politically non-partisan, and institutionally independent fashion. Former Board member Bill Kelty suggested that the one test of the bank's independence rested in evidence of its behaviour:

" ... you look at the behaviour of the Bank when it has to make decisions - whether it has made decisions which in any way could be judged to have a political flavour about them ... and the only politics that I have ever seen in terms of my experience in the Bank, was in a perverse way ... that is to say the Bank didn't make a decision at the right time because of the sake of political considerations. You've got a range of risks when you make decisions, a range of assessments which you have got to make. It's not a clean cut line with any decision, there are pros and cons, advantages and disadvantages. But I would have said that in terms of [those] decisions, the politics of the decision invariably hurt the Labor Party - that is in terms of the timing of making those decisions, the timing of them was not to the advantage of the Government. Again ... the Labor Party went into [the 1996] election with higher levels of interest rates than they should have done. The rates should have been reduced before the election. The reason they were not reduced before the election was that there was some uncertainty about the economy - that is true - some uncertainty engendered by the election and the political process itself ... but the reality is that the rates should have been reduced before the election. I don't complain about that decision, or say that it was not the right decision, but you can't be seen to be political...

... if Keating was manipulating monetary policy he would have had the rates down - he's not an absolute fool. It would have been better to go into the election with rates down ... if Keating was manipulating monetary policy for

political ends, he's the worst politician we have ever seen in this country" (personal interview, 1997).¹⁸

Another Board member alluded to a decision taken by the Board, after the 1996 election, to ease monetary policy in advance of the Treasurer's delivery of his first budget, and under circumstance where the Board was aware of the clear preference on the part of the Treasurer for the rate cut announcement to be made after the budget (thereby being viewed, in part at least, as attributable to the fiscal responsibility of the new government).¹⁹

Respondents also questioned the logic and the utility of the standard indices of central bank independence, Ted Evans suggesting that they were the casualty of lazy economic thinking on the part of those that put them together, and questioning the robustness of the assumptions about the neutrality of monetary policy. As Evans observed, even accepting the argument about the neutrality of monetary policy over the long-run, short runs do matter, particularly in a situation in which, effectively, a series of short-runs are strung together.

And so the rebuttal of the claim that the Reserve Bank of Australia has lacked independence takes the form of a recognition of the evolution of policymaking and institutions to a 'more independent' set of arrangements in which the putative *de jure* independence of the Bank is evidenced in a *de facto* form of behavioural independence - including, but not limited to, the float and financial deregulation, and the development of an 'agreed' policy target; in a defence of the Bank's record in terms of the timing and tenor of monetary policy decisions (and some criticism of popular

¹⁸ A number of respondents questioned the accuracy of John Edwards' account of policymaking under Keating. One Board member suggested that, while Board members would not have been party to the kind and quality of communications between the Governor and the Treasurer, he doubted the veracity of claims that the Bank received any political direction. For his part, Treasury Secretary Ted Evans, while acknowledging that it might be a 'reasonable observation' to suggest that Keating and Russell were influential in monetary policymaking - particularly given the practice of consulting the Government on policy changes before the event - suggested that the government of the time may not have been the dominant partner in the consultative relationship between government and central bank; and indeed that it may have been that Bernie Fraser was able to convince Keating and Russell of the merits of a particular policy recommendation. Former Treasurer Ralph Willis described Edwards' account as "demeaning of the Bank." Bell Kely was unequivocal in his judgement on the Edwards' analysis, characterising it as, "the scuttle-but of second-rate minds ... running around the Prime Minister's Office claiming some sort of self induced authority", and the Edwards biography as, "one of the poorest attempts to understand government ever written in this country" (personal interview, 1997).

Max Walsh observed that, while the Bank would disagree with any suggestion that policymaking was at all politicised, "both the bank and the Government were travelling in the same direction. It's all a matter of timing, and Keating did tend to sort of crack the whip over them" (personal interview, 1997).

¹⁹ And, outside of the sphere of monetary policymaking, another Board member cited the Board's independent capacity to determine the salaries to be paid to the Bank's Governor, deputy, and assistant governors, notwithstanding, the at times, (private) objections of the Treasurer to the course of action adopted by the Board.

accounts of government/central bank relations), and a resistance to the standard measures of central bank independence. But this defence is tempered, on the part of a number of respondents, by the realisation that institutional form, policy and practice notwithstanding, the Bank, and the institutional arrangements underpinning the conduct of monetary policymaking more generally, have at times been viewed as lacking in credibility.

The point of departure for this chapter was the Costello/Macfarlane exchange of letters - the agreed statement on the conduct of monetary policy - an initiative which, whether one perceives it as simply codifying existing policy and institutional practice, or effecting a change in the priorities of policymakers, is credited with having restored some credibility. Clearly the popular accounts of the 'lost credibility' focus on evidence of manipulation and influence, of which there is little, or the comments of politicians and central bankers within a political context and, not infrequently, partisan political contest, of which there is more.

In part the perception of a politically porous relationship between Bank and government is sheeted back to former Treasurer and Prime Minister Paul Keating's remarks about his capacity to influence the Bank (and indeed most other elements of the institutional framework). Those comments, to which reference was made in the preceding chapter, were cited by a number of respondents as damaging the Bank's credibility, particularly in off-shore markets. Bernie Fraser acknowledged that the Keating comment had impacted adversely on perceptions of the Bank, observing that the Keating comment about having the Bank in his pocket was,

"... unfortunate ... He said it in a rather obscure form - it was supposed to be a private function, soon after the death of Chris Higgins. He was boasting a bit in a way, but he was talking more in terms of how he had got this close working relationship with the central bank, and the Treasury, and he's on good terms with people in the IMF and other institutions around the world, and he used this colourful turn of phrase about having all these things in his pocket. It was unfortunate, and he regretted it. I chastised him ... he regretted it, and he never repeated it. He came close a couple of times to more or less backing away but being the person he was he couldn't bring himself to make a full apology" (personal interview, 1997).

And while for Fraser it was the repetition of the comments, for political ends - despite successive Governors' defending the independence of the Bank - that created and maintained the perception that the Bank was not an independent institution,

"... it was repeated and it became a bit of folklore, and that did damage the perception of the Bank's independence, more so overseas I think, in financial markets in London and New York - people who would travel around these

places without really knowing the facts of the matter would have this in the back of their minds - these kind of statements" (personal interview, 1997).²⁰

Bernie Fraser's approach to central banking, and certainly the more selective assessments of that approach, tended to suggest a predilection for the unorthodox. As the review of the trajectory of Australian policy and politics in the preceding chapter clearly demonstrates, Fraser, notwithstanding his inclination towards a less public role, made a number of quite public and contentious forays into the policy and political debate. And indeed the very fact of his appointment, as an outsider, and over the respected, albeit in monetary policy terms, somewhat hawkish, John Phillips, meant that Fraser was always going to be suspect in the eyes of some, and the object of a high degree of market and media scrutiny. However among those interviewed there was an almost universal recognition of Fraser's abilities as a public servant, and his capacity for independence in thought and action. Clearly for some of those committed to radical institutional reform, the demonisation of Fraser is one element of the case for the prosecution. But even individuals critical of the formal institutional arrangements, and of Keating's inappropriate comments on the nature of his relationship with the Bank, suggest that Fraser, while viewed as being both unorthodox and at times viewed unguarded in his comments, was an independent central banker. Alan Wood characterised Fraser in these terms:

"Bernie ... was so obviously a political [appointee]... he was an avowed and openly declared mate of the Treasurer - very clearly a Labor Party supporter, and so any suspicions that were around about the Bank sharpened under Bernie - I don't think with a great deal of justification I would have to say - although I often disagreed with Bernie on other issues I always thought that he was a straight shooter in terms of his policy advice. I don't think he tailored policy advice to Keating - it's not his style - he had a lot in common with Keating's view of the world, but that is a different thing ...

Keating certainly said some silly things in public about the independence of the Bank, like 'I've got them in my pocket' and things like that, but I don't believe that was so, certainly not under Bernie - Bernie is a pretty shrewd operator, but I believe that he is an honest one...

²⁰ Others suggested that the malaise, of which a less than independent central bank was but one element, went much deeper. One respondent suggested that over the period from the late 1980s through to the mid 1990s there was a view that the Australian policy community had been captured by what were referred to as OECD Keynesians, with a consequence that inflation was higher than was optimal, reflecting an attempt to operate the economy with a rate of unemployment below its 'natural' rate or NAIRU, a failure to apply theory to the policy advice being tendered to government, and a reluctance to embrace reforms to the welfare system and to labour market regulation. This OECD Keynesianism, it was argued, permeated both the Treasury and the Reserve Bank, and resulted in the Australian policy community becoming policy laggards. While not subscribing to the view that the Australian policy community was hostage to an 'OECD Keynesianism, Max Walsh conceives of a collective orientation within the Treasury - "they saw themselves as secular priests. They were very well intentioned people [who] had a pretty low opinion of certain interest groups, including the financial markets..." (personal interview, 1997).

so Bernie discredited the Bank, not really by what he did, but by incaution in what he said, because if you believe that Keating was there to do what Keating told him, his interventions in the political debates would only harden your opinion, so ironically I think Bernie, in terms of the operation of the Bank and so on was a pretty good Governor, I think he had a good sense of the cycle, and he was prepared to move on rates at times ahead of his colleagues opinion, ahead of general opinion I think...

when he started cutting rates ... there was an episode where we got rates up quite high in the lead up to the recession, and then Bernie started cutting, and he certainly started earlier than most people expected, or thought was warranted at the time - and in hindsight [Fraser] was clearly right" (personal interview, 1997).

Other respondents, supportive of Fraser's approach, tended to be more defensive of his occasional forays into the wider political debate. Heather Ridout totally rejected the suggestion that Fraser had contributed to the Bank's lack of credibility, while acknowledging the deleterious consequences of some of Paul Keating's pronouncements:

"... if you ever saw the dynamics between the two people there was no way in which Paul Keating had Bernie Fraser in his pocket - Bernie Fraser was his own man, he was a true professional. I think the issue is this - and it goes to the mixed charter of our Reserve Bank - because Bernie Fraser was concerned about employment, the issues in monetary policy terms, and managing interest rates, weren't as transparent - weren't as clear cut. Once you start to intrude into areas like having regard to employment objectives, and the effects on the welfare of the people of Australia - you are intruding into areas where you have to have some kind of political broader perspective - you've got to bring in more qualitative issues...

Alan Greenspan's speech in America recently is an intriguing example of central banks warning society that you can't have high rates of economic growth and take it all in Porsches... you can't do it, it's unsustainable, you either end up with huge wage breakouts or revolution. Now Bernie Fraser presided over a period where he tried to manage the economy to have regard to those objectives, so inevitably, he didn't always act like an orthodox central banker, and I think that might have meant that he might have looked at times that he was running an agenda that was more in line with the interests of the Labor Party... I think that's really the issue" (personal interview, 1997).

And Ridout also noted that, at times, the policies pursued by the monetary authorities under Bernie Fraser had been relatively orthodox:

"I think though that the scorched earth management of monetary policy in the late 80s in Australia where they were ratcheting up rates every 5 minutes which had a disastrous effect, and you couldn't say he [Fraser] was a wimp over that... he was at it, every 3 months"(personal interview, 1997).

Indeed others, while acknowledging that Fraser was indeed a somewhat unorthodox central banker, suggested that, unlike most central bankers he 'acted tougher than he talked.' It was under Fraser that the bank developed its own inflation target - the target that was accepted as an element of government policy through the Costello/Macfarlane exchange of letters. What made Fraser different was that, unlike many central bankers at the time - and arguably this has changed in more recent years - he was prepared to identify economic growth as a priority for the Bank, a priority which, it might be argued, in keeping with the Bank's statutory charter, still informs the Reserve Bank of Australia's conduct of monetary policy.

Fraser's defence tends to be less personal than institutional, and we noted earlier that his tenure as Reserve Bank Governor opened and closed with a public examination of the issue of central bank independence, his last speech as Governor linking the four pillars of the Australian institutional arrangements to issues of independence and accountability. Clearly Fraser defends the form of 'consultative independence' suggested by those arrangements as being appropriate to the challenges facing central banks and bankers in the present environment. Equally he is sceptical of the value of formal measures of central bank independence, suggesting that they are,

" ... based upon the interpretation of rather formal arrangements in legislation put in place a very long time ago, and subject to a selective interpretation by people who aren't in the business. Only an insider or someone very close to the business can know how things really work in practice, as distinct from what the formal arrangements might be..."(personal interview, 1997).

But as Fraser's comments on the various elements of the Australian institutional arrangements suggest, whatever the limitations of the formal measures of central bank independence, he is both comfortable with an approach to policy that entertains multiple instruments and multiple objectives, and sceptical of the institutional models informed by rational economics, and their exclusive orientation towards price stability. In his final speech as Reserve Bank Governor Fraser suggested that when the Reserve Bank of Australia was being heralded as an 'independent institution' was the very time for commentators to take a much greater interest in 'independent' central banks; elaborating on this observation Fraser suggested that,

" .. all around the world there has been this concern about independence, and yet it is not delivering - it is delivering on the low inflation front but that is all. What I really had in mind there was whether 'independence' had any impact on the performance of the Bank - looking to see whether more independence for the Bank didn't make the task of delivering growth and lower unemployment more difficult"(personal interview, 1997).

Institutional reshaping: the Australian case

Whereas in the case of the New Zealand the objective is one of explaining a regime change - a policy change after July 1984, codified into a new statute effective March 1990 - in the case of the Australian arrangements that change that does occur evolves against the backdrop of continuity in the formal statutory arrangements. Clearly a case that assumes a strict correspondence between statute and behaviour is an untenable one. Our review of the political economy of Australian monetary policymaking in the post 1975 period suggests that there have been quite significant changes. But it also attests to the capacity of the formal institutional arrangements to accommodate those changes. There are two possible implications, the first that the formal institutional arrangements are irrelevant to the practice of monetary policymaking and implementation; and the second, that, if not irrelevant, those arrangements in and of themselves have exercised no independent influence on the substantive changes that have occurred. The evidence presented in preceding chapters is very clearly not such as to support either.

It is our contention that the practice of central banking in Australia is reflective of defining features of the formal aspects of the Australian institutional arrangements - what we have referred to as the Coombsian scheme - and that, those arrangements have exercised an independent influence in shaping the trajectory of reform. Moreover, we would also contend that the arrangements do not constitute a 'default' setting, but represent quite deliberate choices made on the part of those within the Australian policymaking community, and the society at large. Within the Australian state directed policy network, members of the 'official family' made a deliberate choice not to proceed down the path taken by their New Zealand counterparts. Those choices are explained by the political-economic environment in which state, central bank, and economic interests and coalitions of interest were and are situated.

In seeking to illuminate the conditions which resulted in the Reserve Bank of New Zealand Act 1989 we have suggested that they are consistent with a political-economy in which the locus of political and economic power had shifted in favour of financial actors, and that the 'bias' of the trajectory of institutional reshaping was such as to elevate 'credibility' considerations above all others. In explaining the trajectory of institutional reshaping within the Australian context we would contend that, within the domestic political economy, the balance of interests was such as to ensure that the quest for institutional, and policy credibility was not such as to militate against the maintenance of legitimacy. The contrast could not be more stark - the trajectory of

institutional reshaping in new Zealand was vigorously resisted by manufacturing and labour interests; the evolutionary trajectory of reform in Australia enjoyed the support of those same interest groups. In New Zealand there is clear evidence of an epistemic community which draws on the rational economics literature, mines an existing seam of institutional design associated with reforms to state trading enterprises, and which drives a process of institutional reform - a regime shift - from within a state directed policy network. In Australia there was and is a constituency for the same kind of prescription, but it constitutes but one of a number of competing world views within the wider policy community, and has never enjoyed the kind of dominating influence within the state directed policy network that one detects in the New Zealand experience. In Australia one sees an epistemic contest, resolved, for the time being, in favour of a model, the dimensions and consequences of which we will return to in the concluding chapter. In New Zealand there is evidence of an epistemic community, but it is one that has largely enjoyed an almost hegemonic influence. The prospects of the New Zealand model remaining uncontested is also a matter to which we return in the concluding chapter.

We will return to the political economy determinants of institutional choice - the particular societal configurations that underpin reshaping strategies - in the concluding chapter. Within the context of that political-economy there are however particular features of the Australian case which serve to further illuminate the nature of the choices that have informed institutional reshaping.

Firstly there is the fact that the case for legislative changes to the Act came from the expected political quarter. The prosecution of that case, as we have seen, reached its apex with the publication of the Liberal-National Coalition's (LNP) 'Fightback' programme, under the leadership of the one time academic economist Dr John Hewson. While the Hawke and Keating ALP Governments were certainly reformist, to attempt, as a number of scholars and commentators have done, to represent that programme of reform as economically rationalist and as an orthodox neo-liberal political project is to do a considerable violence to the subtlety and complexity of Australian public policy over the period reviewed by this research. In very many respects the ALP Governments adopted policies consistent with the tenets of main stream social democracy, albeit within the context of a reform programme that resulted in significant market liberalisation and deregulation within finance and product markets. The extent of the policy shift on the part of the New Zealand Labour Party is evidenced in the fact that in a number of respects, and in terms of the institutional arrangements governing the development and implementation of monetary policy in particular, the LNP

programme sought to replicate much of the New Zealand (Labour Government) programme within the Australian jurisdiction. In terms of the 'checks and balances' expected within a liberal pluralist polity, particularly one characterised by two party dominance, the proposals advanced by the LNP (in Opposition) were duly opposed by the incumbent ALP administration. In this sense, as regards the issue of central bank independence, the partisan pattern established since the emergence of central banking in Australia, and which we surveyed in Chapter 4, has remained intact. Parties of the right have sought to elevate price stability, and have, it can be argued more assertively represented the interests of financial actors, whereas the party of the left has resisted attempts to relegate macroeconomic stabilisation to a secondary role. Moreover, as we noted in the conclusion to Chapter 4, Australia's central bank had its origins in an entity which was promoted by the Australian Labor Party to contest the power of trading banks in the retail market, and, while this is no longer a feature of the role of the Reserve Bank of Australia, in symbolic terms it may impart a greater sense of ownership of the institution on the part of the ALP. The fact that much of the present Act - and the Coombsian scheme - had its genesis in the Labor Government's 1945 legislation would only serve to reinforce this sense of 'ownership'.

Secondly, whereas in Australia the Fraser Government (and the Reserve Bank) had embraced orthodox monetarism over the period from the late 1970s through until the election of the Hawke Government - what we have referred to as a statist monetarism - the Muldoon Government firmly rejected the tenets of monetarism in favour of statist regulation. The import of this difference in the policy sets that predated the election of labour party governments in Australia and New Zealand is two-fold. Firstly, the ALP programme was, as we have argued, developed quite consciously as an alternative to monetarism, but positioned as going, in part to the economic objective to which the monetarist project was directed (and which former ALP governments had failed to adequately address), namely stability of prices. New Zealand Labour prosecuted a change which stood in stark contrast to the statist excesses of Muldoonism, whereas Australian Labor embraced a quasi-corporatist alternative to the proto-monetarism of the Fraser Government. The Accord was quite consciously developed and positioned as a vehicle by means of which competing income claims could be resolved in such a way as to maximise growth and employment, and deliver low inflation. Whatever the changing proclivities and preferences of policymakers over time, the historical record does suggest that the Accord was perceived, from the outset, as an 'anti-inflationary policy' instrument, and represented as such.²¹ Accordingly the issue was not so much

²¹ The extent to which policy over the period of the mid to late 1980s was informed by a desire to deliver low inflation is a matter of some debate within the Australian policy community - see the exchange

one as to whether or not inflation should be controlled, so much as it was one of which instrument or combination of instruments, was best suited to the challenge. In New Zealand, by contrast, while there was certainly a debate within the ranks of the economics profession over the respective contributions of monetary, fiscal, and wages policies, and over the relative weighting that might be given to price stability and macroeconomic stabilisation, that debate occurred outside, and largely marginal to the political debate over the merits of the 1989 legislation - politically the choice was represented as being one between an operationally independent central bank tasked with the one objective, or a reversion to Muldoonism. In New Zealand the policy choice was presented as one between two paradigms - credibility attendant upon the pursuit of price stability, or a return to statist regulation; in Australia the issue was much less one of choosing whether or not to pursue stable prices, and much more which policy vehicle - orthodox monetarism and its successors, or building incrementally on the Coombsian scheme - would be most appropriate.

Thirdly there is the fact the institutional arrangements for the conduct of monetary policy in Australia fell squarely within the terms of reference for the 1981 Campbell Committee Inquiry into the Australian Financial system, and that the Committee rehearsed the case for changes to those arrangements, and concluded that the case was not made. We reviewed the findings of the Campbell Committee in some detail in Chapter 6, and noted the Reserve Bank's support for those findings, notably the recommendations that effectively presaged the floating of the Australian dollar. Significantly the Campbell Committee Report argued persuasively for a much greater measure of market liberalisation in finance markets, and for a move to market based measures for the conduct of monetary policy (open market operations with a floating exchange rate), and at the same time recommended the retention of the institutional status quo as appropriate to the demands attendant upon central banking in that new environment. The case for reforms designed to increase the credibility of policy (and for policies that would enable the Australian central bank to exercise a much more

between Grenville and Hughes in, Reserve Bank of Australia, Monetary Policy and Inflation Targeting, 1997: 125-166). Barry Hughes goes so far as to suggest that in the early years of the Hawke Government policy was effectively a marriage between the Accord and a monetarist targeting regime, with the latter the junior partner. He is critical of those who suggest that the commitment to low inflation only surfaced in the later years of the 1980s:

" ... its one thing to say that theoretically they were confused, its another thing to say that practically they were confused, and basically they bore down pretty heavily in an anti-inflationary kind of way ... why ever would you set real interest rates that high unless you were intending to be anti-inflationary ? ... was this a mistake, were people asleep at the wheel? no, this was quite deliberate, so when [RBA Deputy Governor Stephen] Grenville talks about people weren't serious about inflation, until the late 80s early 90's when 'our crowd' got in there, that just can't be sustained" (Hughes, personal interview, 1997).

independent role) also affirmed those very features of the Coombsian scheme that served to maintain institutional legitimacy.

Fourthly there is the fact that, notwithstanding that both labour governments pursued significant reforms of the public sector, including both commercial and non-commercial entities, there were significant differences in the approaches taken. As we noted above, in New Zealand there was a large measure of cross-fertilisation of principles, and models of institutional design as between the public sector reforms and the institutional reforms of the central banking arrangements - 'public choice' assumptions were central to the diagnosis, and agency theory influential in shaping the prescription. In Australia, by contrast, public sector reforms were more 'managerialist', and, whereas the logic of reform in New Zealand resulted in what some have referred to as a balkanisation of the existing departments and ministries, in Australia the thrust was more towards aggregation and the establishment of mega-departments. Those involved in the development of the Reserve Bank of New Zealand Bill came to that process with an existing portfolio of models, including the SOE model, and while the final institutional form drew on a wider range of models, including, as we have noted, aspects of the present Australian model. In Australia reforms to the public sector focused more on process than form (see Boston and Uhr, 1996; Aucoin, 1990). The suggestion is not that New Zealand's public sector reforms constituted a necessary condition for the revisiting of the central banking arrangements, but simply that, in the absence of those reforms the pace and trajectory of changes to the institution of the central bank may have been different.

Fifthly there is the dominating influence of the ALP/ACTU Accord over the period from 1983 - 1996, and the fact that the development and conduct of monetary policy was influenced by, and was largely reinforcing of the style and substance of policymaking under the Accord. The central bank was clearly one institutional player in quasi-corporatist policy framework that placed a premium on policy co-ordination, and the use of multiple policy instruments in pursuit of a range of objectives. As such the pursuit of (at time conflicting) macroeconomic objectives such as low inflation, economic growth, and external balance was carried by wages and fiscal, as well as by monetary policy. No one policy was set in isolation from an other, and the fact that the Bank's inflation target became a principal element in the later Accord agreements, and by means of these agreements came to be accepted, implicitly at first, and later explicitly as a government policy objective, is illustrative of the degree of policy co-ordination informed by common and mutually reinforcing objectives. The implications of this degree of co-ordination are two-fold. The logic of co-ordination under the

Accord meant that support for an Accord agreement constituted support for the other elements of the policy mix directed to the realisation of agreed targets - including monetary and fiscal policy. While participation in the governance of the Reserve Bank on the part of the trade union movement predated the negotiation of the Accord, the fact of that participation in the context of a co-ordinated policy set undoubtedly resulted in a measure of legitimacy for the central bank, and the policies pursued by it. By implication the end of the Accord agreements, and the resignation of the ACTU Secretary from the Board of the Bank may presage some loss of legitimacy for the Bank (although as we have noted Kelty views his resignation as being protective of the integrity of the institution). However this may be less a threat than the transition to a system of wage fixing in which the Industrial Relations Commission is tasked, in part, with adjusting minimum wages to protect the interests of the low paid, and where such adjustments flow through an informal matrix of relativities into paid rates. If such a minimum adjustment results in an aggregate wages movement inconsistent with the Bank's inflation target there is very clearly the prospect for two arms of policy working against each other. As an Australian central banker is reported to have quipped to a member of the Industrial Relations Commission, 'we set the inflation rate, you set the unemployment rate'. In a context in which the emerging challenge to monetary policymakers is less likely to be inflation than deflation, the risks are somewhat less than they might otherwise have been. But there is clearly the potential for future conflict between institutions and the two arms of policy, and a consequential loss of legitimacy on the part of a central bank which may feel obliged to tighten monetary policy in the face of wage cost-push pressures. The issue of the relationship between agencies respectively tasked with the conduct of monetary policy and the determination of minimum wages might usefully be the subject of further research.

Clearly the fact of Australia operating under a federal political system with a bi-cameral legislature means that policymakers are sometimes constrained in their capacity to successfully prosecute measures through the legislative process. Central banking legislation has in the past on more than one occasion, failed to meet the requirements of the Senate, and has been, amended, withdrawn or reintroduced at a later. Following the 1996 election, the composition of the Senate, and the consequential balance of power as between the Senate and the House of Representatives that confronted the incoming government in and if itself would have given a government pause for thought. However, it is noteworthy that the Coalition had resiled from the orthodox prescription in June of 1994, and equally it is clear that the tenor of the advice provided to the incoming government in 1996 was to adopt measures other than amendments to, or the repeal of the Reserve Bank Act. The uncertainty associated with

the absence of a government majority in the Senate was clearly a factor, but the policy contest had been fought and resolved long before the 1996 election. It might be argued that, had the LNP Coalition won the 1993 election under the leadership of John Hewson, and on the basis of the 'Fightback!' programme, the trajectory of institutional reshaping may have been very different. Politics and political economy rarely permit the kind of counter-factual that would allow this to be tested. The fact is, that for whatever reason, the Keating ALP Government was re-elected, and that, by the time the LNP Coalition was elected to office in 1996, the Coalition had resiled from the orthodox (New Zealand styled) model. It is clear from the discussion in this and the preceding Chapter that the retreat from that model was a decision that enjoyed the support of key actors - both financial and non-financial - within the Australian political economy.

Finally there is the contribution of the Australian institutional framework more generally, which we have examined in detail in earlier chapters. Former Reserve Bank of Australia Governor Bernie Fraser has suggested that there are four defining features of the model, a charter directed to multiple objectives, a flexible inflation target, policymaking and governance being vested in a Board which brings together a diverse range of interests, and a relationship of consultative independence between the central bank and the government. One might also add a capacity on the part of that framework to accommodate quite significant changes in the domestic and international context in which monetary policy has been developed and implemented. Clearly there are elements of that model which serve to impart an appropriate balance between the imperatives of legitimacy and credibility, and which were identified by a number of respondents in their evaluations of the present framework. This Chapter attests to the fact that the present framework enjoys the support of key interests and actors, within the Australian state and without. In the concluding chapter we recast the Australian and the New Zealand trajectories of institutional reshaping within the model we introduced in Chapter 3, and further explain why it is that the institutional reshaping of the Australasian central banks reflects particular configurations of interest within the two political economies.

Appendix One

A note on formal elements of Reserve Bank governance

In Chapter 4 we reviewed a number of episodes of changes to the statutes governing the constitution and powers of central banks in Australasia. In 1973 the New Zealand Labour Party Government amended the Reserve Bank of New Zealand Act 1964. Clause 3 of the amending legislation went to the constitution of the board of directors of the Bank, and the Hansard debate suggests that this provision was one of the more controversial. To rehearse the discussion in the earlier chapter the Government was accused by the Opposition of threatening the independence and integrity of the Bank by requiring that a director of the Bank who was also a director of the Bank of New Zealand (at that point in time a publicly owned trading bank) would automatically be a member of the Reserve Bank's Executive Committee (it is interesting to note in the context of the preceding discussion that the legislation also provided that the Secretary of the Treasury also be a member of that Executive Committee). Speaking in the debate on the Bill the National Party Member the Hon. Brian Talboys commented that:

"The purpose for which the Bank is established is outlined in the Bill, and that purpose is to be served by the members of the bank's directorate. When they accept appointment as directors of the bank they have no function other than that. They accept the burden of the responsibilities as set out in the Bill; they accept the obligation to serve the community through the Board of the Bank of New Zealand. I wish to quote to the Minister of Finance from a judgement in an Australian case: 'This duty of serving the community through the board demands constant vigilance on his part to ensure that he does not to the smallest degree compromise or surrender the integrity and independence that he must bring to bear in the board's affairs'. That illustrates the point I want to emphasise ... I am speaking about the determination of appointees to boards to preserve their independent strength to serve the interests of the body to which they are appointed.

I quote again from the Australian case: 'The predominating element which each individual must constantly bear in mind is the promotion of the interests of the board itself. In particular the board member must not be compromised by looking to the interests of the group which appointed him rather than to the interests for which the board exists'. This is the key point made by Mr Justice Street in Australia. He said, 'He is most certainly not a mere channel of communication or a listening post on behalf of the group which elected him'. I believe that judgement has special relevance to this Bill, and especially to Clause 4 ..." (NZPD, 1973: 2524).

Aside from the obvious sense in which issues of law and institutional design enjoy a common currency across national boundaries, and particularly within the Australasian nations, the extract illuminates an important dimension of the common law as it applies to the governance of companies, corporations, and central banks. And it is a

dimension that may well have been overlooked by those who have developed the indices of central bank independence. Without subscribing to the view that what is correct in law will always be manifestly correct in practice, the common law position would seem to suggest that - at law - it is not reasonable to infer that a person appointed or elected to a position as a director will be bound to represent the interests of the group, or organisation that appointed or elected that person. Specifically, the common law position would seem to suggest that once appointed to a position on a board, a director is bound to serve the interests for which the board exists.²²

In the case of the Reserve Bank of Australia, the Secretary of the Bank, Mr David Emanuel confirms that, "the Reserve Bank of Australia is a Commonwealth Authority established under the Reserve Bank Act 1959. The Bank is not governed by the Corporations Law, but part of the Commonwealth Authorities and Companies Act 1997 (the CAC Act) has implications for the conduct of the Bank's Board members. In particular Division 4 of Part 3 of the CAC Act imposes standards of conduct which are similar to corresponding provisions in the Corporations Law..." (personal communication, 1998).²³

²² For a recent discussion of governance and Australian corporations law see Berns and Baron, (1998: 228-261).

²³ The RBA Secretary noted that, "pursuant to Section 28 of the CAC Act the Treasurer may notify the members of the Reserve bank Board in writing of the general policies of the Commonwealth Government that are to apply to it. While the CAC is relatively recent legislation and its terms have not been tested to this point, our understanding is that the expression 'general policies' in Section 28 might refer to matters such as government policies on employment, relationships with foreign countries etc. This provision does not override the responsibilities of the members of the Board specified in the Reserve Bank Act" (Emanuel, personal communication, 1998).

Appendix Two

Reserve Bank of New Zealand Governor Don Brash on the 1995 and 1996 breaches of the Policy Targets Agreement

Assessments of the New Zealand 'model' by Australian respondents go to a variety of issues, and those assessments differ as to various strengths and weakness of elements of form and process under the New Zealand arrangements. Two issues in particular were identified as being problematic - the first, that whatever the Reserve Bank of New Zealand's contracted target, the Governor of the RBNZ, as with the governor of any central bank, would, either for reasons of political necessity (institutional durability), or for reasons of 'sensible' policy pragmatism, be required to factor 'real economy' considerations into monetary policymaking; and the second, and related issue, that in exceeding the RBNZ's contracted PTA target objective of 0-2% (pre 1996) the Governor acted in a manner consistent with an implicitly dualist framework, but in so doing, and notwithstanding the 'toughness' of the target, lost credibility in the very markets into which the merits of the New Zealand model had been vigorously promoted. On the question of the breaches of the RBNZ's PTA in 1995 and 1996, interviewed in 1998 RBNZ Governor Don Brash offered the following comments:

"Let me just talk about the breach. The first breach was in June 1995 and we hit 2.2 on what we call underlying inflation. Most other countries I suspect would have removed a very sharp spike in fruit and vegetable prices that took place in May that year, there was ... an effect on fruit and vegetable prices which kicked up the CPI about 0.4 in the quarter we reckon and it meant that by May when we could see this happening there wasn't a dogs chance of avoiding a breach given the fact that we were at 1.8 before this particular shock hit us. Now in many countries as you know food and energy are taken out of the CPI because it's regarded as sort of a transient shock, so that breach was certainly not one I could literally have dealt with no matter what I done. In September 1995 it was back to 2.0 and the Bank's judgement at that point was that it was going to gradually track down in 1996 and I must say that was a very widespread public view also - a commentator view. Now in October 1995 after I came back from overseas, I attended a monetary policy committee meeting where everybody but one person was convinced that the economy was falling off a cliff and that underlying inflation was going to move back strongly towards the middle part of the range in 1996 and we must ease. And we issued a statement which was about as cautious as we could have done, you may or may not have read it, which said something like, 'if the data confirms what now appears to be possible it looks as if there may be some scope at some future point for easing'. It was very, very heavily conditional ... I suppose predicably the market eased quite sharply, that was the middle of October 1995, and we were quite wrong and all the rest of the committees were wrong also. Far from falling off a cliff, because you'd never quite know what the counterfactual was and ... that if we hadn't given it such a kick of confidence at that moment we might have fallen off a cliff. You're never quite sure what the counterfactual was, but certainly looking at the track which followed, it looked as if we misjudged that and we

got a further resurgence in the housing market which I think took us to 2.1 in the year to March 1996 and gradually moved up to 2.4 by the end of the calendar year.

Now do we take into account the real economy or not? I guess we did in two senses. One, we of course look at the real economy in trying to forecast inflation and as you'll know we place quite a heavy emphasis on the output gap which of necessity means you're looking at the real economy but you're looking at the real economy for what it's telling you about the inflation rate. You're not looking at the real economy in a sense in it's own right. In that sense if inflation was 6% and the real economy was slack, we would still keep monetary policy tight. And that's different from the traditional RBA view but it's a Bernie Fraser view. Bernie I think under the circumstances would have been inclined to, recognising the weakness of the real economy to have kept policy a bit easier, whereas we're saying if you encourage people to believe that you've got other objectives, behaviour quickly adapts to that and far from actually helping with the real economy you actually hurt the real economy, so you're much better to keep focused on price stability. Our focus on the real economy in that sense, is only for what it says about future inflation.

In the second sense, however, in which having breached the inflation target and having potentially forecast a further breach of the inflation target the question is how much tightening do you do to try to minimise the number of 12 monthly periods during which inflation is above the target. Now in at least one of my letters to the Minister of Finance which has been published ... we said we expected there to be at least two further breaches to the years to June and September but it was neither desirable nor feasible, to tighten monetary policy sufficiently aggressively to prevent breaches in those two quarters. Because the only way we could have done that would have been to tighten so aggressively that the exchange rate would have moved up very steeply so that direct price affects of the exchange rate would have come through quickly enough to offset the inflation in the second quarter out. Now as you know, nothing else in monetary policy is going to work fast enough to have any appreciable effect ... and even then you have to throw it very, very hard to be able to get enough of an impact on prices in a two quarter period to have any appreciable effect and we thought that would not be justified. Now you could say, well Brash after all has got a real economy subsidiary objective but I mean you could equally well say we were perfectly well aware of the fact that if we had tightened policy sufficiently to have reduced the risk of breaching two quarters out we would have run the serious risk of being below zero 8 quarters out, so my own view is that I'm quite comfortable with the idea that we focus only on price stability but that clearly does mean you are watching the real economy quite closely and it does mean that if you've breached to any significant extent you may well not avoid or be able to avoid another breach or two or three because the target has got a floor as well as a ceiling ... It's not because [the price stability objective has] any huge virtue for its own sake. But because by delivering stable inflation, you stabilise output and employment and hopefully maximise those because you make the economy work better than otherwise" (personal interview, 1998).

Clearly Brash acknowledges a sound theoretical and operational case for entertaining a breach at the top end, or the acceptance of a breach for a certain period in order to ensure that in returning to within the target range does not involve breach of the target range at the lower end. Equally clearly Brash does not view this concern as being

tantamount to an explicit acknowledgment of real economy factors - output and employment - even over the transition. Operationally, it might be argued, the issue is moot - politically, in terms of how such a policy is represented to the non-finance sector in particular, there is a risk that the Bank is perceived as giving too much weight to the top end of the target range, and too little to the risks of falling below the lower bound.

Chapter 9

Conclusion

This research has been directed to the examination of two markedly different institutions and trajectories of institutional reshaping. The point of departure and of difference is the fact of two statutes that differ in a number of important respects - specifically in the charters informing the design and execution of monetary policy, and in governance arrangements. In seeking to account for and explain the logic of institutional reshaping in Australia and New Zealand, we have argued that institutional form reflects the configuration of interests within the domestic political-economy. The institutions of central banking we have argued, are more than the formal rules within which institutions are recognised, tasked and governed, and extend to the relational and organisational dimensions of monetary policy formulation and execution. That which is static - the formal statutory arrangements within which such policy formation and execution occurs - provides a window to the dynamic context of the political-economy, a context in which the substantive dimensions of the institution are shaped and reshaped within that political-economy.

The methodological framework which has guided this research is premised on the existence of difference, and we would contend that the institutional difference we seek to explain and account for is central to the conduct of public policy generally, and macroeconomic policy and outcomes in particular, in both the Australasian nations. The two nations are accepted as being, 'most similar', indeed arguably no two other nations within the advanced industrial democracies are more similar, and as we noted in the introduction, have, with some justification been viewed as constituting a 'family of nations' within the taxonomies of comparative politics and public policy. As such the adoption of a 'most similar systems' approach has much to commend it, and it is within this kind of methodological framework, and utilising the analytical tools of political-economy that we have sought to explain and account for the quite distinctive institutional contexts within which monetary policy is developed and implemented in the two nations, and two markedly different trajectories of institutional reshaping. In this concluding chapter we rehearse the rational economics and political-economy approaches to central banking, summarise the principal findings in the context of the model, and foreshadow the likely trajectory of institutional reshaping over the short to medium term.

The rational economics literature reviewed in Chapter 2 provides the theoretical and empirical underpinnings for the normative case for central bank independence. An

independent central bank is one possessed of operational independence from government to pursue the objectives given by government (typically price stability). In summary the rationale for central bank independence is three-fold:

- firstly the assumption is that politicians will be guided by a Downsian calculus which will privilege retention of office above other considerations (including optimal economic welfare), and that voters are also rational utility maximisers and myopic;
- the assumption of a rational utility maximising politician underpins the notion of a dynamic inconsistency constraint where monetary policymaking is informed by electorally expedient and opportunistic policymaking producing sub-optimal economic outcomes (positive inflation);
- evidence of political business cycles tends to support the assumption that the actions of politicians are informed by a Downsian calculus, that policy instruments will be exploited to this end, and that policy outputs and outcomes (the business cycle) will manifest a cyclical pattern consistent with the electoral cycle - typically politicians will engineer outcomes which are electorally propitious (and which may differ according to the preferences of parties and constituents), with such electorally propitious outcomes timed to maximise votes (and with less electorally propitious economic policies/outcomes timed for earlier in the electoral cycle);

The prescription seeks to inoculate the policy process from the democratic distemper by limiting the damaging consequences of the political on the economic - specifically by making the conduct of monetary policy independent of elected politicians, and tasking the independent central bank with the achievement and maintenance of price stability. There are, as we noted in Chapter 2, a number of caveats to the prescription. In tasking independent central banks to deliver and maintain stable prices, the assumption is that monetary policy is neutral in its effects on the real economy over the long-run (that the long-run Phillips Curve is vertical). However at very low levels of inflation some have argued that monetary policy may not in fact be as neutral or benign. Whatever the effects of monetary policy over the long-run, it is generally agreed that the short-run Phillips Curve is not vertical (although there is far less agreement as to the slope and shape of that short-run curve). In other words, even if one accepts the premise that over the long-run monetary policymakers are not in a position to engineer a trade-off as between employment and inflation, over the short-run the adjustment path associated

with disinflation will have negative impacts on output and employment. Moreover, while the existence of an equilibrium or 'natural' rate of unemployment may be such as to militate against the use of monetary policy-induced demand-side stimulation, in circumstances in which the rate of unemployment is in excess of that natural rate (where unemployment is cyclical) monetary policy will have a counter-cyclical role to play. These caveats suggest that, while the rational economics literature would support operationally independent central banks tasked to deliver and maintain price stability, and to operate monetary policy with a medium term focus, monetary policy may appropriately be directed to objectives in addition to, and not necessarily in conflict with, price stability. Accordingly some variants of the normative institutional case suggest the need to encourage central banks, and central bankers, to focus on objectives in addition to price stability, and/or to ensure that the objective of price stability is not pursued at the cost of other macroeconomic considerations.

The literatures reviewed in Chapter 2 are central to the arguments developed in this thesis. One is unable to fully appreciate the import of the orthodox institutional prescription without the theoretical and empirical foundations on which it is based - the literature on the dynamic consistency constraints is particularly significant in this regard. In terms of the logic of the argument - whereas central bank independence is typically treated as exogenous in the rational economics literature - the mechanics of accountability (with implications for central bank objectives and governance), and the necessity of political codification, provide a bridge to the political. One cannot establish that logical connection in the absence of the normative prescription suggested by the rational economics literature. More specifically, it is this prescription that is manifest, in perhaps its purest expression, in the 1989 New Zealand statute, and it is this statute which serves as the backdrop to the Australian policy debates of the 1980s and 1990s.

The essence of the rational economics case for central bank independence is, we have argued, captured in the requirement that the design and execution of monetary policy satisfy the test of credibility. Moreover, credibility is by its very nature a relational attribute, inasmuch as it implies that those with whom the central bank engages will exercise a judgement as to whether or not policy is, at any given point, credible. Credibility in turn implies accountability, and we have argued that the imperative of accountability adds an important political dimension to the institution of central banking. The rational economics literature would have it that politically porous institutional arrangements lack credibility - opportunistic and discretionary monetary policymaking conducted with a short-termist bias will cause price setters to factor a

risk premium into forward contracts. Credible policy is policy in which price setters in markets have the confidence that they will not be embarrassed by politically informed surprise inflations. The stock of credibility will clearly appreciate over time where a central bank demonstrates a capacity to operate monetary policy independently of political influence (reputation), but an initial and ongoing endowment of credibility will also accrue where the formal institutional arrangements impose accountability requirements. Such requirements take a number of forms, and are clearly suggested by the transparency of contracting regimes where the central bank, as agent, is tasked to achieve publicly verifiable outputs or outcomes, and where central banks and bankers are required to publicly account for the conduct of policy in pursuit of such objectives. Such forms of accountability, we have suggested, are not only relational, but are typically codified into formal requirements through central banking statutes, and/or through agreed policy guidelines. Accountability is a subset of credibility, and is codified through the political process.

Accountability provides the bridge to the political-economy model we elaborated in Chapter 3. While the normative case for central bank independence is clearly predicated on the import of economic assumptions to the domain of politics, and while particular institutional configurations require codification within the political process, the rational economics literature largely treats central bank independence - as a particular institutional strategy - as exogenous. The political-economy approach is predicated on the endogeneity of the political, and takes the political to a further dimension by positing that particular institutional configurations will be both reflective of, and sustained by, configurations of interest - societal coalitions - within that political-economy. This approach, we have argued, is premised on assumptions that are both pluralist and materialist - pluralist in the sense that policies will reflect the dominance of particular interests or coalitions of interest, and materialist in the sense that policies (particular institutional configurations) will be consistent with the economic interests reflected in those societal coalitions. And it is the fact of different economic interests that underpins the distinction between credibility and legitimacy. We do not argue that there is an exclusive nexus between financial actors and credible monetary policy - clearly trade union negotiators will be embarrassed by surprise inflations as much as any other price setter or negotiator with forward contracts. Credible monetary policy is as much a public good as one that meets the needs of sound finance in isolation.

However the issue for practical central banking is one of degree - low versus no inflation - and clearly other manifestations of the monetary policy transmission, for

example interest rates impacting on the cost of capital, and exchange rates on the competitiveness of the export sector, suggest that different economic interests will place differential weightings on, and be differentially impacted by the policy transmission process. More generally, there are clearly economic interests - labour, retail and domestic manufacturing for example - that will seek to maximise the growth potential of the economy. Financial actors may not welcome policy that tests the lower bounds of the 'natural rate' of unemployment, those representing employees on the margins of the labour market may. This distinction between the kinds of outcomes that will inform the preferences of financial versus non-financial actors is reflected in the distinction that we have drawn - after Coleman (1991) - between credibility, on the one hand, and legitimacy on the other. There are two dimensions to the notion of legitimacy as we have employed it. The central bank, and the conduct of monetary policy more generally will be perceived as legitimate where policy outputs and outcomes balance the need for stable prices with the needs of non-financial actors with real economy interests. Secondly, both the institution and the conduct of policy will be perceived as legitimate to the extent that the conduct of policy conforms with preferences regarding the nature of policymaking and execution within a liberal-democratic state. While the rational economics literature highlights the dangers posed by politically porous institutional arrangements, the political-economy approach identifies the emergence of a democratic deficit as problematic for the institutions of central banking. Central bank and policy legitimacy are informed by considerations as to the appropriateness of policy, and the appropriateness of policymaking. And clearly the formal elements of institutional governance may go to both - real economy interests may ensure that there is an appropriate balance in policy, and at the same time impart a sense of procedural legitimacy to policymaking. In this sense legitimacy evokes both substantive and procedural considerations.

As we noted in the conclusion to Chapter 3 the concepts of credibility and legitimacy are central to an understanding of the genesis and drivers of particular institutional configurations and of trajectories of institutional reshaping. To see them as the consequences of a particular institutional configuration or trajectory of institutional reshaping would be to deny the endogeneity of the political, and the relevance of the political economy. Moreover it would invite the kind of a historical analysis that historical institutionalism seeks to remedy. We have acknowledged that legitimacy and credibility may well enjoy a differential weighting within the political economy - but this reflects the fact that these qualities are made manifest as institutional attributes. These institutional attributes or endowments are manifest in particular, and verifiable qualities of institutional form - policy objectives and modes of governance in

particular. We would contend that the model elaborated in Chapter 3, and the evidence advanced in testing the propositions suggested by that model support the conclusion that, in a very real and substantive sense, the effectiveness of policy and the viability of institutional forms is a function of credibility and legitimacy. In the absence of 'credibility' there may be no remedy to the dynamic inconsistency constraint discussed in Chapter 2. In the absence of a mandate or charter that requires a central bank to factor short-run adjustment effects into the policy calculus, policy and institution may fail the test of legitimacy, calling into question the political viability of a given set of institutional arrangements.¹

The political-economy model that we elaborated in Chapter 3 situates the institutional in the political-economy, with particular institutional configurations and trajectories of institutional reshaping viewed as a function of the configurations of interests in that political-economy. However in seeking to account for a variety of possible institutional forms and policy trajectories within a single model we have argued that the approach adopted in this work represents a significant advance on approaches which have contrasted 'conflict and politicisation' approaches, on the one hand, and the 'state directed network' approach on the other. In essence the model we have advanced entertains both, and holds out the possibility that both of these approaches may be apposite to the study of a particular institution in an historical context. In terms of our distinction between equilibrium and disequilibrium conditions, where formal and informal aspects of the institution of the central bank result in an appropriate balance between credibility and legitimacy within a state directed network (including institutional reshaping realised through informal or extra-statutory processes), an equilibrium condition will obtain. A failure to maintain that equilibrium condition - whether by reason of a change in the underlying topography of the political-economy or a failure on the part of the existing institutional arrangements to accommodate change - will 'spill over' into 'conflict and politicisation', the disequilibrium condition. This distinction between an equilibrium and a disequilibrium condition underpins the propositions advanced at the close of Chapter 3 which have served to integrate the discussion in subsequent chapters.

We suggested in Chapter 3 that a simple bifurcation based on high and low scores for each of legitimacy and credibility suggests a fourfold system of classification. That system of classification, represented in Figure 3.1 suggests four discrete 'types' of central bank. It would be entirely possible to codify formal statutory arrangements

¹ Future research could however refine these concepts to the point of quantifying particular institutional attributes. A recent paper by Alan Blinder reports the findings of surveys of central bankers and macro and monetary economists examining the empirical criteria for central bank credibility (See Blinder, 1999).

within this kind of schema, and we would argue that an index reflecting both credibility and legitimacy considerations would be a significant advance on the indices of central bank independence that have tended to privilege credibility, and, insofar as they have factored in the issue of central bank accountability, have seen accountability as exclusively a subset of credibility.

The point of departure for this study is the marked differences in the formal statutory arrangements for the development and execution of monetary policy in Australia and New Zealand, and a static interpretation of those formal arrangements is very clearly suggestive of locations within the four-fold schema outlined above. A narrative confined simply to the formal elements of institutional form would be a narrative of difference. But the notion of reshaping is, by its very nature, an active one. The logic of institutional reshaping in Australia and New Zealand is, we have argued, a markedly different one, and reflects the underlying configuration of interests - private and public - within the political economy. Again the contrasting trajectories of institutional reshaping suggest a narrative of difference - a regime shift in New Zealand and a more evolutionary process of change in Australia.

The Reserve Bank of New Zealand Act 1989 represented a regime shift of paradigmatic proportions - an institutional change that in form and in substance was consistent with the tenets of rational-comprehensive policymaking. Moreover so far as the distinction between 'conflict and politicisation' and 'state directed networks' is concerned, a distinction which we have recast in terms of disequilibrium and equilibrium conditions respectively, the genesis and passage of the 1989 New Zealand Act supports the contention that a change of this kind will reflect both changes in the locus and distribution of power within the political-economy, and a government facing the prospect of electoral defeat and concerned to tie the hands of its successor. As the politics and policies of 'domestic defence' unravelled in the post 1984 period, so too did the political-economy that had sustained and been sustained by that paradigm. The political topography of the time is very much in evidence in the submissions made to the Finance and Expenditure Select Committee, and which we reviewed in detail in Chapter 5. Moreover the Reserve Bank itself, which had de facto since late 1984 enjoyed the kind of 'independence' codified in the 1989 Act was a significant actor in its own institutional reshaping. There is evidence of a shared policy and institutional world-view, of an epistemic community, but it was clearly a community that, while agreed on the theoretical rationale, differed (and not inconsiderably) on the detail of institutional form. The Reserve Bank of New Zealand was instrumental in its own reshaping, driving the process of policy formation, and, not insignificantly, mobilising

sufficient support within the government sub-structure of the state network to ensure that its own preferences as regards the detail of institutional form prevailed over those advocated by the New Zealand Treasury.

The fact that an incumbent government might wish to limit its own capacity for discretionary policymaking is, given the Downsian (rational choice) foundations of the rational economics case for central bank independence, conceptually somewhat problematic. The 'conflict and politicisation' accounts (e.g. Goodman, 1992) seek to remedy this by postulating that an incumbent government will act where it faces the prospect of imminent defeat and wishes to limit the capacity for discretionary action on the part of its successor. The model elaborated in Chapter 3 effects a synthesis of the 'conflict and politicisation' and 'policy networks' models. As such the 'imminent electoral defeat' thesis does not enjoy the same causal primacy in our model, as it does in some of the 'conflict and politicisation' accounts. The question as to why a government would seek to limit its own capacity for independent policy action is however an important one, the more so if one adopts the assumption of a Downsian political calculus. Moreover, the circumstances under which a left-party government would prosecute such a change are particularly deserving of consideration (notwithstanding the conceptual limitations of the 'left/right' taxonomy in the case of the fourth New Zealand Labour Party Government). The model we have elaborated illuminates the conditions under which that Government prosecuted the change, independently of the 'imminent electoral defeat' thesis, but there is much in the New Zealand case to support this latter line of argument - certainly by 1988/89 the fourth Labour Government was facing the probability of defeat in the 1990 election, and the public justification for the Act, captured in the political discourse of the time, was one predicated on the policy failings of Muldoonism, and the prospect for those failings informing the conduct of policy under future National Party Governments. The legislation codified in law that which was already de facto in place. In policy and operational terms, notwithstanding the credibility bonus attached to the successful passage of the legislation, the government of the day did not require a change in the statute. If it had, one would have expected the legislative change to have preceded the substantive shift in policy made shortly following the 1984 election.² The legacy of the

² One would however expect opposition parties to oppose the passage of legislation of this kind - something which did not happen in the case of the 1989 New Zealand legislation. In part this reflects the fact that the move to place the central bank on an independent footing came from the unexpected political quarter - from a left-party, albeit a party that acted in a manner inconsistent with standard social-democratic programmes. Secondly there is the fact, as we noted in passing in Chapter 5, that the vote within the National Party Caucus was very evenly split, and could well have gone against support for the Bill, but for the unexplained absence of one of the principal critics. Finally there is the possibility that in supporting the passage of the Bill some in the National Party Caucus entertained the prospect of exercising a greater measure of influence over the conduct of monetary policy than the architects of the

Muldoon era was an institution that arguably lacked both credibility and legitimacy - and an institutional framework from which the conduct of monetary policy was liberated in the post 1984 period. Seized with the opportunity to codify its de facto independence in a more durable form, the government of the day created the conditions for a significant reconfiguration of the domestic political-economy, and for a more independent political role for the central bank, and in so doing nurtured a critical mass of support for the kinds of legislative changes it moved to prosecute in 1988.

Moreover by zero-basing the process of institutional design the architects of the Act - within the Government and within the Bank - were able to draw on the prevailing institutional prescription, one that privileged operationally independent central banks tasked exclusively with the achievement and maintenance of price stability. For those architects - and the epistemic community of which they were a part - the principal objective was the restoration of credibility to the conduct of monetary policy. This is not to suggest that there was total and absolute disregard for considerations of institutional legitimacy - indeed, as we noted in Chapter 5 those most closely involved in the design of the Act were concerned to arrive at an institutional settlement that respected the rights of the legislature in a Westminster democracy - but, to the extent that legitimacy was a consideration, it was captured and disposed of in the contractual nature of the accountability regime, and not viewed as a consideration in designing either objectives or governance arrangements. The fact that the government of

Bill envisaged, or simply renegotiating the terms of the Policy Targets Agreement (PTA), as provided for in the Act.

It is noteworthy in this regard that within the National Government Cabinet the issue of the Reserve Bank's independence - evidenced in the specific provisions of the policy targets agreement - would resurface over the summer of 1991/92. Ruth Richardson recalls a paper by her Associate Finance Minister Wyatt Creech which advanced a number of criticisms of aspects of the macroeconomic policy mix at the time, and specifically lamented the failure to engender economic growth. Richardson also recalls that Creech was suggesting at the time that the Prime Minister and the Reserve Bank Governor also discuss the level of real interest rates and the exchange rate (Richardson, 1995: 130).

Former Reserve Bank of New Zealand Official Dr Arthur Grimes recalls a meeting in the Prime Ministers Office in January 1992 at which he, Reserve Bank Governor Dr Don Brash, the Prime Minister, Finance Minister Ruth Richardson, and Bill Birch were present

"... there wasn't anything formal to discuss and they really put the heat on to get monetary policy eased - It was the most blatant I ever came across and if it hadn't been for the Act I'm sure we would have. It was you know, 'things are not going well', Bolger's pulling his hair out and we said 'yeah, sorry there is a recession ... it will turn around and it's not monetary policy by itself it's a whole lot of other things as well and it won't be helped if we suddenly change course' ...but there was an enormous heat put on us at that meeting to ease monetary policy by Bolger ... Richardson didn't want to change ... I'm pretty sure she was there ... Bolger's the one I remember, he really put the pressure on to try change. Because you see he had never been in favour of the Act in the first place. He was still leading a government in which there wasn't a lot of support for it at the time ... at that stage it was far from safe. You know, I went away from that meeting there was a good chance that he would try and introduce some changes to the Act" (personal interview, 1998).

the day retained the right in statute to provide the Governor with policy targets, and, in limited circumstances, to override the principal objective, was viewed as sufficient. The dominant economic interests demanded credibility in the conduct and substance of policy, and the Bank, concerned to administer a further circuit breaker to inflationary expectations, was also driven by this imperative. The rational economics literature suggested that credibility could be enhanced through the appointment of a conservative central banker - and whatever his views on the ultimate objectives to which public policy might be directed - Don Brash was technically a conservative and orthodox central banker. The literature also suggested that operational independence coupled with goal dependence constituted institutional best practice, and in the context of an environment in which the institutions of the New Zealand state were being progressively reshaped according to the tenets of agency theory, the vehicle of a contract between the government, as principal, and the central bank Governor, as agent, was one readily at hand. The de facto changes in the post 1984 period shifted the Bank, and the subsequent codification of those changes in 1989 were informed by the quest for credibility, and the form of the new institution reflected this. In 'credibility/legitimacy' space the Bank's stock of credibility had appreciated. The changes effected a movement up and out in 'credibility/legitimacy' space - the credibility deficit had been addressed, but the issue of institutional and policy legitimacy had not.

Our model suggests however that the optimal equilibrium condition is one in which both credibility and legitimacy are optimised. In Chapter 2 we noted some important caveats to the normative rational economics case for central bank independence, including the possibility that in designing or shaping the institutions of central banking there is a risk that the pursuit of low inflation may militate against an appropriate balance between this objective, and other policy objectives, including macroeconomic stabilisation over the short and long-run. Hence the argument, in part, that central bank independence requires accountability - independent central banks need to be held accountable for reaching, and over-reaching their contracted objectives. In this context the issue for those responsible for the shaping of the institutions of central banking is effecting an appropriate balance between credibility and legitimacy, and the risk is one of the former militating against the latter. It is our contention that this risk is present in the New Zealand institutional arrangements - that contention is supported a priori on theoretical grounds, and, as we shall argue below, is suggested by the preferences of New Zealand's central bankers - who have either focused on credibility at the expense of institutional legitimacy, or have assumed that the latter is an automatic consequence of the former. In short, while the New Zealand arrangements in the early 1980s lacked

both credibility and legitimacy, the post 1984 changes addressed the deficit in the former, but failed to address the latter. Moreover by risking a deflationary bias to the conduct of policy, they presaged the possibility of a further diminution in an already depleted stock of legitimacy.

The Australian Labor Party Government of 1983 inherited a set of institutional arrangements in which the stock of institutional credibility and legitimacy was relatively higher than that which obtained in New Zealand in July 1984. We have noted the fact that the institution of central banking was subject to a searching evaluation through the Campbell Committee Inquiry into the financial system, the report of which recommended the liberalisation of the finance sector and presaged the floating of the Australian dollar, and, in reference to the Reserve Bank of Australia, recommended the retention of the institutional status quo. As a number of our respondents noted, the float was to have the effect of significantly increasing the operational independence of the Reserve Bank of Australia, within the context of the existing statutory arrangements. Moreover because the ALP/ACTU Accord was developed quite consciously as an alternative to both the monetarist project of the Fraser Government, and the policy excesses of the Whitlam era, the threshold test of policy credibility - evidenced in the commitment to pursue low inflation - was viewed by the Accord's architects as a critical one. The statutory arrangements - and in particular the Bank's dualist charter and representative board structure - ensured that the relationship between institutional credibility and institutional legitimacy amounted to a positive sum game. In the post-Campbell era, and with the added credibility attendant upon a floating exchange rate, the Australian arrangements were characterised by high endowments of both credibility and legitimacy.

Whatever the endowments at the start of the thirteen year period of Labor Party Government in 1983, the subsequent contest for the Australian central bank was one predicated on the allegation of an acute credibility deficit. We have rehearsed the case for radical institutional change - along the lines of the New Zealand model - in previous chapters. That case reflected elements of the formal statutory arrangements, which, as we have noted conspired to produce a low score on the standard indices of central bank independence. These indices, as we have already noted were one element in the rational-economics case for central bank independence, a case which was given practical embodiment in the 1989 New Zealand Act. The intellectual climate of the times was one that privileged an institutional model in which central banks focused exclusively on price stability, and in which operational independence from government - and indeed the implementation of monetary policy clearly at variance with the

political interests of incumbent governments - was held to be virtuous. In a climate in which the quest for low inflation was the only game in town, a central bank tasked to deliver multiple objectives - governed by a Board, membership of which on the part of financial actors was specifically precluded (and which included a 'representative of the Treasury'), and enjoined to develop and implement policy in consultation with the government of the day, was a central bank that 'invited' a credibility deficit - particularly in those centres in which the assumption was one of a direct correspondence between statute and behaviour (which was, after all what standard text book accounts implied). In short, the intellectual climate of the times conspired to suggest a zero-sum game as between institutional credibility, on the one hand, and institutional legitimacy on the other.

In such a climate the statute itself risked the appearance of a credibility deficit - the perception that the Australian institutional arrangements were politically porous was further encouraged by the imprudent remarks of politicians who claimed to be able to influence the conduct of monetary policy. As we have noted such politicians were, in the words of the Reserve bank Governor of the time, 'chastised' for these observations, and may well have regretted them, but while, within the domestic environment financial actors may have been inclined to dismiss such observations as evidence of a systemic hubris, within overseas markets such comments merely served to reinforce the appearance of a weakness in institutional design. Keating's remarks were seized upon by his political opponents, and appeared to confirm the assessments of those who viewed the Australian arrangements through the prism of the Act, and from a distance. While there was little, if any evidence of direct political involvement in the conduct of monetary policy decision making, and, if anything evidence that 'political considerations' influenced the Board of the Bank to time policy changes specifically to avoid the appearance of political influence, a prevailing view - particularly in off-shore markets - was one of a politically porous set of institutional arrangements, and of an increasingly acute credibility deficit. From 1988, with the introduction of the Reserve Bank of New Zealand Bill into the New Zealand Parliament the Australian arrangements would increasingly be assessed - and found to be wanting - against the institutional best practice of the New Zealand model. And for their part New Zealand's central bankers were happy to point out the superiority of the New Zealand arrangements as compared to those in Australia, including to opinion leaders in off shore financial centres. The Australian arrangements were perceived by some, and represented by others as carrying a credibility deficit.

In the post 1983 period the Bank had managed to maintain a stock of legitimacy notwithstanding that from time to time the exhortation to 'Blame Martin Place' was accepted by a public concerned at the Bank's role in producing and prolonging the 1989/91 recession. That legitimacy derived in part from formal aspects of the institutional arrangements - the charter and the Board - and from Fraser's capacity to cast the nature of the monetary policy project in a manner which resonated with the preferences of real economy interests and the public at large. Notwithstanding Bernie Fraser's tendency to 'act tougher than he talked', it is clear that his capacity to cast the monetary policy 'project' within a wider context served to secure a measure of legitimacy for the Australian institutional arrangements.³ This is not in any way to reduce the institutional or aspects of the conduct of monetary policy to the preferences of an individual, or indeed to deny that Fraser quite consciously prosecuted a particular approach to the institutions and practices of monetary policy. In one sense, the political-economy of monetary policy and the institutions of monetary policymaking in Australia is a story of the ascendancy of one prescription of institutional reshaping over another.

We have considered the influence of the personality and preferences of Reserve Bank of Australia Governor Bernie Fraser. There can be little doubt that within some quarters Fraser's views on monetary policy and institutional design only served to increase concerns over the credibility of the Australian model. From the vantage point of the final year of the twentieth century the risk of deflation is perceived as more pressing than that of inflation, and in which some central bankers appear willing to test the limits of the NAIRU and entertain a measure more 'exuberance' in equity markets than might hitherto have been tolerated, Fraser appears to be relatively mainstream. While the benefit of hindsight might support the observation that Fraser was, if anything, ahead of his time, in the context of the late 1980s and early 1990s in which the intellectual climate of the times was such as to privilege orthodox central bank independence, Fraser's defence of the institutional status quo, his support of the ALP/ACTU Accord, and his obvious empathy with the mission and personality of Paul Keating marked him, in some quarters at least, as decidedly suspect.

Competing approaches to the reshaping of the Australian institution sought to address a credibility deficit - the specific placement of the Australian arrangements in 'credibility/legitimacy' space differed across different interests - domestic and

³ One respondent suggested that Fraser became something of an 'icon' within the wider community - (evidenced in the fact that Sydney taxi drivers claimed either to know him, or know of him). This ability to speak to a wider audience - a sense of legitimacy with ordinary people - became a powerful weapon when the time came to putting up interest rates - 'he could go to all these people - he was seen as someone who, if he said that it needed to be done, then it had to be done.'

international - and at different times. Objectively the Australia/US bond rate differential, considerably narrowed by the Costello/Macfarlane exchange of letters, was taken as evidence of a credibility deficit. The contest for the central bank was one between two competing trajectories of institutional reshaping - one advanced by the political right, with support from some in the finance sector and the media, sought to replicate the New Zealand model; the other sought to effect an increase in credibility without any consequential diminution in the legitimacy of the institution. The contest for the bank reached its zenith following the release of the Liberal-National Coalition's 'Fightback!' manifesto in 1991. While at the political level the appearance of a politically porous and suspect set of institutional arrangements provided an immediate rationale, within the context of the overall programme countenanced by the Opposition at that time credibility was of fundamental importance. In an environment in which an incoming government would have been seeking to ensure that the impact on the price level of the introduction of a broad based consumption tax was one-off, and in circumstances in which wages outcomes would no longer be guided through a quasi-corporatist incomes agreement, the central bank was positioned to assume the role of containing price pressures in the product and in the labour market - so far as the latter was concerned the discipline was to be provided by a central bank independently tasked to deliver price stability, and to do so whatever the consequences in terms of output and employment effects. No longer enjoined to deliver multiple objectives and tasked to deliver and maintain price stability, legitimacy was no longer a factor - it mattered only that the central bank would be perceived to be credible in the face of any challenge to its mandated objective. The Coalition failed to win the 1993 election and the Reserve Bank of Australia Act was, as a consequence not amended along the lines of the New Zealand model. But the process of institutional reshaping continued over the remaining three years of the Keating Government, and into the first year of the incoming Howard Government. As our model would suggest, having moved to a position where both legitimacy and credibility have been optimised, the reshaping of the Australian central bank has resulted in a position of relative equilibrium, manifested in part by a bi-partisan policy settlement. The changes effected a movement to the right in 'credibility/legitimacy' space, with endowments of both maximised.

Two elements of the on-going institutional reshaping were particularly significant. The first of these was the development within the Bank of an inflation target - the target of an annual rate of inflation of between 2 and 3 per cent over the course of the business cycle. As we have noted, the target was one that was imported into the later versions of the ALP/ACTU Accord agreements. The development of an inflation

target was seen as mitigating the deleterious consequences of the credibility deficit, while at the same time being consistent with the maintenance of the dualist approach suggested by the Reserve Bank charter. The second, which in combination with the change of government and changes in fiscal policy resulted in a narrowing of the bond rate differential, was the agreed statement on the conduct of monetary policy embodied in the Costello/Macfarlane exchange of letters. From the vantage point of a number of those in the Bank, including Board members, the exchange of letters served simply to codify that which the Bank had already de facto put in place. In this sense the vehicle used to 'announce' the reshaping - the exchange of letters - provided an expedient by means of which the markets' appetite for 'theatre' was assuaged.

If we represent the trajectories of institutional reshaping in 'credibility/legitimacy' space the stylised pattern that emerges is represented in Figure 9.1.

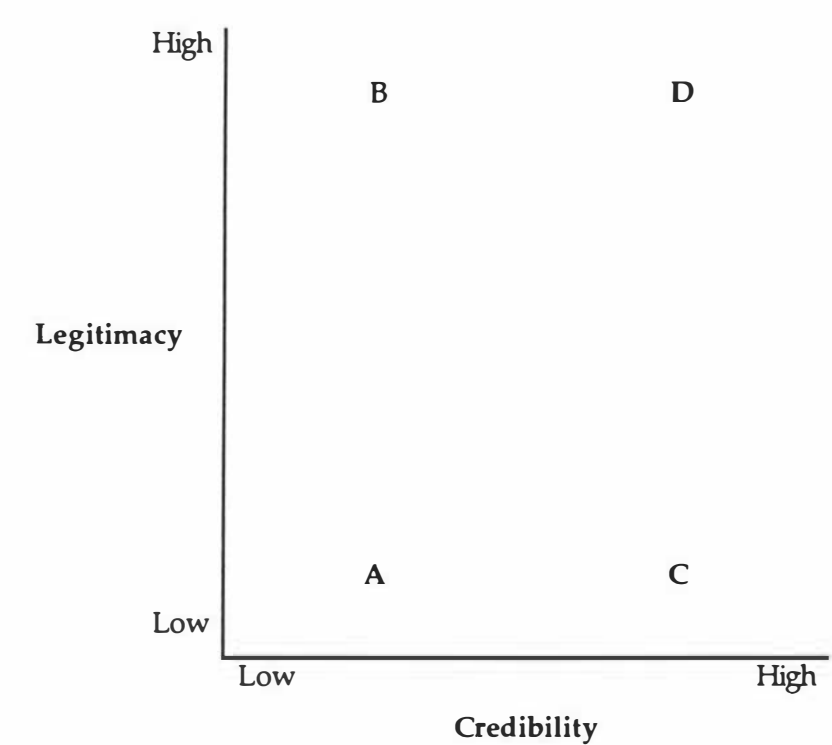


Figure 9.1 Reshaping trajectories in credibility /legitimacy space

Clearly points A - D in 'credibility/legitimacy' space correspond with the four-fold typology introduced in Chapter 3. While the analysis of the two cases took as its point of departure the fact of institutional difference, and while the narrative has been one that has illuminated quite significant differences in the trajectories of institutional reshaping within each, the tendency, as our model implies, is towards convergence in

the optimal quadrant. We would argue that the Australian arrangements were located at point D in the period immediately following the implementation the Campbell Committee recommendations. By contrast we would locate the New Zealand arrangements at point A - low on both legitimacy and credibility. In Australia the movement is from D to B, a movement (or the perception of a movement) reflective of the political and statutory elements we noted above.

In the post 1984 period New Zealand moves from A to point C - high on credibility, but carrying a legitimacy deficit - and the contest within Australia can be represented as between those wishing to preserve the status quo (some of whom would not have accepted that any loss of credibility had occurred), and those seeking to move the Australian arrangements to point C. In effect the 'Fightback!' prescription and the 1993 election campaign were about the merits or otherwise of effecting a movement to point C. Subsequently the Bank itself, through its development and articulation of an inflation target, together with an incoming Government willing to exploit the credibility potential of an 'exchange of letters', combined to effect an adaptive movement back to point D.

The model allows us to map movements over time in 'credibility/legitimacy' space, but it is also predicated on the assumption that such movement will be a function and reflection of the underlying configuration of interests within the political economy, and that, assuming a representative distribution of financial and real economy interests within the political economy, the imperative will be towards the equilibrium condition - Type 4, or at point D. If we are correct then we would expect to see some pressure emerging within the New Zealand political economy for a movement towards the equilibrium condition, a movement which would imply a tendency towards convergence.

From difference to convergence?

The reshaping of the institutions of central banking in Australia and New Zealand has been characterised by two markedly different trajectories, underpinned by particular configurations of interest within the political economy. The model we have advanced however implies that the requirement to optimise both credibility and legitimacy will impart a bias, over time, towards the optimal equilibrium condition. If this is the case, and if, as we have argued the trajectory of institutional reshaping in New Zealand has privileged credibility over institutional legitimacy, then we would expect, progressively

to detect some measure of institutional disequilibrium, and - assuming that the present institutional arrangements are both a source of that disequilibrium, and constrain the capacity of the Bank to effect a managed (or adaptive) resolution - evidence of that disequilibrium manifesting itself within the political domain. Two questions are raised, firstly the extent to which the existing New Zealand arrangements privilege considerations of credibility over institutional legitimacy (and may therefore impart a deflationary bias to the conduct of monetary policy), and, secondly, the extent to which any resulting disequilibrium has manifested itself in proposals to revisit the institutional status quo - to further reshape the institutions of central banking in New Zealand.

Questioned on the challenge posed in reconciling, what we have characterised as the need to optimise both the credibility and the legitimacy of monetary policy, Governor Don Brash affirmed that, "credibility and legitimacy are the things you want but you don't want to get legitimacy at the cost of credibility" (personal interview, 1998, emphasis added). And Brash did suggest, in his use of one particular illustration, that policy credibility was the first-order requirement:

"I remember in 1990 when this framework had been in place in a formal sense for only a few months and policy was pretty tight and unemployment was going up. I remember Ken Douglas who even then was President of the CTU [the New Zealand Council of Trade Unions] signed an article - whether he wrote it or not I don't know, but he probably did - had an article in The Dominion which basically said 'this Reserve Bank Act is mad. The Reserve Bank is in the hands of a bunch of obsessed idiots and they're driving the economy down the gurgler' - I'm paraphrasing now of course, 'but unfortunately as long as those madmen are running monetary policy, we in the unions have no choice but to adjust our wage demands to that'. Now my public relations people at the time were very distressed by this article - we were described in extremely uncomplimentary terms and I said look, it doesn't matter if people think we're a bunch of uncaring so-in-so's. The important thing is they adjust wage demands to the inflation target which we have been set by the government and as fast as that adjustment takes place the smaller the unemployment cost of getting there. Everyone accepts that unemployment costs will reduce the inflation from 15 to one but the way we minimise that is to obviously encourage people to believe you are going to deliver it so people adjust their behaviour so I ... yeah, there is a short term trade off - how do you minimise that? By convincing people that you are serious about getting there" (personal interview, 1998).⁴

⁴ Arthur Grimes recalls the reaction at the time:

"We were delighted when we saw it ... I think we all had the same thing, look these guys they don't like what we're doing, but they knuckled down. So at that stage we talked to them a lot. They knew we meant business at that stage. Before hand they never knew if we meant business, I think, and so therefore the wage demands were coming in at 7 percent well it just seemed to be the thing to do - it would be validated by the monetary authorities - the manufacturers thought that, the unionists thought that so everyone acted in that way, so it was self perpetuating, finally they realised, no that's not the way the world is" (personal interview, 1998).

Clearly in the name of **managing** expectations the bank has afforded a primacy to credibility over legitimacy. But the Bank would deny that, by its very nature the New Zealand arrangements impart a deflationary bias to the conduct of monetary policy. Invited to comment on Stanley Fischer's observation that exposing central bankers to public scrutiny was an important check against the development of a deflationary bias - that, "[s]hielded as they are from public opinion, cocooned within an anti-inflation temple, central bankers can all too easily deny - and perhaps even convince themselves - that there is a short-run trade-off between inflation and unemployment, and that cyclical unemployment can be reduced by easing monetary policy" (1994: 293, emphasis added), Don Brash couched his response in terms of the contrast between recent Australian and New Zealand contributions:

"...my response to that, is the one I used to say to Bernie Fraser. And Bernie used to say 'look any twit can get inflation under 2%'. I said 'Bernie you're right. Of course any twit can get inflation to below 2%. It isn't my job. My job is to get it below 2% and above zero'. And that's a much tougher proposition and that to my mind is my response to Stanley [Fischer], that I dare not just keep tightening and tightening and tightening because I can argue that it doesn't matter what the unemployment costs are and the real economy costs. I dare not tighten too far. And I mean as you know if you look at the track record, the point that Gareth Morgan keeps pointing out, we haven't been in the bottom half of the target range I don't think ever since we got within the target range in 1991 so it would be awfully hard to argue that we've had a deflationary bias over the last little while and if our projections are right. And who knows, we won't be in the bottom half of the target range even though the target range has been widened and the target at mid point has been raised, any time between now and March 2001 - so it would be pretty hard to argue that we've shown a deflationary bias" (personal interview, 1998, emphasis added).

Moreover Don Brash expressed little sympathy for the kind of argument advanced by former Vice Chair of the United States Federal Reserve Alan Blinder, who in supporting the US Federal Reserve's dual mandate has suggested that it is appropriate both on the grounds of legitimacy, and sound monetary policy practice:

"... the argument for the dual mandate is both straightforward and convincing. The central bank exists to serve society. The public cares deeply about fluctuations in the pace of economic activity. And well-executed monetary policy has the power to mitigate fluctuations in employment. As the mathematicians say, 'QED'. Fortunately, almost all central bankers accept this argument nowadays, notwithstanding a great deal of misleading rhetoric to the contrary" (Blinder, 1996: 8).

Given that the preferred Blinder approach would seem to be at variance with an institutional arrangement privileging price stability to the exclusion of any other objective, Don Brash was invited to comment on the Blinder argument. He responded by suggesting that:

"I don't think I would see the distinction as clearly as he implies in this statement ..." (personal interview, 1998);

and went on to observe that,

"... the point I have tried to make ... if you are focused on price stability the sort of distinction made between stabilising output and stabilising inflation I think is a somewhat artificial one in most circumstances ... we certainly have an output gap as now intrinsic to our inflation forecasting approach because output running at less than capacity, all things being equal ... is going to tend to reduce inflation and vice versa, so I think the two are closely related. Now there are plenty of circumstances where they might not be related and in our own case some of those are allowed for through caveats which in effect quite explicitly allow for greater variability in inflation in order to reduce variability in output. I guess the one situation where they would be in sharp contrast is if for some reason you have a shock to inflationary expectations and you had pricing and wage setting behaviour consistent with a 7% inflation rate and you were targeting one percent of inflation rate and clearly you would have monetary policy tending to produce some down-turn in output and some down-turn in employment as the price of reducing inflation ..." (personal interview, 1998).⁵

⁵ Brash took the opportunity of an address to the Auckland Chamber of Commerce on the 20 April 1998 to respond to the criticisms and commentaries that had followed the March 1998 easing in monetary policy, and to reassert the appropriateness of the Bank's exclusive focus on price stability:

"Monetary policy aimed at stable prices assists growth in output and jobs by helping the price system, which is at the heart of the market economy, work more effectively.

And monetary policy aimed at stable prices assists the economy by helping to smooth business cycles. Ah you say, he admits it: the Reserve Bank is using monetary policy to try to smooth the business cycle. No, I am not saying that at all. What I am saying is that when monetary policy is aimed at delivering stable prices it has the ancillary benefit that the business cycle may be smoothed to some degree also. Why? Because the situations where inflationary pressures are increasing are by their nature situations where demand in the economy is running ahead of the economy's long-term capacity to supply, so that monetary policy aimed at restraining those inflationary pressures inevitably tends to dampen down booms. And conversely, those situations where demand falls short of the economy's long-term capacity to supply are usually situations where inflationary pressures are falling towards zero, so that monetary policy aimed at preventing inflation falling below zero (as required by my agreement with the Treasurer) tends to work to mitigate those downturns" (Brash, 1998).

A similar argument was also advanced by Arthur Grimes, who suggested, nonetheless, that a wider target range would enable what Don Brash referred to as the 'ancillary benefit' benefit to be somewhat more readily delivered:

"... if you've got a situation where inflation is low and unemployment is cyclically high and therefore you are going to relax monetary policy because inflation is at risk of going out the bottom end of your target range or the bottom end of your target range, and therefore your monetary policy response to that slackness of demand, because that is what it is a lack of demand, is going to be the same whether you are targeting inflation or cyclical unemployment - you are going to relax monetary policy in that situation to allow inflation to increase back to the middle, or within your target range. Now that is another reason why I would probably favour a slightly wider range implicitly because it gives you a little bit more freedom to do that but I think it is still far more preferable to be couching it in terms of your reacting to the lack of demand putting downward pressure, on than to a cyclical rise in unemployment. Because as soon as you try and get to say that the central bank will react to a cyclical rise in unemployment,

In effect, for New Zealand policymakers the argument is that there is such a correspondence between inflation and real economic activity that any targeting of the former will have the ancillary benefit of smoothing cyclical variations in the latter. While credibility of policy has enjoyed primacy over considerations of institutional and policy legitimacy, the present institutional arrangements are not perceived as imparting a deflationary bias to the conduct of monetary policy. Indeed, in assessing the political durability and security of the present institutional arrangements Reserve Bank of New Zealand insiders conflate credibility and legitimacy, and use a common measure for both. In essence, the logic would have it that if any real prospect emerged of a revisiting of the New Zealand arrangements, a credibility deficit would start to accrue, and this would be reflected both in interest rates and expectations of future inflation. Reserve Bank of New Zealand Communications Manager Paul Jackman observed that:

" ... I suppose in practical terms if people think it's legitimate they'll certainly think it's credible and part of credibility comes from a perception that it's politically durable. Clearly if you had substantial sections of the community wanting to tear down the framework that would be reflected in interest rates, wouldn't it? There would be a risk premium" (personal interview, 1997).

But this logic would only hold if the assumption is that any change to the existing institutional arrangements would indeed prejudice the Banks capacity to maintain price stability and corrupt the integrity of the existing targets, an assumption that is at least arguable. To the extent that financial markets operate across national boundaries - and given that the Australian arrangements no longer bear the weight of the credibility deficit - there is no reason to suggest that the prospect of an institutional change would necessarily result in a significant loss of credibility, manifested in higher interest rates and inflationary expectations. Indeed the markets' reaction to the breaches of the Policy Target Agreement range in 1995 and 1996, and on which we commented in Chapter 8, suggests that a loss of credibility only accrues when that which is breached is indeed credible.

We have argued that particular institutional configurations reflect configurations of economic interest within the political economy. The passage of the 1989 legislation reflected the ascendancy of finance and farming over manufacturing and labour interests. There is some evidence to suggest that, within the New Zealand business

when unemployment rises for a non cyclical reason people will say 'you should be reacting to it', whereas all the other pressures, demand or what have you, are showing it that it's not that - well how do you convince the public or the government or anything else? They can't tell the difference between cyclical or structural unemployment. ... obviously the target range, the smaller it is the less room there is for any leg room what so ever. The wider is the room the more, so you don't want to leave it too large, because it is not really a target, but if it's too narrow ..." (personal interview, 1998).

community there has been some redefinition of preferences in the period since the passage of the 1989 legislation (Cronin 1997a, 1997b).

We have suggested that the absence of an institutional capacity, or political willingness to accommodate changes within a state directed policy network will result in an agenda for change surfacing within the formal political arena. There is evidence to suggest that at the level of the political articulation of interests, there is support for a revisiting of the formal institutional arrangements.⁶ The bi-partisan support for the Reserve Bank Act that was evidenced in its passage in 1989 is no longer so clearly in evidence, reflecting in part a greater diversity in political organisations with a larger number of parties represented in a Parliament which since 1996 has been elected under a Mixed Member Proportional (MMP) electoral system. In the 1996 election the New Zealand First Party - which was to be part of the governing coalition as a result of the election - campaigned on a platform that included the amendment of the Reserve Bank Act. While the Act was not amended (indicating a capacity on the part of the state directed network to accommodate the kinds of pressures represented by New Zealand First policy), the Policy Targets Agreement was however renegotiated following the 1996 election. The new PTA, signed on the 10 December 1996 made two substantive changes. The first went to the wording of clause 1, with the amended clause providing that:

"Consistent with section 8 of the Act and with the provisions of this agreement, the Reserve Bank shall formulate and implement monetary policy with the intention of maintaining a stable general level of prices, so that monetary policy can make its maximum contribution to sustainable economic growth, employment and development opportunities within the New Zealand economy" (emphasis added).⁷

⁶ Interviews with Malcolm Bailey, President of Federated Farmers, and Simon Arnold and Peter Crawford of the Manufacturers' Federation evidenced support for the retention of the Reserve Bank Act. The New Zealand Council of Trade Unions continues to advocate significant changes to the Act, and there are dissenters from the official view with the business community, most notably former Fletcher Challenge CEO Hugh Fletcher (Personal interviews, Bailey, Arnold, Crawford, Harris, Fletcher 1998).

⁷ The Governor commented on this change in releasing the Monetary Policy Statement on the 17 December 1997:

"Clause 1 of the Policy Targets Agreement ... makes it clear that the Bank is required to maintain 'a stable general level of prices, so that monetary policy can make its maximum contribution to sustainable economic growth, employment and development opportunities within the New Zealand economy.' Some people have expressed surprise that I was willing to sign a PTA which explicitly refers to growth and employment. On the contrary, I welcome the fact that the PTA makes explicit what was previously only implicit, namely that price stability is valuable not only for its own sake but also for the contribution that it makes to growth and employment. Too often people assume that there has to be some kind of trade-off between inflation on the one hand and growth and employment on the other. On the contrary: by protecting the purchasing power of the nation's money, monetary policy promotes the creation of wealth and jobs. I am determined that we in the Reserve Bank of New Zealand will do that to the very best of our ability" (Monetary Policy Statement, briefing notes to media, 17 December

The second change widened the target range from 0 - 2 percent, to 12 monthly increases in the CPI of between 0 and 3 percent.⁸

Whatever the extent of the bi-partisan settlement that accompanied the passage of the 1989 legislation, there are signs that, within the new configuration of parties represented in the New Zealand Parliament, that settlement no longer exists, and there is some measure of agreement on the centre-left of the political divide that the present arrangements require revisiting. For its part The Alliance - a party typically located to the left of the New Zealand Labour Party on the orthodox spectrum - has consistently advocated the replacement of the 1989 Act, and, while the Labour Party continues to support the retention of the Act, that support is now tempered by publicly expressed reservations about the conduct of monetary policy, and a desire to institute a review of the conduct of policy. In a detailed analysis of the conduct of monetary policy published in July 1998, The Alliance identified a number of deficiencies in both institutional and operational elements of monetary policymaking and implementation. That analysis argued that the weakness of the New Zealand economy over the period from late 1994 was attributable to domestic factors, specifically the conduct of monetary policy by the Reserve Bank of New Zealand, and not to adverse international circumstances. In particular, The Alliance identified the exclusive focus on price stability, the 'very low' target specified in the Policy Targets Agreement, and the "preference of the Governor of the Reserve Bank for ultra-low inflation"(1998: 2).⁹

1996).

⁸ In an address delivered on the 23 January 1997, the Governor commented on the new target:

" ... I think it is crucially important that nobody misunderstand what the Reserve Bank is doing. Let me be absolutely clear. The Reserve Bank has not gone soft on inflation. We will not be targeting an inflation rate of 3 percent, or even an inflation rate close to 3 percent. The Reserve Bank will be striving to keep inflation well inside the 0 to 3 percent range, and we best do that by trying to have inflation as close to the middle part of the range as possible" (Brash, 1997).

The sense is of a contest between the imperatives of credibility and legitimacy - with the Bank concerned to reassure that markets that a concession to the former in no way detracted from its commitment to the latter.

⁹ The Alliance summarised the faults of the present policy regime as follows:

" (a) Its inflation target (with a mid-point of 1.5%) is unrealistic for overall economic stability.

(b) It has failed to achieve monetary stability on all measures (i.e.. interest rates, the value of the NZ dollar, money supply and credit growth, asset price inflation) other than the rate of CPI inflation.

(c) It relies excessively on high interest rates and a high exchange rate (price-based measures) to achieve its inflation target, and shuns the use of quantitative monetary control instruments (such as reserve assets ratios and open market operations).

(d) Its policies underpin a permanently high rate of unemployment.

(e) In relation to the balance of interests between lenders and borrowers, it favours lenders of

To this end, the Alliance argued, the Reserve Bank Act 1989 should be repealed, and replaced with an Act requiring the Bank to:

" ... [a]dopt a more balanced monetary policy objective, which should be to promote New Zealand's economic well-being by maintaining a stable monetary system and minimising actual and potential conflicts between the monetary system and the real economy, whether arising from inflation (in asset prices as well as goods and services prices), inappropriate changes in the value of the New Zealand dollar, inappropriate money supply growth or an inappropriate interest rate structure" (1998: 41).¹⁰

The policy position advocated by the Alliance is of the kind that would be expected from a party representing interests on the centre-left of the political spectrum. If we accept the rather crude premise that parties of the centre-right will typically advance the interests of 'sound finance' and those of the centre-left, real economy interests (and, in the case of the Alliance specifically, wage and salary earners at the lower income end of the spectrum) it is entirely logical to expect a preference for monetary policy objectives and techniques which place a premium on maximising levels of domestic economic activity, and optimising employment prospects in particular. However it is noteworthy that the macroeconomic objectives which the Alliance suggests should inform policymaking generally are, in the main, not qualitatively different to those that would be advanced by most governments within the industrial democracies. Where the policy represents a significant departure from the orthodox is less in the nature of the targets per se than in the priority attached to policy co-ordination, with multiple instruments being deployed for multiple objectives.¹¹

money over borrowers by providing them with both very high interest rates and near-zero inflation" (1998: 41).

¹⁰ An alternative approach to monetary policy, the Alliance suggested would be,

" ... co-ordinated with social, environmental, fiscal and economic development policy with the aim of achieving a number of inter-related economic goals simultaneously, i.e. annual growth in per capita GNP of around 1.5% (implying long-term GDP growth of around 3%); a maximum balance of payments current account deficit of around 3% of GDP; fiscal balance over the economic cycle; full employment; real income growth to match productivity improvements (across the whole economy); a moderate (1-4%) rate of inflation; equity in income distribution; infrastructure development to match population needs and the growth of the private economy; protection of the eco-system and sustainability in the use of natural resources" (1998: 41).

¹¹ That said, the Alliance policy is of further interest, both for what it says, and what it omits. In terms of the former, there are resonances with the tenets of an orthodox 'monetarism' in the recommendation to develop and operate targets for money supply and credit growth, the use of these instruments having fallen into disrepair, if not disrepute, in the period following financial deregulation when the relationship between monetary aggregates and economic activity started to break down. In terms of the latter, the Alliance policy is surprisingly quiet on issues of governance and accountability. While the policy expressly indicates support for an alternative charter, it implicitly foreshadows the continuation of some kind of regime in which policy targets are expressed in some detail, but fails to elaborate on the means by which the Bank, a governor, of the government of the day would be held accountable for the realisation of a new charter or objectives. That being the case, the policy is open to the critique that the proposed regime is premised on less independence for the Reserve Bank. There is no mention of the role that might be played by contractual vehicles akin to the present Policy Targets Agreement, nor of the respective roles

In Opposition since 1990 the Labour Party has maintained a consistent policy of support for the retention of the 1989 legislation. Over the course of 1998 however that policy was modified as the Labour Party increasingly focused its attention on the need for a policy mix more accommodating of higher levels of economic growth. In a speech on 18 August 1998 Labour Finance spokesperson, Michael Cullen observed that,

"... the most crucial element in the macroeconomic framework is to seek to maintain an exchange rate which enables New Zealand businesses to be internationally competitive.

The operation of monetary policy over recent years has not delivered that" (Cullen, 1998a: 8).

Cullen went on to suggest that in seeking to facilitate an average annual rate of economic growth of four per cent, "... [i]ndustry policy, trade policy ... will all help. But if the operation of monetary policy leads to the exchange rate taking off as soon as growth picks up again then those other efforts we undertake will be substantially nullified" (Cullen, 1998a: 8).

The import of these observations is two-fold, the implication being there is the risk of monetary policy being too risk-averse, and/or informed by a target which privileges pre-emption over a 'cautious expansionism'; and of monetary policy being operated with insufficient regard to the overall objectives of economic policy, and the contributions of other policy instruments. Cullen reaffirmed the commitment of the Labour Party to the retention of the Reserve Bank Act, and the focus on price stability, but tempered this support with the observation that,

"... we accept the need for the Bank to manage monetary policy in such a way that in achieving its price stability target it takes account of the impact of its actions on the real economy, particularly the exchange rate. We also argue very strongly for a full, independent review of the operation of monetary policy, particularly to ensure that the Bank has available to it, and is using, the full range of policy instruments consistent with supporting the achievement of the overall objectives of economic policy" (1998a: 9).

In a speech to the Wellington Regional Chamber of Commerce on the 18 November 1998, Michael Cullen again returned to the issue of monetary policy:

"We must also maintain a sound approach to monetary policy. That means not abandoning the Reserve Bank Act. But it does mean reviewing the policy targets

of governor, Board, Ministers, or Parliament's Finance and Expenditure Committee in an alternative regime. Given that one of the defining features of the present regime is the use of a manifestly public process of target setting (and departure from contracted targets) and extensive monitoring and reporting mechanisms, the absence of any comment on governance and accountability is surprising.

agreement and the operation of monetary policy to achieve far better and more consistent outcomes than we have seen over the last few years The tradeables sector cannot be crucified on the cross of the financial sector's demands for unattainable and extreme levels of certainty. I welcome the fact that there is now some sensible debate coming from within that sector on the operation of monetary policy. For too long it was simply treated as a litmus test of economic rationalism" (1998b, emphasis added)¹².

And within the print media editorial opinion has supported a revisiting of the New Zealand arrangements. In an editorial on 8 October 1998, the Wellington daily The Dominion (traditionally supportive of the trajectory of the post-1984 reforms) took the Reserve Bank to task, suggesting that its forecasting record had been 'abysmal', and that the Bank's caution risked accentuating the amplitude of the economic recession:

"The caution from the Reserve Bank over loose monetary conditions is quite the wrong signal for the bank to send. The problem is not so much the unlikely prospect of a little inflation, which could easily be tolerated, but the prospect that the Bank's rigid grip will strangle the life out of what is left of the economy...

¹² The Labour Party Policy, due to be released in November 1999, provides, inter alia, that:

"Price stability will contribute to Labour's aims of growth, full employment, and a fair society. Both high inflation and excessive deflation are destructive of all three of these.

Inflationary expectations lead to a loss of business confidence and to reductions in both the level and the quality of savings. This makes growth in the real economy and thus employment creation more difficult.

At the same time, inflation redistributes wealth and income in ways which are often disadvantageous to working families and to people on fixed incomes. The only certain beneficiaries are property speculators.

Deflation leads to a loss of economic confidence, reduced economic activity, and consequent reductions in employment.

That is why the Fourth Labour Government passed the Reserve Bank Act in 1989 with the unanimous support of Parliament. And that is why Labour will keep the present Act when in government.

Labour is concerned, however, to minimise the risk that the exchange rate undergoes another round of rapid appreciation, thus destroying the prospects for export-led growth.

Consistent with the Reserve Bank Act, Labour will:

- maintain the target range for price movements at 0 to 3 per cent a year.
- amend the Policy Targets Agreement to ensure that the Bank, in meeting this target, pays appropriate attention to the need to minimise adverse impacts on the real economy, including excessive appreciation of the New Zealand dollar.
- undertake a full review of the operation of monetary policy to ensure the Reserve Bank has the full range of policy instruments it needs to be effective, and assist in meeting the government's overall macroeconomic objectives" (personal communication, Office of the Hon. Dr Michael Cullen, October 1999)

Now that New Zealanders have had their inflationary expectations knocked out of them, a case could be made for a wider target band being more suitable for New Zealand's commodities based economy. The Australians are more flexible and their record is more successful. This would give Governor Don Brash more 'wobble' room. The role of the exchange rate could also be considered.

The Reserve Bank Act served New Zealand well in ending the days of double digit inflation. It would be a disaster if it now became a garrotte around the neck of the economy" (The Dominion, 8 October 1998).

Over the course of 1999, with the New Zealand economy exhibiting very modest levels of economic growth, the debate continued over the role of the Reserve Bank. In May Sir Frank Holmes, Emeritus Professor of Economics of Victoria University's Institute of Policy Studies raised a number of issues regarding the conduct of monetary policy, and the institutional context within which that policy is developed and implemented (see Grimes, 1999).¹³ In August Professor Roger Bowden of Victoria University suggested that the Bank was focusing on the 'threat' of inflation when the real risks were posed by an economic contraction:

"Professor Bowden said all the Reserve Bank had to worry about was keeping a lid on inflation. If it looked like stirring the bank 'just whacked on' interest and cash rates.

¹³ Grimes lists the questions posed by Holmes at an Institute of Policy Studies (IPS) seminar held in May 1999, questions which are clearly apposite to the broader institutional issues raised in the present research:

"Questions which Sir Frank raised included:

- Have inflation methods had unnecessarily adverse effects on achievements of other important objectives through maintenance of unnecessarily high real interest rates and exchange rates; have they aggravated rather than smoothed cycles of activity; have they had an adverse effect on the balance of payments?
- In defining price stability, is a focus on consumer prices adequate, or should the target be set in terms of the external value of the NZ dollar as well as its internal value; should asset prices be given greater weight; and should financial stability in this broader sense be given greater weight?
- Do we have to accept that the real exchange rate moves through 'inevitable cycles' of 15-20%?
- Do we expect too much of the Reserve Bank in achieving its targets irrespective of what other economic policies are being followed; is there adequate coordination of economic policies?
- Can a small economy, like New Zealand, do more to reduce its vulnerability to flows of mobile capital, e.g. through a Chilean-style capital inflow tax?
- Can the Reserve Bank learn from Australia's use of intervention in the foreign exchange market; and is there some instrument that can help control credit cycles without impacting on interest rates?
- Which government body is responsible for balance of payments stability, and how should the Bank's impact in this areas be coordinated with other bodies?" (Grimes, 1999: 19).

'It doesn't matter if there wasn't a real stirring at all. There has been some reassessment, at least in my mind, of the whole business of separation of inflation from general economic activity. In other words there's no incentive for the Reserve Bank to get things right'.

It was time to ask questions, he said.

'It seems the wall between the Reserve Bank and the economy is too high' (The Dominion, 21 August 1999).

The following week, an editorial in The Dominion, under the heading 'Keep interest rates down', suggested that an increase in interest rates (with the objective of ensuring compliance with the Bank's Policy Targets Agreement), would be inappropriate:

"If that [an interest rate increase] were to choke off the fragile and uneven recovery which most economists believe is underway, governor Don Brash's name will be mud. The bank (sic) has been blamed for snuffing out an earlier recovery, by refusing to let an overvalued dollar ease sufficiently to stimulate exports at the time of the Asian economic crisis and a serious drought. Dr Brash must not make the same mistake by raising interest rates just when business appears to be picking up in some areas ...

As the bank (sic) says: 'Monetary policy is inevitably an exercise in making choices in the face of uncertainty'. This time it should err on the side of ensuring that a delicate patient is nourished, not suffocated'" (The Dominion, 27 August 1999).

On the 24 September 1999 Statistics New Zealand reported that the New Zealand economy contracted by 0.3 per cent for the June quarter 1999, with an annual rate of growth of 0.6 per cent for the year to June 1999.

The political-economy approach implies that societal interests underpin institutional continuity, and drive institutional reshaping and regime shifts. Accordingly, the prospects for change through the political process are a function of interests securing a critical mass of political support for political and legislative changes. In the 'equilibrium' condition, which, we have suggested reflects an optimal balance of institutional credibility and legitimacy, societal interests will have no reason to prosecute changes, and the institutional status of the central bank is unlikely to be the subject of partisan conflict. Under conditions of disequilibrium, societal interests and coalitions will seek to prosecute changes through the political process, and disequilibrium will surface in the political market place.¹⁴ Within the New Zealand political system the reshaping of the institution of the central bank is very much on the

¹⁴ Kelsey observed in 1998 that a "monetary policy debate has already begun", and suggested that the 'failure' of the changes made to the PTA following the 1996 election presaged, "a more fundamental debate about the nature and role of monetary policy" (1998: 386).

agenda, a development which is consistent with, and predicted by the model which has informed the present research. A *prima facie* case would appear to have been made.¹⁵

Recasting the argument in terms of Figure 9.1, while clearly there are marked differences in the trajectories of institutional reshaping in Australia and in New Zealand, and differences in the vehicles used to prosecute that reshaping, because of the imperative towards an equilibrium condition in which both credibility and legitimacy are optimised, the tendency is towards convergence. The Australian arrangements now occupy a position close to what we have identified as the likely the point of convergence, and we would predict that over the short to medium term the pressures will build on New Zealand policymakers to effect a reshaping that will have the effect of shifting the New Zealand institution towards the same point.

The argument that the Australian arrangements now occupy a position in which both credibility and legitimacy are maximised will not be without its critics, and we review one line of argument in the following section. One strength of the political-economy model that we have elaborated is that it admits of a more dynamic conception of institutional reshaping within the political economy, and contests the assertion that the existence of a formal statute implies a 'settlement'. State directed networks operate within 'credibility/legitimacy' space, and the dynamic and relational nature of those networks implies that any codified statutory settlement will be subject to the

¹⁵ Two developments in February 1999 provided further evidence of institutional disequilibrium. The first was the announcement by the Bank on the 8 February that it would be adopting the practice of announcing an Official Cash (interest) Rate, and that the much criticised Monetary Conditions Index (MCI) would no longer be used to describe 'desired conditions'. The MCI had increasingly been the object of much critical commentary and assessment by domestic and overseas commentators. In October 1998 Alan Wood had singled out the MCI as a misleading indicator, reliance on which had exacerbated the onset and depth of recession. Wood commented that:

"The RBNZ failed to appreciate the deflationary world it was operating in. New Zealand could profit from looking to Australia for a model that offers greater flexibility and a more effective monetary policy mechanism" (*The Dominion*, 5 October 1998).

The adoption of an Official Cash Rate, while represented by the Bank as merely a technical change, can be viewed as an attempt to move the framework 'up and out' in 'credibility/legitimacy' space.

The second development was the announcement of the appointment of former National Party Government Finance Minister Ruth Richardson to the Board of the Reserve Bank for a 5 year term effective 3 February 1999. An enthusiastic supporter of the post 1989 institutional framework, Richardson's appointment suggests that the National Party Government was less concerned about any progressive diminution in the stock of institutional legitimacy, than in attempting to secure the present framework under a future government of an alternative persuasion (or at the very least increase the potential costs of any attempts to revisit that framework). In this sense the appointment of a 'conservative' to the central bank board is consistent with the Goodman thesis that an incumbent Government will seek to tie the hands of its successor through changes to the institutional framework - in this case an appointment within the context of the formal institutional framework.

development and maintenance of the equilibrium condition. Our analysis suggests a number of potential pressure points within the Australian framework. Firstly there is the issue of personality - an important factor in the narrative to this point. The preferences of a central bank governor clearly influence the framework. Perhaps the present Governor, Ian Macfarlane is somewhat more orthodox than his predecessor, but we would argue that he has embraced those elements of the Bank's mission which serve to maximise both credibility and legitimacy. An observation in a speech by Ian Macfarlane given in June 1997 illustrates the point:

"The statement agreed between the Treasurer and myself at the time of my appointment saw low inflation as a requirement for sustained growth, which is another part of the Bank's Charter. Containing inflation is not an end in itself; it is one of the preconditions for sustained growth ... We do attract criticism ... from people who think that because we have an inflation target it means we are not interested in economic growth. This is not true - as I have pointed out on a number of occasions. In fact, the reverse is true: we are interested in sustaining a good inflation performance *because we are interested in growth*" (1997: 2, emphasis in original).

Secondly there is the risk of over-achievement on the part of the Bank - specifically over-achievement in terms of the Bank's target of 2-3 per cent inflation over the cycle. The risk is that the Bank could prejudice its commitment to growth because of an inappropriately risk-averse approach to the conduct of monetary policy, but also that those who remained concerned at the risk of institutional slippage away from the current framework might see it as appropriate to revisit the present exchange of letters - to shift the target zone down.¹⁶

Thirdly there is the risk that we foreshadowed in the conclusion to Chapter 8, posed by a potential lack of congruence between the institutions responsible for monetary and wages policies. There is every indication that the future of the latter is somewhat uncertain, but there is clearly the potential for damage to the standing (legitimacy) of the Bank if it were to be required to contest a recommendation to address the needs of the low paid, in the name of containing aggregate wage movements.¹⁷

¹⁶ Writing in The Australian of the 8 February 1999 Ian Henderson quoted Bankers Trust economist Rory Robertson as observing that, "[t]here would simply be little point in sticking with a target band whose mid-point is above actual inflation on an ongoing basis" (The Australian, 8 February 1999). However the other side of this argument might be that with inflationary pressures subdued, monetary policy might be put on hold for a time.

¹⁷ Moreover the Bank is clearly the hostage of the decisions of others in such matters as taxation reform. The introduction of a Goods and Services Tax would result in a one-off movement in prices, and the Bank would be tasked with the responsibility of ensuring that the movement was indeed one-off.

Institutional reshaping and the quest for 'cautious expansionism'

We have argued that the optimum is an equilibrium condition for a central bank, and that the political-economy of central banking illuminates the conditions under which particular institutional configurations, and trajectories of institutional reshaping arise out of configurations of economic interest within the political-economy. Our point of departure was difference - specifically marked differences in the formal institutional arrangements within which the conception and execution of monetary policy occurs. Our research strategy - the adoption of a most similar systems approach - has sought to account for difference, and, in accounting for difference in that which is static, we have also accounted for differences in the dynamic of institutional reshaping within our two most similar nations, and identified a tendency towards convergence.

There is a risk of over determination in reducing trajectories and strategies of institutional reshaping to the underlying political-economy, and we have noted the influence of such factors as the accumulated policy experiences of both nations, of state and constitutional structures, of the ideological and organisational preferences and positioning of parties, and not the least, of personality, all of which have exercised a degree of influence over the trajectory of institutional reshaping, and have mediated the influence of the political-economy. In earlier work, we sought to advance an explanation of what we then described as the exceptional quality of the Australian approach to monetary policy (Eichbaum, 1993). We concluded that:

"It is in the make-up of the representation on central bank boards that we can identify the source of central bank preferences, and it is the specific make-up of the Board of the Reserve bank of Australia that explains the exceptional nature of Australia's central banking culture ... Fundamentally, where central bank boards consist of bankers, then we might expect the ethos of central banking to be the ethos of the banking community more generally - one disposed towards the maintenance and protection of 'the soundness of the currency'.

By contrast the Board of the Reserve bank of Australia represents those broader interests with a greater investment in the real economy than typically expected of those confined within the financial and banking sectors ... [t]he answer to the question. 'Why do Australia's central bankers, quite contrary to what happens in virtually every other country, argue against a single inflationary target and instead, prefer the existing reserve bank charter stating a broad range of macro-objectives?' rests in the interests represented on and articulated by the Board of the Reserve Bank" (Eichbaum, 1993: 14-15).

This 'board-centric' approach has been critiqued on a number of grounds, and the guiding assumption, namely that in institutional form and behaviour, the Reserve Bank of Australia is, or has been, somewhat unorthodox, questioned, particularly in the light

of developments in the post-1996 period, which, it has been argued, increasingly manifests the hallmarks of a more orthodox approach to central banking (Bell 1997b; see also Bell 1997a).¹⁸ We would concur with the argument that to reduce what was, at the time, a somewhat less than orthodox approach to one element of the formal institutional scheme - namely the representation at Board level of a range of interests, principally non financial/banking interests - risked over-determination. However to the extent that the initial work hypothesised a causal relationship between the particular configurations of interest and policy outcomes it quite properly presaged a productive line of inquiry. The limitation lay in an implicit treatment of the genesis of institutional form as exogenous - a deficiency which the present research has remedied.

The optimal institutional form is given by a theoretical framework that suggests that the equilibrium condition - a relatively stable state directed network - will be one in which endowments of credibility and legitimacy will be optimised. The two cases illuminated within our most similar systems research strategy provide clear support for the propositions derived from the model. Trajectories of institutional reshaping that privilege both credibility and legitimacy will facilitate the emergence of an equilibrium condition - a stable state directed network - whereas those that compromise either credibility or legitimacy will have a tendency towards disequilibrium, a state which, if unresolved within the network, may surface in the form of political demands for reform.

There is a certain inelegance in identifying the optimum as a 'Type 4 outcome' or 'Point D in credibility/legitimacy space'. A political-logic of institutional reshaping has seen the Australian model arrive at what we argue is the optimal location, and we predict that imperatives within the New Zealand political economy presage a similar shift. The institutionally optimal represents a combination of formal, conventional and organisational elements, but it also reflects an acknowledgment that the implementation of monetary policy in and of itself has direct distributional implications, that the short-run Phillips Curve is not vertical, and that 'the short-run' is a significant period in real time for actors in the real economy.

The optimal institutional form we characterise as 'cautious expansionism' (Stiglitz, 1997). The model of 'cautious expansionism' is differentiated from those derived from

¹⁸ Bell argues that the contemporary practice of Australian central banking is such as to suggest, "a shift by degrees towards policy orthodoxy" (1997b:26) suggesting in support of this conclusion both that Australian central banking is considerably closer to international 'best practice' than the statute reading measures of CBI have acknowledged, and that changes in the leadership of the Bank, and in the composition of the Board may presage a greater focus on price stability - "as the stick of inflation looks like it has been broken the Reserve Bank has decided to become more orthodox" (Bell, 1997b:26).

the rational-economic literature in four significant ways. Firstly, cautious expansionism is informed by the assumption that the conduct of monetary policy requires a dualist framework, that while monetary policy may well possess a comparative advantage in securing price stability, it also has the power, as Alan Blinder has argued, to mitigate fluctuations in employment - "monetary policy is the only game in town nowadays ... a central bank that decides to concentrate exclusively on price stability is, in effect, throwing in the towel on unemployment" (1996: 8). More recently, United States Federal Reserve Governor Laurence H. Meyer has suggested that there is an 'emerging consensus' about the objectives of monetary policy:

"I would describe the consensus as an acceptance of a dual mandate for monetary policy. Monetary policy seeks first to achieve and maintain price stability over the longer run and, second, to retain the flexibility to damp cyclical fluctuations in the economy around full employment ...

While monetary policy cannot raise the level or rate of growth of output over the long run through any means other than maintaining price stability, it is widely, although not universally, accepted that monetary policy can affect the level and growth rate of output in the short run and, perhaps, therefore contribute to smoothing out fluctuations in the economy around full employment. This is sometimes referred to as the short run stabilisation objective for monetary policy. A central issue for monetary policy is how to balance the dual objectives of price stability and output stabilisation and how explicit to be about the commitment to these dual objectives" (Meyer, 1999).¹⁹

Secondly, while operational independence from government should be maintained, the institutional arrangements within which monetary policy is designed and executed should be such as to ensure that the central bank is appropriately independent of those economic interests with which it engages. As Alan Blinder has noted,

"... delivering policies that the markets expect - or indeed demand - may lead to very poor policy.

This danger is greater now than ever, I believe, because the prevailing view of financial markets among central bankers is one of deep respect. The broad, deep, fluid markets are seen as repositories of enormous power and wisdom. In my personal view, the power is beyond dispute, but the wisdom is somewhat suspect" (1998: 62)

Joseph Stiglitz implies a similar threat to the independence of central banks in his observation that:

¹⁹ Stiglitz observes that, "... the gains in economic performance in the dimensions where it really counts - the ability of the economy to live up to, and expand, its productive potential, is little affected by central bank independence. Indeed the results that the variance of inflation has been reduced, but growth not enhanced, suggest that it is output variability, not price variability, which should be the focus of concern of macro-economic policy" (Stiglitz, 1997).

"[t]he fact that monetary policy involves trade-offs, that values affect not only the choices one makes, but even one's perception of magnitude of those trade-offs, has one clear implication in a democratic society. The way those decisions are made should be representative of the values of those that comprise society. At the very least, they should see as their objective [central bankers] the application of their expertise to reflect broader societal values. The central bank should not be seen as a mechanism for the imposition of the values of a subset of the population as a whole" (1997).

The third feature goes to the need for transparency - a quality which the rational-economics case for accountability holds as necessary condition for credible monetary policy. However the cautious expansionism model privileges transparency of process for reasons of technical efficiency, and institutional legitimacy. As Alan Blinder has argued,

"... the public has a right to demand honesty from its central bankers ... The central bank owes this to the body politic in return for its broad grant of power. A central bank which dissembles or is imperiously silent is, in my view, behaving in a profoundly undemocratic manner. So are those who would cloak central bank actions in misleading rhetoric ...

One important improvement would be to make the central bank's thinking on monetary policy more transparent. I have argued that such an innovation could both improve the quality of stabilisation policy and make independent central banking more consistent with democracy. The arguments on the other side strike me as thin gruel. While anything can be better rationalised by some theory, economists do not normally claim that markets function better when they are less informed" (1998: 75).

Joseph Stiglitz has advanced a similar argument in defence of greater transparency and openness on the part of central banks:

"There has been extensive discussion of the extent to which central banks should act in secret: should they disclose their proceedings, and if so, with what lag and with what fullness of detail? Again, there is a certain irony in these discussions: while market advocates praise the price 'discovery' function of markets, much of the price discovery function in the bond market is directed at figuring out what central bankers believe and are likely to do. Rather than having this indirect 'dance', would it not make far more sense to have the Central Bank directly disclose the information? If the market believes that that information is of value - as evidenced by the large number of individuals who watch the actions of central banks throughout the world - then shouldn't government make that information available? And in a timely way? Evidently, central banks (and their governments) are less than committed to transparency when it comes to their own operations!" (Stiglitz, 1999)

The fourth defining feature of this model goes to the involvement of real economy/societal interests in the governance of central banks. The logic of the case is one that is readily acknowledged, including within the rational-economics literature -

central bankers may place too great a weight on securing and maintaining price stability, to the exclusion, and possibly at the expense of, macroeconomic stabilisation. Within the rational-economics literature the solution is seen as contracts which enforce lower, as well as upper bounds, and the facility for independent review. Stiglitz suggest that the capacity for 'mistakes' is amplified by the nature of the governance arrangements within central banks: "all too often the governance structure of central banks makes these mistakes more likely, and more costly than they need be" (1997). And while Stiglitz applauds the recent conduct of monetary policy by the United States Federal Reserve, and comments favourably on the institutional arrangements governing that institution, his comments on the relationship between policy balance and forms of governance are more generally apposite to our consideration of the defining features of 'cautious expansionism':

" ... most importantly, have we achieved the best balance between stabilisation and fighting inflation? ... the balance ... depends on the composition and beliefs of the Fed as presently constituted, there are important voices not being heard - voices I dare say that may represent a majority of Americans. These voices ought to have some say on how the inter-temporal trade-offs that are central to monetary policy should be made. These voices could be represented, without compromising on the independence of the monetary authority, and indeed, these voices could be represented at the same time that the quality of expertise in the conduct of monetary policy is improved" (1997).

And in a comparative assessment of the merits of the New Zealand model by David Mayes, the former chief manager of the Reserve Bank of New Zealand's Economics Department, links the issues of transparency and responsibility for the development of monetary policy, and illuminates these issues in a manner that resonates very clearly with the model developed in this thesis. Mayes comments that:

" ... other countries have been rather more concerned to have a structure of responsibility for monetary policy that is clearly both technically competent and representative of a wide range of views.

In that way both the independence from party politics and the general acceptance to society - legitimacy - of the decisions is heightened. New Zealand is largely alone in placing all the responsibility personally on the governor. The members of monetary policy committees in other countries tend to be appointed for relatively long periods and some at least do not have to rely on the governor for their appointment.

... It is easy to confuse the need to have clear responsibility and the need to take clear and firm decisions with having a single view. Diversity of view among independent people is not only to be expected but is desirable in the face of an uncertain future ..." (Mayes, 1999, emphasis added).

It is our contention that these four elements - a dualist charter, independence, transparency of process, and a pluralistic governance structure - together define the model that we have labelled, after Stiglitz, 'cautious expansionism'. Appropriately in the context of the times, it is a model that is defined by the nature of the outcomes it generates. And it is important to emphasise what the model is not. The model does not deny the important contribution that stable prices can make to macroeconomic management, the virtue of removing responsibility for the operation of monetary policy from political influence and/or control, the necessity of transparency of process, and the importance of independent scrutiny of the central bank on the part of the legislature. Moreover the model is entirely capable of accommodating the kinds of contractual arrangements that feature in the Reserve Bank of New Zealand Act, and which are suggested in a somewhat more understated manner in the Costello/Macfarlane exchange of letters discussed in earlier chapters.

The central banking of cautious expansionism suggests an appropriate balance between containing inflation and macroeconomic stabilisation, an acknowledgment that the conduct of monetary policy will involve inter-temporal trade-offs, and the assumption that the quality of policy outputs and outcomes is enhanced by inclusive modes of policymaking and governance. The resonances with the Australian institutional arrangements, and in particular Bernie Fraser's advocacy of the four pillars of that framework, are clear. There is clearly a measure of inconsistency between the cautious expansionism of the 'practical central banking' model and the New Zealand arrangements. Far from being consistent with 'practical central banking' and 'cautious expansionism', we would contend that the limitations of the New Zealand model are such as to risk a deflationary bias in the development and conduct of monetary policy, and a failure to optimise the growth and employment potential of the economy.

The assumption within the present New Zealand policy community appears to be that the case for any reform of the present institutional arrangements must assume a misplaced and erroneous belief in the long-run Phillips Curve, and will inevitably risk imparting a bias towards short-termism in the conduct of monetary policy. If we are correct in viewing the maintenance of an institutional equilibrium as a function of a supportive societal coalition, and if, as appears to be the case, the present institutional arrangements presage a revisiting of those arrangements, an institutional correction will be countenanced by policymakers, even in the face of opposition from the Bank. Logically, there is no reason to expect that, given the integration of international finance markets and the interface between the Australian and New Zealand markets, that which is seen as virtuous and sensible in one, should not also be welcomed in the

other. Indeed some revisiting of the present institutional arrangements need not move the markets in an inappropriate or unwelcome manner. That revisiting need not involve a repudiation of the general scheme of the Act - instrument independence, and the greater transparency attendant upon the development and implementation of monetary policy under the 1989 legislation are fundamentally important elements of the new regime, and should be retained. Indeed a more permissive interpretation of what might be entertained in realising the Act's 'principal objective' may well serve to provide a bridge to the alternative.

To the extent that 'cautious expansionism' constitutes the new orthodoxy within practical central banking then we would have little difficulty in suggesting that the trajectory of institutional reshaping in Australia has produced a movement towards the orthodox. But if indeed this constitutes the orthodoxy, then the alternative, which is exemplified in the New Zealand arrangements, and which Australian policymakers chose not to replicate, can no longer lay claim to that institutional mantle.

Both the New Zealand and the Australian economies have undergone significant structural reforms in the period since the early 1980s. And one might ascribe a common theoretical and philosophical progenitor in a combination of neo-classical economics and elements of a neo-liberal political ideology. However the import of a common progenitor should not mask significant differences in particular elements of institutional design, public policy, and policy outcomes. Within the Australasian 'family of nations' there has been, and continues to be, significant diversity and difference. Moreover, a failure to recognise, and to account for and explain such differences militates against adaptive public policymaking within the confines of that 'family'. The possibility of a move to a trans-Tasman currency union in the short to medium term gives these issues an added dimension, with the prospect that a union of the two existing currencies (as distinct from New Zealand adopting the currency of its neighbour) would necessitate the design of a new institutional formations (see Lloyd, 1990, Grimmond, 1991, Coleman, 1999)²⁰. As the politics of domestic defence give way to new political and economic formations, reflection on the political-economy of emerging formations and institutions will not only constitute a significant contribution to scholarship in comparative public policy but may also serve to advance the integrity of policymaking and policy outcomes, and impart a greater sense of credibility and legitimacy to the conduct of public policy and to the shaping and reshaping of the institutions of macroeconomic management.

²⁰ An examination of the prospects for, and implications of an Australasian currency union is clearly suggested as a relevant and productive line of future research.

Appendix: Method and Methodology

Researching the political-economy of central banking

Former Reserve Bank of Australia Governor Dr H. C. Coombs once described the profession of central banking as, "an international freemasonry, a kind of 'mystery' in the medieval sense of a group who possess some exclusive knowledge or skill ... "(1981: 141). That 'mystery', Coombs observed was,

" ... intensified ... by the personality of Montagu Norman, who for twenty-one years was Governor of the Bank of England, in his day the best known central banker in the world. Norman cultivated an enigmatic style. He had a neat grey beard and wore a broad brimmed black hat and a long cloak. He travelled between the financial centres of the world appearing in the passenger lists under the pseudonym of 'Professor Skinner'. He had a gift of silence that wrapped his occasional monosyllables in an aura of apparently profound significance" (1981: 141).

The institution of central banking has changed somewhat since the days of Montagu Norman, but the metaphor of 'mystery' is still apposite to a consideration of the particular challenges presented to scholars seeking to research the institution. And while, as we have argued, the requirements of accountability - effectively a subset of the imperatives of credibility and legitimacy - now require a greater degree of transparency and openness on the part of central banks and central bankers, Montagu Norman's successors within the international profession are still perceived or received as drawing on 'secrets of the temple' not easily accessed by those outside the profession. The practice of central banking is, we have argued a relational one, inasmuch as the credibility of policy is a function of a nexus between the central bank and financial actors, and legitimacy, a function of a nexus between the central bank and the wider community - including business and other economic, political, and social interests. For scholars of central banking - and in particular those working within a political science or political economy framework - the relational dimension to central banking and the fact of the central bank interacting with a variety of interests - both financial and non-financial, economic and non-economic - is problematic.

It is problematic because of its constraining influence on access to central bank insiders. In part problems of access may be a legacy of a 'Montagu Norman' approach to central banking in which one objective is the maintenance of the 'mystery'. However the relational character of contemporary central banking makes this less likely - the modern central banker makes a point of being seen and heard. What is problematic is that the

comments of central bank insiders have the capacity to 'move the market'; indeed, from time to time statements will be designed to achieve this very objective - the more so where the 'instrument' for effecting changes to monetary policy settings allows for a measure of interpretation. Interviewed in 1998 Reserve Bank of New Zealand Communications Manager, Paul Jackman commented that in his contact with the members of the Fourth Estate he gave priority to those filing stories for the wire services:

"... you look at my list of journalists I need to talk to, the ones at the top are the wire services and they lead terrible lives because they get their rocks off when they move the market, and it doesn't even matter if the story really was true, it just has to move the market ... our problem is that most of the time ... we don't want to move the market ..." (personal interview, 1998).

In part then, the caution of central banks and central bankers is understandable, given the risk of unintended market consequences. As a result, access to central bank insiders may be problematic, and it is more likely that the central bank will be concerned to speak with one voice, and through one individual. Moreover because of this consideration when the bank communicates with external audiences, those communications are often 'off the record'.¹

If procedural access can be problematic, so too can accessing the substance of what it is that a central bank seeks to communicate from time to time. John Woolley suggests that scholarship on central banking evokes two modes of discourse - the technical, and the political:

"In the technical realm, debate focuses on control issues such as the implications of selecting different kinds of instruments; the implications of setting instruments in different kinds of ways; the nature of the relationship between monetary and fiscal policy, and the implications for policy of actions being taken by actors in the private sector ... Typically, dense technical debates about policy tactics 'crowd out' debates about which ultimate targets to select and which values of those targets should be achieved...

Ordinary political discourse is less precise and rigorous; it is empirically and theoretically causal. Compared to technical discourse, it is more explicitly normative, more concerned with distributive issues, and more concerned with assigning responsibility for undesired distributive outcomes ... Interest in monetary policy is episodic and reactive. Ordinary political discourse changes

¹ Interviewed in 1998 Reserve Bank of New Zealand Governor Don Brash commented that,

"I would give most years in excess of 100 speeches a year almost all of them off the record so that they can be repeated to a lot of different audiences - and because they don't therefore attract financial market reaction - explaining to farmers, manufacturers, trade unions, ... rotary clubs, church groups, ... why low inflation doesn't involve permanent social cost and indeed why low inflation is better for social outcomes than inflation" (personal interview, 1998).

with the changing impacts of current economic performance. Typically, discourse is dominated by negative reactions to undesired economic conditions..." (Woolley, 1984: 182).

The fact of these two modes of discourse may go some way towards explaining why it is that there is a paucity of scholarship - particularly marked in the Australian and New Zealand academic communities - on the political-economy of central banking. More concretely however it suggests that within state directed policy networks relations between central banks and financial actors in particular will be conducted within a technical discourse, and one which is less accessible by observers external to that layer of the network within which the technical and operational dimensions of monetary policy are conducted.

Of most significance in the context of a discussion of method and methodology is the fact that communications between a central bank and the various actors - financial and non-financial - with which it interacts, will be variant within what we have conceptualised as 'credibility/legitimacy space'. Indeed the theoretical model which this thesis seeks to advance and test is suggested by an observation by Reserve Bank of New Zealand Communications Manager, Paul Jackman. Jackman's comments on the nature of the communications function within the Reserve Bank suggested a 'dualist' approach:

"...one of the many things that makes this job interesting ... and makes the Bank an interesting PR challenge is that it always has two audiences. And they are a lay audience and the markets. The difficulty is that they don't speak different languages but they speak different dialects" (personal interview, 1998; emphasis added).

Asked to elaborate on the difference between language and dialect, Jackman suggested that:

"If one spoke Swahili and the other spoke Classical Greek it would be fine because you could talk to one with the other not knowing what you were talking about. That would be dead easy. But unfortunately they both speak English but with very different vocabularies and the classic problem is that you say something to a lay audience and the market picks up and accidentally interprets something which wasn't meant to be there ... at a mechanical level the problem is that we may say something of a very general nature when we are talking to the lay audience and the markets may see a meaning about current monetary conditions, but the market's always desperate to know what Brash is thinking about the TWI and the 90 day bills, today. And does the Bank have any new information about the projection of inflation by which some smart reader can get a drop on what the Bank will do next in terms of where desired

monetary conditions are - and if you know that and can work that out you can make money" (personal interview, 1998).²

For scholars of central banking the task is one of differentiating between the dialects in the common language - or, in terms of the distinction advanced by John Woolley between technical and political discourse.

Equally significant is the fact that central banks and central bankers will react to what they perceive to be the placement of the central bank (or monetary policy more generally) in 'credibility/legitimacy space' at any given point in time, or, for that matter where a particular actor, set of interests or societal coalition places the central bank in that space. At one level this is simply a manifestation of the problem facing social scientists who deal with subjects that can, through responses or behaviour seek to influence the construction that is placed on those responses or actions. This also means that responses and/or behaviour will be variable over time reflecting the particular circumstances in which central banks and central bankers are placed. For example, if a central banker perceives the central bank to be suffering from a 'credibility deficit', then arguably one is more likely to elicit an assessment that privileges the need for credibility, over institutional legitimacy (the more so if the loss of credibility is perceived to be a function of inappropriate softness in policy, or populism in the representation of the central bank or monetary policy). Equally, a central banker who perceives a loss of legitimacy - for example associated with a hard inflation target - may be inclined to focus on the lower bounds of that target and suggest that the mission is as much about preventing a breach at the lower end as at the upper end. Central banks and central bankers are, within the political-economy, actors in their own right and will seek to shape the perceptions and the preferences of other actors within the state-directed policy network, with a view to maintaining their institutional

² Paul Jackman observed that the demands of communicating with two audiences, sharing a common language but speaking different dialects presented challenges:

" ... well you write very carefully. You write carefully and you try to have very predictable procedures in the handling of information So it's very important that people know how we do release market sensitive information and our strict rule is that - market sensitive information - the markets, everybody gets it instantaneously, which means a screen message, a lock up ... we have to be very predictable about how things happen and we always try and avoid surprises about that sort of stuff and then when we do this, when we are speaking to the lay audience - I mean one of the things I do is sit on the phone and the financial jocks ring up and say "What does this mean Paul?" and I say "it means nothing." ... you're always trying to be very honest about which of the two kinds of things it is. It's really about predictability and professionalism ... accidents still happen sometimes ... but we are always trying to eliminate that ...

... our stuff-up rate is very low. However, where sometimes I professionally have to work hard is to be effective in talking to the lay audience, given that sometimes what you want to say - you are in this bind and that you have to be very careful about the other audience. And always the challenge is between the precision required for the technical audience and the comprehensibility of the lay audience. Sometimes one struggles with words" (personal interview, 1998).

and operational independence. Scholars need to be attuned to the nuances of representation, and be sensitive to the fact that institutional actors will have an interest in shaping perceptions of placement within 'credibility/legitimacy space'.³

Research strategy and method

While the methodological framework is given by the logic of comparative public policy, and the adoption of a most similar systems research design, research methods are suggested both by the interdisciplinarity of the inquiry, and the tenets of a methodological pluralism (Bell and Newby, 1977). The principal research method deployed was face to face interviews with key respondents in Australia and New Zealand over the course of 1997 and 1998. Interviews were conducted over two periods, with Australian interviews completed over the period from February to May 1997 during which period the author was a Visiting Fellow in the Reshaping Australian Institutions Project based in the Politics Program of the Research School of Social Sciences at The Australian National University, and New Zealand interviews completed over the period from February 1998 to March 1999. In total 33 interviews were carried out with 32 respondents (some respondents were interviewed on more than one occasion, and as the schedule of interviews records, at some interviews more than one respondent was present).

Selection of respondents

Respondent selection was largely informed by the political economy literature reviewed in Chapter 3. Given a political economy model which posits that institutional form is a function of relationships between state and 'civil society' - principally economic - actors, interviews were sought with policymakers situated within the institutions of the central bank and government (public interests) with the representatives of economic interests group with which the central bank interact (private interests), and, in the

³ For example, in the period immediately following the retirement of former Reserve Bank of Australia Governor Bernie Fraser one might have expected the Australian central bank - given the accusations of politicisation over the period from 1984 to 1996, the imprudent remarks of Treasurer Keating, and the at times strident defence of the Australian arrangements by Governor Fraser within the political domain - to be concerned to maximise the credibility of the institution, and to rebut any suggestion that the institution was (and is) in any way other than orthodox. In an interview with Stephen Bell, Reserve Bank of Australia Deputy Governor Stephen Grenville argued that the characterisation of the Australian institutional arrangements (by Eichbaum, 1993) as 'exceptional' was wrong, and, citing a problem of credibility within overseas financial markets (that had largely been overcome in his assessment with the Costello/Macfarlane exchange of letters) argued that the RBA was operating within the mainstream of international practice (personal communication, Stephen Bell).

Australian case, with two leading financial journalists who not only possessed an intimate knowledge of the issues and actors, but had also been directly involved in both monitoring and shaping the public policy agenda over the period under review.

In the case of Australian respondents the focus was on the period from 1983 to the present, whereas while New Zealand respondents were provided with the opportunity to advance evaluations of the post 1989 institutional regime, the focus - as reflected in the chapter sequence - was largely on the circumstances under which the 1989 legislation was prosecuted.

Notwithstanding that all potential participants were invited to participate in their present or former capacity as officials or office holders and not as private citizens, procedures were consistent with the ethical standards that apply to research involving human subjects, and were predicated on informed consent. Discussions with respondents resulted in a variety of arrangements being adopted for the conduct of interviews, and for the use of data generated in those interviews. Some interviews were taped, while others were not. And while some respondents agreed to attribution, others agreed to participate on the grounds that their comments were not for attribution.

In both Australia and New Zealand approaches were made to the Reserve Bank, and in both cases the central banks agreed to cooperate, with the Reserve Bank of Australia providing access to a senior official, and with the Governor of the Reserve Bank of New Zealand agreeing to be interviewed. In the case of the Reserve Bank of Australia, the practice typically has been that the Governor alone provides comments for attribution. Accordingly, as agreed with the Reserve Bank of Australia, the material generated out of a number of interviews with the one respondent - interviews conducted at the start and towards the completion of the series of interviews - is not attributed. An interview was also conducted with former Reserve Bank Governor, Bernie Fraser. Reserve Bank of New Zealand Governor Dr Donald Brash agreed to be interviewed, and to interviews being taped and comments attributed. Two interviews were conducted with Dr Brash. Where comments were not for attribution this was made explicit in the course of the interview. In addition to interviews with the Governor, an interview was also conducted with the Reserve Bank of New Zealand's Communications Manager, Paul Jackman. Following discussions between Mr Jackman and the Governor of the Bank, it was agreed that this interview would be on the record and for attribution. Moreover New Zealand respondents included a former deputy

Governor of the Reserve Bank (Dr Roderick Deane) and a former Chief Manager of the Bank's Financial Markets Department (Dr Arthur Grimes)

In the course of Australian research Reserve Bank Board members were invited to participate, with a number making themselves available, some having discussed the matter with the Bank. Moreover one Board member, in agreeing to an interview indicated that, having consulted with one of his Board colleagues, he would be attempting to represent a shared analysis of the issues to which the interview was directed.⁴ Material generated out of interviews with 'part-time' Board members has been used on a non-attributable basis. Interviews were also conducted with a number of former members of the Board of the Bank. Interviews were also requested with other individuals within the public interest domain, and with former members of the Reserve Bank Board. Respondents included individuals closely involved with policymaking within parties and governments (ALP and Liberal-National Coalition) over the period from 1983 to the present, and senior members of the public service. With one exception (Mr Ted Evans) material has been used on a non-attributable basis.

Within the domain of 'private' economic interests interviews were sought with individuals representative of finance, manufacturing, farming and labour (trade union) interests. The selection of sectors from which assessment and comment would be sought was informed by the political economy literature rehearsed in Chapter 3.⁵ Within the political economy literature on central banking we have noted the significance of relations between central banks and finance actors in particular. However, while a priori, the literature would have suggested the need to elicit comment and assessment from these interests, somewhat more inductively, sectoral responses to the Reserve Bank of New Zealand Bill 1987, as evidenced in submissions to the Finance and Expenditure Select Committee confirm the distribution of interests reflected in the respondents invited to participate in the research.

As already noted, in Australia interviews were also conducted with two senior finance/economics journalists. These two respondents feature prominently in the print

⁴ The correspondence from this particular Board member noted that he was aware that an approach had made to a colleague on the Board, "and following a discussion with him, it has been decided he will present both our views to you" (personal correspondence, April 1997).

One other member, who replied to the request for an interview through the Secretary's Department at the Reserve Bank of Australia, while indicating his non-availability noted that, at that point in time interviews had already been conducted with other members of the Board, and with a senior member of the Bank's management.

⁵ Gourevitch, by way of example, differentiates business, agriculture and labour, and on the basis of sectors or product families for the first two, and type of employment for the third (1986: 56).

media materials which form an important part of the narrative in Chapters 6 and 7, and are acknowledged as individuals with very well established contact both with the Reserve Bank of Australia, and with the political elites and economic interests with which the Reserve Bank of Australia interfaces.

Additional sources of research materials

The balance of research methods employed within the two jurisdictions is in part reflective of the fact that, within the New Zealand domain the focus of the research was on an episode of formal institutional reform - the genesis and passage of the Reserve Bank of New Zealand Act 1989. Accordingly whereas in Australia the political-economy dynamic was evidenced exclusively in the extra-legislative arena, in the New Zealand case interest articulation (both public and private interests) occurred within the formal context of the legislative process, specifically in the genesis of the Bill, and in submissions to the Select Committee that considered and reported back on the Bill.

Information was provided to the author by both Reserve Banks, and both provided access to their research libraries. Two Official Information requests were made to the Reserve Bank of New Zealand for information relating to the development and passage of the Reserve Bank of New Zealand Act 1989. In April 1993 the Reserve Bank of New Zealand provided the author with copies of all the submissions made to the Finance and Expenditure Select Committee, the Reserve Bank's general response to these submissions, responses to particular submissions, and copies of papers to the Board clarifying certain aspects of the legislation. In a letter accompanying the documents, Samantha Johnson from the Bank's Economic Department commented that,

"[s]ome of these papers are clearly already public documents. However, others are not and have been provided for the purposes of your research. It would therefore be appreciated if you could take this point into consideration in your use of the documents" (personal communication, 21 April 1993).

A second request for Board papers was made on the 4 April 1997 (at which point in time the author was based as a Visiting Fellow at the Australian National University). In his reply to this request, the Bank's Deputy Governor, Richard Lang, advised that:

"The Bank has a policy of not publicly releasing papers written by staff for internal discussion purposes. Views expressed in such papers are not necessarily the views of the Governor or the Bank's Board. We encourage staff to put forward their ideas as part of our policy development process. If such

internal papers were to be routinely released, they would need to be drafted with this in mind and probably, often 'censored' by senior management before finalisation. That would seriously inhibit the development of policy by discouraging the free and frank flow of ideas.

However, we are concerned not to inhibit genuine academic research and thus I am enclosing the two papers you have requested. These are released on the condition that they are for your research and that they will not be passed to others, except those assisting you, without our prior agreement. If you were wishing to quote directly from the papers, we would also request that you clear the quotations with us prior to publication.

We have used the above 'conditional release' procedure in a number of previous cases involving academic research and it has proved satisfactory to all parties..."(personal communication, 8 April 1997).

A formal Official Information request to the New Zealand Treasury was made in April 1993 for information relating to the development of the Reserve Bank Bill, and this information was provided to the author on the 14 May 1993. Nine Treasury reports were released and these are listed in the bibliography and further identified by way of Treasury file numbers (TRXXXX).

Aside from other documentation accessed from library collections in Australia and New Zealand, a number of respondents also provided the author with materials relevant to the research. Much of the historical narrative in Chapters 6 and 7 is provided by way of Australian print media material. This material was accessed from the print media archive held in the Politics Division of the Research School of Social Sciences at The Australian National University.

Australian respondents*

Dr Fred Argy, (formerly Director of the Economic Planning Advisory Council; Secretary to the Campbell Committee of Inquiry into the Australian Financial System), Canberra, 19 March 1997

Ted Evans, Secretary to the Commonwealth Treasury, Canberra, 15 April 1997

Bernie Fraser, (formerly Governor of the Reserve Bank of Australia, and Secretary to the Commonwealth Treasury), Canberra, 28 April 1997

Professor Bob Gregory Economics Program, Research School of Social Sciences, The Australian National University (formerly a member of the Board of the Reserve Bank of Australia), Canberra, 22 April 1997

Dr Peter Jonson, Managing Director, ANZ Funds Management, Melbourne, 24 April 1997

Dr Barry Hughes, Chief Economist, Credit Suisse First Boston, (and formerly economic policy adviser to Treasurer Paul Keating), Sydney 9 December 1997

Dr Michael Keating, Economics Program, Research School of Social Sciences, The Australian National University (formerly Head of the Department of Prime Minister and Cabinet), Canberra, 24 February 1997

Bill Kelty, Secretary, The Australian Council of Trade Unions, (formerly a member of the Board of the Reserve Bank of Australia), Melbourne, 23 April 1997

Paul Orton and Jeff Schubert, Australian Business Limited, Sydney, 25 March 1997

Heather Ridout, Director of Public Policy, Metal Trades Industry Association, Sydney, 9 May 1997

Todd Ritchie, Director of Economic Research, National Farmers' Federation, Canberra, 7 May 1997

Max Walsh, Economics Editor, the Sydney Morning Herald, Sydney, 25 March 1997

Hon Ralph Willis MHR, (Cabinet Member 1983-1996, including a period as Treasurer in the Hawke and the Keating Labor Ministries), Canberra, 20 March 1997

Alan Wood, Economics Editor, The Australian, Canberra, 22 April 1997

*The list does not include 7 respondents with whom interviews were conducted on a non-attributable basis.

New Zealand respondents

Simon Arnold (CEO), and Peter Crawford (Trade and Economic Analyst), New Zealand Manufacturers Federation Inc, Wellington, 26 March 1998

Malcolm Bailey, President, Federated Farmers of New Zealand (Inc.), Wellington, 16 April 1998

Dr Donald T. Brash, Governor, Reserve Bank of New Zealand, Wellington, 19 March 1998 and 9 April 1998

Hon. Dr. Michael Cullen, Finance Spokesperson, NZ Labour Party, Wellington, 25 March 1999

Dr Roderick Deane, Chief Executive Officer, Telecom New Zealand (formerly, Deputy Governor, Reserve Bank of New Zealand), Wellington, 28 April 1998

Paul Jackman, Communications Manager, Reserve Bank of New Zealand, Wellington, 28 April 1998

Dr Arthur Grimes, Director, Institute of Policy Studies, Victoria University of Wellington, (formerly Chief Manager of the Financial Markets Department, Reserve Bank of New Zealand, and Southpac Investment Management Limited), Wellington, 16 April 1998

Peter Harris, Economist, Director of Technical Services, the New Zealand Council of Trade Unions, Wellington, 19 March 1998

Hugh Fletcher, Member of the Board of Directors, and formerly Chief Executive Officer, Fletcher Challenge, Penrose Auckland, 12 March 1998

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