

ASPECTS OF RESERVE BANK GOVERNANCE

Address to the ABE, 18 August 2005

By Ted Evans

Traveling home a couple of nights ago, listening to the ABC quiz show, the question of the moment was ‘who is the Chairman of the ACCC?’ The first caller admitted he didn’t know; but he did recall the ‘earlier bloke, who spoke a lot, and sounded like Bernie Fraser who’, he added, ‘sounded like the Sandman’. A subsequent caller referred back to those observations and opined that ‘if you hear a finance spokesman on the TV or radio, and he doesn’t speak in a monotone, then he’s not believable.’

On that basis, you should find me ‘believable’ – even if the topic I have been asked to address today is one that I do not regard as being of great importance; certainly it would not rate in the ‘top 10’ economic issues that many would place on a current reform agenda.

Nonetheless, the ABE Committee has asked that I address the issue which, specifically, is ‘would we be better served by a Reserve Bank Board comprised of people with more obvious monetary policy experience and expertise than the current Board?’ Having addressed that question, and thus earned my lunch, I shall turn to a couple of related areas where I believe marginal improvements might be made to RBA governance arrangements.

Such questions can be addressed from either a ‘bottom up’ or ‘top down’ perspective.

By ‘top down’, I mean looking at the results of the current arrangements i.e. the success or otherwise of the conduct of monetary policy.

Coming from that perspective, I believe that most informed observers or researchers would say that the conduct of Australian monetary policy over the past decade and a half has been exemplary – whether measured against Australia’s own history over a longer term, or against the performance of monetary policy in other jurisdictions over the same period. On either basis, the RBA’s record since the early 1990’s has been outstanding, perhaps not bettered around the world.

And the period concerned has not been a benign one. It has contained periods of international financial market turmoil, domestic demand pressures (including wage pressures) and episodes such as unprecedented exchange rate swings, large current account deficits and asset price outbreaks, all of which, in earlier times, have been factors in bringing monetary policy undone.

Instead, we have had a decade and a half of low inflation and high and virtually continuous growth, such that unemployment is now at its lowest for several decades – and definitely set to go lower.

Those macro outcomes, of course, were not the result, solely, of deft monetary policy – they mainly reflected the working out of other policy changes made over the course of the last two decades: improvements to the operation of markets (goods, labour and

capital) and, more recently, improved fiscal policy outcomes. But the point to make is that monetary policy could easily have thrown developments off track, and it did not.

Q.E.D? Not quite. It is possible, with the benefit of hindsight, to point to occasions within that period when monetary policy might have been more appropriately fine-tuned – though it might not be as easy to get agreement on that assessment, particularly among the ‘experts’. Even so, thinking about those occasions, even with the benefit of hindsight, it is not obvious to me that a differently comprised Board would have yielded different results.

Hence, looking at the issue purely from the top down perspective, the results achieved, there is no obvious case for change. Of course, some might argue that the results have been achieved despite the Board; and the ‘ain’t broke, don’t fix it’ perspective is not an adequate test in today’s ‘continuous improvement’ world.

Hence, let’s devote some thought to the bottom up perspective; for it is from here that the suggestions for change have come. It has been noted, in particular, that the Reserve Bank Board is unique; no other central bank around the world has a decision making body comprised along the lines of ours: an argument for change, surely!

Let’s look first at the facts: how do our arrangements differ; and then turn to the arguments which, *a priori*, might suggest that one set of arrangements is to be preferred. The facts, as I understand them, are as follows:

- There are two basic models of the decision-making process within central banks: a single decision maker (the Governor or President) or a committee (Board). And within the committee structure, there are committees comprised of so-called experts and so-called laypersons or some combination of the two.
- Ninety percent of the world’s central banks use a Committee structure. New Zealand is an exception, as is China.
- Australia, obviously, uses a committee, the Board, and one comprised of both experts and laypersons (as so far defined). That sets it apart from many of the major central banks – where committees of experts are now the preferred model – but what makes Australia unique is that the Board also includes a so-called Government representative, the Treasury Secretary. Some other central banks also include such an official on the committee or board but not, as Australia does, as a voting member.

Before turning to the arguments for and against the alternative models, it is interesting to note, in passing, that the Australian model has remained unchanged since the RBA was set up under the Reserve Bank Act in 1959. In the four and a half decades since then, the conduct of monetary policy and the instruments used have changed enormously, reflecting developments both in the world economy and our understanding of monetary transmission mechanisms. It should not be surprising that such environmental changes have occasioned debate about the efficacy of a Bank governance model conceived in a very different setting.

So let’s look at the alternatives.

I don’t believe it is difficult to conclude, *a priori*, that a committee structure is likely to lead to better outcomes over the longer-term than a single decision-maker. Even where the latter is supported by an advisory mechanism which provides for debate around the decision (as in New Zealand), the probability of bias influencing the actual decision is

an observed risk. This is the conclusion of studies in many fields of governance and decision making but would seem particularly relevant to monetary policy which (ostensibly) pursues a single policy outcome, such as inflation. The pressure on the individual to achieve the single outcome, at any cost, is a real concern. Hence I won't pursue the single decision maker model further here.

Turning to the choice between expert and lay committees, the issues are less clear-cut, even if, *a priori*, the arguments might generally seem to favour the committee of experts. Obviously, in any field, it is an advantage in making decisions to understand the subject matter. But we should be clear that the task of the Board is to **take decisions** – not to collate the information on which the decisions will be based.

So we need to ask – and this is why I have earlier used the “so-called” terminology – how does one judge who is the expert and who is the layperson when it comes to decision-making? How does one recognize an expert decision-maker? To which the answer might well be ‘you’ll know one when you meet one’.

More seriously, the judgment on that cannot be made in a vacuum; it requires an understanding of the type of decisions that a monetary policy board is called upon to make.

Monetary policy decisions are classic cases of decision making in the presence of uncertainty. Fundamentally, this reflects the imperfect state of our understanding of monetary issues: we know that monetary policy operates with lags which are long but variable. We know less about the factors that affect that variability in a predictable manner. And given the existence of the lags, we know that we must rely upon forecasts; and, again, we know there are limits to our forecasting ability; as there are limits to our forecasting techniques and, generally forgotten, limits to the data which inform both our forecasting models and our gut feelings.

All of this means that by the time information is presented to decision makers, it has undergone multiple layers of judgmental manipulation. This does not mean that the decision-makers need to understand the intricacies of those manipulations i.e. to be ‘experts’. It does require that they be able to weigh up facts and uncertainties as presented to them. My own experience in working with both experts and laypeople in such processes does not incline me decidedly in favour of the experts.

Moreover, there are other considerations that arise from the greater degree of independence that central banks now enjoy. Namely, an expectation on the part of those who bestow the independence – i.e. governments – that the decision-making body will bring a diversity of expertise and experience to the table: not views that are representational, or partisan; certainly not; rather, views that are formed in a real world (real economy) context or in the research rich world of academia.

I am not convinced that the Australian model, which brings together precisely such a rich diversity of decision-making ability, is bettered by the alternatives on offer.

I'll add a couple of footnotes to that.

- First, I have not addressed the accountability argument i.e. that individual members of the decision making body need to be held publicly accountable. I have not done so because I believe it to be a red herring. In any well-functioning decision making body, it is neither necessary nor desirable for

individual members to be publicly accountable: the Chairman is accountable for the group. If the body ceases to be well functioning, the matter becomes academic – individuals will speak up.

- Secondly, I have not addressed the special case of the presence on the Board of the ‘government representative’, the Treasury Secretary.

The first thing to be said on that latter point is that, as a matter of law, the Treasury Secretary is not on the Board as a government representative. He could, of course, play that role *de facto*. I will simply say that I have not met one who did, or would. The second thing to be said, consistent with my earlier arguments, is that his presence on the Board is not critical. He does, however, bring to the Board a policy–advising experience that cannot be matched by any other Board member; and he brings the Treasury’s forecasting ability, which is also unmatched, including by the Bank. In the absence of an obvious alternative, his presence adds to the Board’s diversity and decision making ability.

Let me turn, in drawing to a close, to a related governance issue that has been the subject of some comment, namely the information released by the Bank and suggestions that the Bank should publish minutes of its meetings; and/or should make a statement after every meeting, giving reasons for its decision.

I am not attracted to the idea of publishing minutes, even though that is the practice in other places. Minutes that are to be published will be written for publication. Moreover, when published with a lag, as most others are, there is the benefit of hindsight (such as market reaction to the policy move) to assist in fashioning the minutes. I see zero value in such minutes. Moreover, reflecting my earlier comments regarding accountability, I see no public interest case whatever for the publication of voting records i.e. if minutes were to be published, voting records should be removed to preserve proper accountability.

I see more to be said for the Bank’s making an explanatory statement after each meeting, not just, as now, when a change of policy is announced. Certainly, advising the public of reasons for a change is of first importance. But for some of the public, e.g. market participants, knowing the Bank’s thinking in not making a change may well rank as highly, and for good reason: that reason being to follow the course of the Bank’s thinking in the context of the decision making process; not in the context of the next Bank announcement, when the ‘benefits of hindsight’ again help to blur the picture. This issue gains particular importance in ensuring markets gain sufficient confidence in the predictability of Bank decision-making to foster more stable markets.

It is true, of course, that the RBA today is at the forefront of world best practice in terms of the amount of information that it makes available through its regular publications. It is also true that central bankers have long been the world’s best at making Delphic statements; and financial markets have been world’s best at misinterpreting them. It is for this combination of reasons that I believe statements are best made in the context of the decision that are taken – as much when those decisions are ‘no change’, as otherwise.

I suspect there may be reluctance on the Bank’s part to being obliged to make a statement after every monthly meeting.

There is a simple solution to that problem: meet less frequently. There is no

compelling reason for the Bank to hold a decision-making meeting every month. I have commented earlier on the limits to our knowledge of the variable lags that attend the operation of monetary policy. I also have a reasonable knowledge of the amount of new information, about the future, that appears on a monthly basis. The simple fact is that the increment of knowledge from one month to the next is very very small. The Bank could readily meet, say, every two months without any detriment to policy making, and without anyone noticing the difference – other than those in the markets whose livelihood depends on volatility, such as that which can be generated around monthly Bank board meetings.

Fewer meetings combined with post meeting statements could serve several useful purposes.