**Mr. Macfarlane examines monetary policy developments in Australia during the last quarter of the twentieth century** Text of the Shann Memorial Lecture given by the Governor of the Reserve Bank of Australia, Mr. I.J. Macfarlane, in Perth on 15/9/98 (exluding bibliography).

## 1. Introduction

It is an honour to be invited here tonight to deliver the Shann Lecture. As is customary when giving a memorial lecture, I have re-acquainted myself with the writings of the man whose memory we are honouring. It is noteworthy that for most of his working life he held a Chair at this University in History and Economics, as opposed to Economic History. This allowed him to range over a broad area, both as a scholar and as a polemicist.

His scholarly reputation rests mainly on his economic histories, and I am pleased to record that he also wrote a fine piece on monetary policy in 1933 called “National Control of Banking”.[1] His best known work, “The Boom of 1890 - and Now”, was not much more than a pamphlet, but was extremely important in establishing his reputation among the wider public. Written in 1927, it was an account of a period about 40 years earlier - a period that was recent enough to matter, but too long ago to have figured in people’s working lives. I see a lot of value in this type of work, and have even tried my hand at a similar piece myself.

Tonight, I would like to move to a more recent era and to a narrower topic, by examining the development of monetary policy over the last quarter of the twentieth century. In doing so, I intend to cover not only the institutional changes, but, where relevant, the intellectual cross-currents and the political influences that were at work. It may seem strange to give a prominent role to political influences, because the end point we have now reached in our monetary policy framework in Australia is not dissimilar to that of a number of countries that have had very different political developments. But even though the end points are similar, the sequence of events in the Australian development has been unique, and political influences have played a role in that sequence.

## 2. The starting point in the mid-1970s

Around the world, the mid-1970s was a very unhappy period for macro-economics - to find a worse period in terms of economic mismanagement, we would have to go back to the 1930s. In the 1930s a severe deflation was let loose on the world economy, while in the 1970s it was a severe inflation. To make matters worse, even though the inflation of the 1970s was initially tolerated because it was thought to be helpful in pushing unemployment down to very low levels, it ended up having the perverse effect of yielding a higher level of unemployment. The word stagflation was coined to describe this period.

The experience of the Australian economy in the mid-1970s reflected these unfortunate worldwide developments to the full. The underlying rate of inflation reached 20 per cent by early 1975 and was in double digits again in the early 1980s. Unemployment rose from 1.4 per cent at the start of the decade to 6.5 per cent by 1978. While the unemployment rate rose further in later decades, it was the 1970s that transformed Australia from a low to a high unemployment economy.

All macro-economic policies came in for severe and justifiable criticism at this

[1] Published in Shann (1933).

time, monetary policy being no exception. A similar phase of self-examination occurred in all OECD countries, and there was intense debate about monetary policy in the economic literature. In this lecture, I would like to examine how this debate evolved in Australia and how it led to changes in our monetary institutions, our guiding economic principles, and the responsibility for decision-making. I intend to concentrate on these three main areas:

- First, changes to the institutional structures which formed the underpinnings of the money supply process - regulations on banks, methods of government debt financing and the exchange rate regime. Changes to these features amounted to fixing up the underlying "engineering" of the monetary system.
- Second, changes to the guiding economic principles which determined whether monetary policy was on the right course.
- Third, changes to the "governance" of the monetary policy decision-making process.

From the above description it may still not be completely clear exactly what the difference is between these three main areas of change. Perhaps it will be a little clearer if I employ a metaphor. If we were to picture monetary policy as a ship, the first of these changes was to stop it leaking, the second was to equip it with a more reliable navigation system and the third was to work out who should be at the helm.

## 3. Fixing up the underlying "engineering"

I do not wish to spend a lot of time describing how the monetary ship was made seaworthy because there are already some very good accounts available.[2]

At our starting point in the mid-1970s, most observers agreed that loose monetary policy had been a major factor behind the rise in inflation, and that it needed to be tightened. Unfortunately, there were significant structural deficiencies in the system which meant that no one could be confident that a tightening could be achieved with any reliability.

The first deficiency was that the system relied heavily on direct controls on banks, including interest rate ceilings imposed on banks' deposit and lending rates. This meant that, even if monetary policy was successful in limiting the expansion of bank deposits and lending (and it was by no means clear that it would be), the tightening of conditions would not extend to the non-bank financial intermediaries. It was this group - merchant banks, building societies and finance companies (formerly called hire purchase companies) - which were usually the fastest growing providers of finance.

The solution to this problem was to remove the interest rate ceilings and allow banks to compete on equal terms with other providers of finance.[3] This meant that if banks were short of liquidity they could raise interest rates and compete for funds with other intermediaries who, in turn, would probably have to match them. In this way the tightening of conditions would be spread across the whole financial sector. Interest rate ceilings on deposits were removed in December 1980 and on smaller business loans in April 1985. With the removal of the ceiling on

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[2] Grenville (1991).

[3] This may seem obvious now, but it was not the first response to the problem. The first response was to set in train a process whereby interest rate ceilings would be extended to cover all non-bank financial institutions. An Act of Parliament was passed - the Financial Corporations Act of 1974 - to do this, but Part 4 of the Act was not proclaimed and therefore the powers to extend controls never came into effect.

loans for owner-occupied housing in April 1986, the last of the interest rate ceilings was gone.

The second deficiency in the system was that there was no mechanism in place to ensure that the budget deficit was financed entirely by borrowing from the public. Any shortfall in borrowing from the public was automatically met by the Government borrowing from the Reserve Bank, a method of financing which is colloquially known as "printing money" or "monetising the deficit". In order to stop these unintentional monetary injections into the system, the Government needed to move from its existing system, where it set interest rates on government bonds and issued only the amount of bonds that the market wanted to buy (the "Tap System"), to a new system where it sold the amount needed to finance the deficit at whatever interest rate the market demanded (the "Tender System"). This move occurred in 1979 for Treasury notes and in 1982 for government bonds.[4]

Finally, the fixed, quasi-fixed or occasionally changed exchange rate regimes that Australia had used over the post-war period introduced another element of unintended monetary injections or withdrawals into the system. Under all these systems, the Reserve Bank had to clear the foreign exchange market at the end of each day. If there were more buyers of Australian dollars than sellers, this effectively represented an injection into the Australian money supply. This meant that if monetary policy was tightened in Australia with a view to slowing the growth of the money supply, its effects could be offset through the foreign exchanges. This is because the tightening of monetary policy would raise Australian interest rates relative to other countries, and attract money into Australian dollars. In the first instance, this could be offset by Reserve Bank open market operations, but in the long run it could be self-defeating. This problem was overcome with the floating of the Australian dollar in December 1983.

These three changes were effectively completed by the mid-1980s. Even though one of them - the float of the currency - was a massive change to Australia's economic structure,[5] the three changes were seen by economists as largely technical in nature, and there was little dissent in the economic community. Also, there was no political polarisation with one party supporting and the other party resisting the change. The Campbell Committee, which reported in September 1981, had been an important influence in establishing a consensus for change. This Committee had been set up by a Coalition Government, but most of its recommendations were implemented by a Labor Government.

## 4. A better guiding principle

The move to greater exchange rate flexibility, which, as explained above, had begun well before the float, meant that monetary policy needed a new guiding principle (or a new navigation system, to quote the metaphor used earlier in this Lecture). Instead of having an external guide (the fixed exchange rate), a satisfactory *internal* guide had to be found. This process, beginning in the mid-1970s, took Australian monetary policy from a system based on pure discretion, to monetary targeting, and ultimately to the present system of inflation targeting. The changes were not always smooth and there were some important gaps along the way which

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4 This change permitted another important improvement - the separation of debt management from monetary policy. See Phillips (1985) and Reserve Bank (1993).

5 Even here the break was not as dramatic as it seems, because Australians had already got used to daily bilateral exchange rate movements under two of the pre-float exchange rate regimes. Under both the "fix to the trade weighted basket" (1974 to 1976) and "adjustable peg to the trade weighted basket" (1976 to 1983), the exchange rate of the Australian dollar against the US dollar could change every day, even though the Reserve Bank cleared the foreign exchange market at the end of each day.

have never been satisfactorily explained. I would like to retrace some of this ground tonight. In doing so, I hope to skip lightly over the periods that have been covered fully before and concentrate on those that have been neglected.

From 1945 to 1971 the Australian dollar was pegged against the US dollar, and this effectively formed the centrepiece of Australian monetary policy. If our economic conditions got too far out of line with those in the United States it would imperil the exchange rate, and so fiscal and monetary policy would have to change in order to prevent it. It is a simple system, and one that still finds favour in a number of quarters around the world. The best known current example of this system is the Exchange Rate Mechanism of the European Monetary System, which is scheduled soon to go a step further into monetary union with a single currency (the euro) and a single central bank - the European Central Bank.

Our link with the US dollar was broken in 1971, and thereafter the discipline exerted by a fixed exchange rate dissipated; once the link was broken the first time, it was no longer “sacred” and could be broken again. Although we retained a pegged exchange rate system in one form or another until 1983, parity adjustments became increasingly frequent. We were effectively on our own with no clearly enunciated guiding principle behind our monetary policy until monetary targeting was introduced in 1976. This period of four-and-a-half years could therefore be regarded as one where unconstrained discretion was the underlying basis of monetary policy.[6] Since it was also the period when inflation accelerated most quickly and reached its highest level, it confirmed the general suspicion among monetary economists that something more than pure discretion was needed. Some guiding principle, or rule, that limited the capacity for discretion in monetary policy was essential to keep it from falling under the influence of expediency or succumbing to populist pressures for an excessively expansionary stance.

*(a) The period of monetary targeting*

By January 1976 that guiding principle was found when Australia fell into line with a large number of other industrialised countries by introducing a monetary target. This move, which coincided with the election of the Fraser Government, had strong support from the Reserve Bank and the Treasury. Within the Bank, the Research Department had been heavily influenced by academic monetarism, as evidenced by much of their research output in that period and the choice of visiting overseas scholars.[7] At the top of the Bank, the Governor and Deputy Governor were supportive of the new regime, but retained a degree of scepticism and a recognition of the need for some flexibility.[8]

The Australian system of monetary targeting was based around an annual target for M3, which was not unusual by world standards. What was unusual was that it was set by the Treasurer on the joint advice of Treasury and the Bank. Another unusual feature was that the Bank always preferred to use the term “conditional projection” rather than target. Its success, as measured by how often it was met, or by the size of over-runs, was not very different to

6 The term discretion is used by economists to describe the conduct of monetary policy where the authorities adjust policy by reference to a range of indicators, none of which has any special standing. A criticism of discretion is that the public does not know what the monetary policy framework is, and therefore has trouble telling whether the authorities are acting in accord with principles or expedience. As a system, it is the opposite of a rule (such as a fixed exchange rate or monetary targeting).

7 Professors Laidler, Parkin and Poole all spent time at the Reserve Bank during this period.

8 See Sanders (1979) and Sanders (1982).

experience elsewhere.[9] This degree of success was somewhat surprising considering that for most of the period over which it operated the underlying monetary "ship" contained all the leaks and distortions referred to in the previous section.

The era of monetary targeting lasted for nearly nine years (from April 1976 to January 1985), which roughly coincided with the period which Goodhart describes as "the high water mark of international monetarism".[10] I do not propose to examine its strengths and weaknesses at any length because I have done so elsewhere, as have others.[11] Suffice to say that it did bring some order to Australian monetary policy and was a big improvement on its predecessor. Nevertheless, it had only limited success in its central task of reducing inflation, and as time went on its inherent weaknesses began to show. The logic of monetary targeting presupposes a stable statistical relationship - the demand for money - which implies that inflation is ultimately linked to the rate of growth of the money supply. This relationship, as in other countries, was never very precise over short periods, but that could be tolerated if it retained its long-run stability qualities. In time, particularly as a result of financial deregulation, the long-run relationship started to become unstable. At some point, M3 targeting had to be abandoned.

*(b) The replacement for monetary targeting*

In the event, monetary targeting was discontinued in January 1985. The immediate reason for it was the extent of overshooting that was occurring during 1984, which seemed to indicate the effects of financial deregulation rather than a major rise in incipient inflation. Also of importance was the fact that Treasurer Keating had made no secret of his lack of enthusiasm for this approach to monetary policy.[12] Even so, the decision to discontinue targeting was seen by some as precipitate, and many in financial markets were unprepared for the change. The Bank was criticised for not having produced a convincing body of work containing the evidence for the change in policy regime. Some of this criticism was justified, but to prove the breakdown in a long-run relationship always takes a long time.[13]

To allay the fears of those in financial markets who thought that the end of monetary targeting meant a return to unconstrained discretion, the Bank looked for an alternative framework which it could use as the basis for its monetary policy. As a result, the so-called "checklist" was born. Its birth was announced in May 1985 by one of my predecessors, and its most detailed exposition was given in his 1987 Shann Lecture.[14] In the event, it proved to have a short life and there was little further mention of it after that time. The checklist contained a number of economic variables that were to be taken into account in setting monetary policy. Up to a point, it was useful in conveying the sensible idea that monetary policy needed to look at a wide range of indicators, not just one. Its problem was that it did not have a sufficiently well-thought-out economic rationale or any criteria for determining which indicators were more important. In particular, it failed to distinguish between the instrument of monetary policy, intermediate targets and ultimate targets (an essential framework that is to be discussed in the next section). They were all in there, along with at least one variable that did not fit into any of these categories.

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9 Argy, Brennan and Stevens (1990).

10 Goodhart (1989).

11 Grenville (1997), Edey (1997).

12 As explained earlier, it was the Treasurer who set the annual monetary target, which he announced in his budget.

13 Decisive evidence was produced in series of research papers beginning in 1987.

14 Johnston (1985 and 1987).

The checklist was introduced in haste - barely four months after the end of monetary targeting. It had not undergone close economic analysis within the Bank, and had not been exposed to prior public scrutiny through research papers. In defence, it has to be said that the circumstances of the time were very turbulent; in 1985, the currency was plunging, bond yields were rising and there was a loss of confidence in Australian macro-economic policy and serious doubts about the sustainability of our external position. There was a feeling something had to be done. Nevertheless, an important lesson was learnt from the episode - no central bank should commit itself to a new monetary policy regime until it has researched the subject thoroughly and established its credibility with reference to the economic literature and overseas practice.

*(c) A new period of discretion? The Reserve Bank and its critics 1988-1993*

With the short-lived "checklist" period over, the Bank entered 1988 with no articulated framework for monetary policy, but a determination not to introduce a new one in haste. At first, there was little pressure from the markets, the press or the economic community to deliver a new framework because by 1988 the currency woes of 1985 and 1986 seemed well behind us. But that mood soon changed as critics began to focus on the fact that Australian inflation had not returned to relatively low rates as it had in most OECD countries. It is this period of intense criticism - roughly from 1989 to 1993 - that I would like to cover in some detail. I trust I can do this safely now because we are far enough past this period for it to have lost its political sensitivity, but close enough to still remember the details.

The main charge of the critics was that Australia was still an inflation-prone economy, and that its central bank was never going to be able to improve the situation while-ever it relied on unconstrained discretion as the basis of its monetary policy.[15] The critics also attacked the Reserve Bank for a lack of independence. Other high inflation countries such as the United Kingdom (which was opting for membership of the European Monetary System) and New Zealand and Canada (which were opting for inflation targeting) were doing something about "stiffening up" their monetary policy frameworks, but Australia appeared to be doing nothing. To make matters worse, in the eyes of the critics, the newly appointed Governor - Bernie Fraser - was known to be a close associate of Treasurer Keating, and they therefore assumed his appointment would result in a reduction in the Bank's independence, already perceived as being too little. This was another subject where they also had some suggestions, but I will save the discussion of central bank independence until the next section. For most of the critics, there was no alternative but radical reform of the legislation to create a new type of central bank subject to some form of binding monetary rule.

Many of the critics were also influenced by academic thinking which held that discretionary monetary policy would inevitably fail. Discretion was held to be destabilising, and to have an inevitable inflationary bias which could only be corrected by the imposition of a rule

[15] Many of the criticisms took place in the political arena and in the columns of newspapers, but the more substantive ones mainly appeared in economic or political journals. A reasonably comprehensive sample of the substantive ones would include, in chronological order, Hartley and Porter (1988), Jonson (1989), White (1989), Cole (1990), Dowd (1990), Jonson (1990), McTaggart and Rogers (1990), Morgan (1990), Stone (1990), Hartley and Porter (1991), Sieper and Wells (1991), Evans and Dowd (1992), Hanke, Porter and Schuler (1992), Moore (1992), Stone (1992), Makin (1993), Evans (1994) and Weber (1994). The titles of some of the conferences organised on the subject around this time convey the flavour: e.g. "Do we need a Reserve Bank?" (CIS, 1989); "Can monetary policy be made to work?" (IPA, 1992).

on the central bank. These conclusions, deriving mainly from the writings of Friedman and other members of the monetarist school, received empirical support from the events of the 1970s and 1980s.[16] This debate is usually called the “rules versus discretion” debate, and those supporting a rule generally got the better of the argument. They were reinforced by the newer sophisticated writings of the rational expectations school, and in particular by its introduction of the concept of “time inconsistency”, which purported to show that there was a technical reason why only a rule could contain inflation.[17]

While there was a degree of agreement among the Australian critics about what was wrong with Australian monetary policy, there was less agreement about what rule should replace the existing system. The critics proposed a wide range of alternative models, including a currency board, monetary base targeting, a return to targeting broader monetary aggregates, various forms of commodity standards, and a combination of inflation targeting and central bank independence.[18]

Within the Reserve Bank there was some sympathy for an important part of the critics’ case; it was conceded that monetary policy based entirely on discretion was intellectually and practically unsatisfactory, and it had been associated with high inflation in country after country. We also agreed that something better was needed, but most of the concrete proposals could be dismissed as impractical. There were no practical working models of strict monetary base control or commodity standards, and monetary targeting and fixed exchange rates had already been rejected as unsatisfactory for Australia.

The difficulty arose with respect to the inflation targeting proposals. There was recognition within the Bank that this was the most promising approach, but political circumstances contrived to make our participation in the debate marginal at best. This was because from about late 1989 onwards the most vocal proponent of the view was John Hewson, first as shadow Treasurer, then as the Leader of the Opposition. This had the effect of forcing the Government into defending its record on monetary policy and hence the existing institutions and approach. It was a great disappointment for the Bank that this debate was politicised[19] before the economics profession had time to explore it fully in an objective non-partisan way. But it would be unfair to criticise either of the two political protagonists for this - there is nothing wrong with them being quicker off the mark than the economics profession.

The Bank had long agreed with its critics that Australia’s high inflation rate was an obstacle to sustained economic development and that monetary policy would have to play the

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16 Friedman (1968), Brunner (1980) and Poole (1980) are good examples of this literature.

17 See Kydland and Prescott (1977) and Barro and Gordon (1983).

18 Hartley and Porter (1991) proposed either a monetary base control regime or a currency board. Hanke, Porter and Schuler (1992) favoured a currency board. McTaggart and Rogers (1990), Sieper and Wells (1991) and Makin (1993) supported monetary base targeting, while Weber (1994) supported targeting M1. Commodity standards were proposed by White (1989), Dowd (1990) and Evans (1994).

19 I have reviewed the files in our Press Office for this period, and am still surprised at the huge amount of material they contain. Although only the most important pieces have been kept, the Hewson versus Keating controversy over the Reserve Bank is detailed in literally hundreds of press cuttings, excerpts from Hansard, competing press releases and media interviews. The files confirm that Dr Hewson initially criticised the Bank in late 1989 for being too close to the Government and called for greater independence and more emphasis on medium-term anti-inflationary policy. This general critique was made more concrete in mid 1991 when he proposed legislative changes to ensure independence and the single objective of inflation, plus the introduction of an inflation target of 0 to 2 per cent. It was this proposal that became part of the “Fightback” package in late 1991 which formed the basis of the Opposition’s 1993 electoral platform.

major role in remedying the situation. During 1988 and 1989, the Bank's research efforts were taking it towards a model that had a lot of similarities to those which underlay the New Zealand or Canadian style inflation targeting.[20] Our research had taken us down a path that led to the same general framework as those models, (and of the model of inflation targeting we eventually adopted in 1993). It is summed up in the schematic framework below:

**Table 1: Schematic Framework for Monetary Policy**

| ***Possible Instruments*** | ***Possible Intermediate Targets*** | ***Possible Ultimate Targets*** |
|---|---|---|
| Overnight interest rate* | None* | Inflation* |
| *or* | *or* | *or* |
| Money base | Money supply | Nominal GDP* |
| | *or* | *or* |
| | Exchange rate | (Real GDP) |
| | | *or* |
| | | (Employment) |
| | | *or* |
| | | (Balance of payments) |

In August 1989, which was just before the subject had become politically charged, I was able to summarise our views to an international audience of central bankers as follows: the cash rate is the instrument of monetary policy,[21] there is no intermediate objective,[22] and the ultimate objective has to be a nominal variable such as the rate of inflation or nominal[23] GDP (the asterisked elements in Table 1).

While we accepted some of the arguments of our critics, and we shared a common framework with the most practical of the alternative models put forward, there were still some major differences. First, and most importantly, we believed that we could achieve what our critics wanted - a return to a low inflation environment - without radical overhaul or a complete rewriting of the Reserve Bank Act. In a sense, we believed that reform from within was possible and that this would gradually return Australia to being a low inflation country. Secondly, we believed that the early overseas formulations of the inflation targeting/central bank independence model were too rigid in several ways:

- There was a tendency to suggest that the single objective of low inflation meant that central banks should pay no attention at all to other economic variables. We felt that there are a number of circumstances where, even if primacy is given to maintaining low inflation, the effects on output and employment had to be taken

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20 Some of this was presented in a conference held by the Reserve Bank in June 1989; see Macfarlane and Stevens (1989) and Edey (1989). See also Grenville (1989).

21 "For all intents and purposes, the cash rate is our instrument." Macfarlane (1989).

22 "No-one can dispute the need for an instrument, or for the ultimate aim of monetary policy to be made clear. The one part of the trilogy that is not self-evident is the need for an intermediate objective. It is the part we have come to doubt, and ultimately to discard." ibid.

23 "We have no desire to dispute the widely-held proposition that the ultimate objective of monetary policy should be a nominal variable such as the rate of inflation or the rate of growth of nominal income. A system which operates directly from instrument to ultimate objective still has to contend with the fact that there is a long interval between the movement in the instrument and the resulting change in the ultimate objective. For this reason, actual inflation is not a good guide for monetary policy; leading indicators of inflation are much more useful." ibid.

into account and had to influence monetary policy actions. The best central banks overseas, moreover, clearly behaved in this fashion.

- There was a tendency for proponents to understate the output and employment costs of the initial reduction in inflation. This was because they relied on the conclusion from the rational expectations school that *credible* disinflations would be relatively costless.
- We were worried that if central banks were to be judged *only* by inflation results, there would be a tendency to over-achieve, i.e. they would be very reluctant to allow inflation to rise, even if only slightly and for short periods, but would readily accept circumstances that pushed the economy in the deflationary direction.
- Because New Zealand and Canada had chosen 0-2 per cent as their target, that had become the numerical norm in discussions of inflation targeting. We regarded this as probably too low, and certainly too narrow a range.[24] No country had achieved this sort of inflation performance over any significant time interval in the past 50 years. We did not like the concept of a "hard-edged band", particularly the early formulations which suggested some decisive action occurring whenever the band was breached.[25]

During the early 1990s, particularly between the 1990 and 1993 elections, the Bank had to keep a pretty low profile in the debate because of the political constraint alluded to earlier. Governor Fraser made a number of speeches which defended the Bank and its monetary policy. In some of these he also questioned the more extreme versions of inflation as the single objective, and disputed the view that central bank independence meant that there should be an adversarial relationship between the central bank and the Government.

During this period, the lack of a monetary policy framework that could command widespread support had its costs. It meant that each of the monetary policy easings of 1990 and 1991 were met by the charge that they were only done for political reasons (lowering interest rates was presumed to make the Government more popular). There was clearly great distrust of monetary policy, the Government and the Reserve Bank - or, in modern parlance, a lack of credibility.

It is interesting that virtually all of the serious criticism of the Bank in this period was coming from the perspective that it was too soft on inflation.[26] Hence the proposals for reform were all aimed, in one way or another, at eliminating the supposed inflationist tendencies. Yet, while all the debate was going on, inflation was actually falling to its lowest level for a generation. In some senses, it was this that ultimately proved decisive in confirming that it was possible to return to a low inflation environment without radical change to the Reserve Bank or its Act. It was this economic development that ultimately ended the debate in our favour.

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24 We think our views were vindicated when Canada shifted its end-point target to 1-3 per cent in 1994 and New Zealand to 0-3 per cent in 1997. On the other hand, Canada and New Zealand could respond by pointing out that they are now well within their "old band", and did not need the change.

25 For example, the automatic dismissal of the Governor, or a system where the Governor's salary was inversely related to the rate of inflation. While these have never become a part of any country's system, they were widely believed to be an important part of inflation targeting in much of the early Australian discussion.

26 There were some exceptions - Phipps and Sheen (1995), Bell (1997), Langmore and Quiggin (1994) - but they came after the 1989-1993 period. Also, they did not propose any restructuring of the Reserve Bank; they merely argued that it should have run easier policy.

Having said that, I do not want to suggest that we foresaw the whole development and were always confident of the result. We, like our counterparts in other countries, were surprised by how far and how quickly inflation came down at the beginning of the 1990s. We also did not forecast the depth of the 1990/91 recession. But once inflation had come down, we felt that there was a high likelihood that it would stay low during the subsequent phase of economic growth. We also felt that an inflation target would help to bring about that result.

*(d) The introduction of inflation targeting*

As I have already suggested, much of the intellectual groundwork for the development of our inflation target had been laid well before its introduction. The crucial step required to turn this into reality was the adoption of a published numerical target. For reasons already alluded to, it was some time before this step was taken. Not only was the issue highly politicised, but there was a strong presumption (by both the critics and proponents of inflation targeting) that an inflation target had to be "0-2", which the Bank felt would have been too restrictive. Although we had a general aim of getting inflation down, we did not follow the New Zealand or Canadian sequence of announcing, in advance, a planned reduction to a particular range over a specific time period. As it turned out, that sequence was reversed in our case - inflation was reduced, and a commitment to keep it low as then put in place.

The process of establishing that commitment in the public arena was itself a gradual one. Governor Fraser in 1993 referred in two speeches to the objective of keeping inflation around 2 to 3 per cent[27]. The initial flavour of these remarks was that inflation had reached a trough in the early-1990s recession, and that the Bank wished to ensure that it did not rise appreciably during the recovery. This commitment was expressed increasingly firmly with time.

In developing our inflation target, the Bank was encouraged by the examples of other countries such as the United Kingdom and Sweden, which adopted inflation targets in 1992 and 1993. These showed that alternative, less rigid inflation targeting models could gain acceptance. Both countries specified targets higher than the original "0-2" model.[28] Our own choice of a 2-3 per cent figure was based partly on pragmatic considerations.[29] Inflation had declined to a trough of 2 per cent, and the main priority was to stop it rising too much from there. There was also a respectable body of academic opinion to suggest that it was optimal to aim for something in the low positive range rather than too close to zero.[30]

The other unusual aspect of inflation targeting in Australia was that it was introduced by the central bank. In other countries such as New Zealand, Canada and the United Kingdom, it was from the outset a joint undertaking by both government and central bank, with the former setting the target and expecting the latter to achieve it. Usually, the agreement was formalised in a public document. The evolutionary nature of this process of change in Australia was no doubt unsatisfactory to some of the Bank's critics. They would have preferred a more

27 Fraser (1993(a) and 1993(b)).

28 In the United Kingdom, the initial target was 1-4 per cent, but to be in the lower half of the range by the end of the parliamentary term. Sweden's target range was 1-3 per cent.

29 See Stevens and Debelle (1995) for a discussion of the considerations involved in specification of the target.

30 Summers (1991) and Fischer (1994) outline reasons why a low positive inflation rate may be optimal. Summers suggests an optimal range of 2-3 per cent, while Fischer's preferred range is 1-3 per cent. Alan Greenspan had talked about the need to ensure that inflation was "low enough not to materially affect business decisions".

decisive regime shift, and there were some who felt that the absence of such a shift meant that we did not have a "proper" inflation target.

But gradually, the Government began to recognise that the inflation target was helpful to good economic policy. They had not argued against it after it was introduced, but it was difficult for them to embrace it enthusiastically, given its chequered political history. Even so, by 1995 and 1996, Treasurer Willis was publicly giving the Government's endorsement to the Reserve Bank's target. In June 1995, in Accord Mark VIII, the ACTU agreed to aim for wage increases that were compatible with an inflation outcome of 2 to 3 per cent. Thus, Australia was gradually arriving at a very satisfactory position whereby most of the monetary policy regime was now receiving bilateral support - a huge improvement on the situation in the early 1990s.

## 5. Improving the governance of monetary policy

This is the third and last of the areas of monetary policy that needed to be clarified and improved. Returning to the nautical analogy introduced in the first section - this area concerns the question of who should be at the helm now that the vessel has been made seaworthy and equipped with a reliable navigation system? Most listeners will recognise that this boils down to the much-discussed subject of central bank independence, to which I promised to return.

Although there has been a worldwide movement towards greater central bank independence over the past decade, I propose only to talk about the aspects that have been unique to Australia. One of the peculiarities of the Australian debate on this subject is that the Reserve Bank, by virtue of its Act in 1959, was always given a high degree of general independence as an institution.[31] The fact that it had been unable to exercise this independence in monetary policy for much of the post-war period was due to a practical impediment - it did not possess the instruments of monetary policy. In the heavily regulated financial world which characterised most of the post-war period, virtually all the instruments - in the form of interest rate controls on government debt and on bank lending and borrowing rates - were vested in the Treasurer. It was not until deregulation was largely completed in the mid-1980s that the Reserve Bank was in a position to exercise the monetary policy powers contained in its Act. Only when it became possible to use open market operations to "set" the overnight cash rate, was the Reserve Bank in a position to adjust monetary policy in the same manner as (say) the Federal Reserve Board in the United States or the Bundesbank in Germany.

This development occurred at about the same time as the intellectual case for central bank independence was gaining momentum in major economies around the world.[32] But, just as in the case of inflation targeting, the issue of central bank independence in Australia also got caught up in the political crossfire between the same two parties. It is perfectly reasonable that it should become a political issue, because it is about the optimal delegation of decision-making authority, a decision which rightly rests with the Government. While the Bank throughout the 1990s had independence, the political stand-off delayed its official recognition for a period longer than the delay of the Government's recognition of the inflation target. The final

31 Phillips (1992) and Macfarlane (1996).

32 A much earlier expression of the case for central bank independence can be found in Professor Shann's piece on monetary policy, where he wrote … "My main theme is that central banking can give a community and, indeed, a world economy stable money …, if the politicians will give it fair scope and if men of technical skill and professional morale are given charge of the job with a judicial security of tenure." Note that this was written in the middle of the Depression and that the stable money to which he referred meant principally the avoidance of deflation. Shann (1933).

recognition was not achieved until after a change of government had occurred. In August 1996, the present Treasurer and I signed the *Statement on the Conduct of Monetary Policy* which set out the Government's recognition of the Reserve Bank's independence and support for the inflation target.

There is still a lingering misconception in Australia that parties of the political right support central bank independence and that those of the left oppose it. This is a peculiarly Australian perspective based on our experience in the early 1990s; it is not true at present, was not at an earlier date[33] and has not been the case in other countries. The two best known examples of countries adopting central bank independence are New Zealand, where the legislation was introduced by the Lange Labour Government, and in France, where it was introduced by the Socialist Administration of President Mitterand. In the United Kingdom, the Conservative Government resisted granting independence to the Bank of England to the end, but the incoming Blair Labour Government introduced it as one of its first Acts. In all of these three cases, unlike Australia, new legislation was required because the existing Acts did not provide for independence.

## 6. Conclusions

I have covered a full quarter of a century in this account, and have attempted to fill in some of the political, as well as the intellectual, background. It has been an eventful quarter of a century for monetary policy, but one where a lot of progress has been made. Some of this improvement has been easy because the starting point was so bad - the mid-1970s to late-1970s saw inflation peak at 20 per cent, while unemployment was rising and economic growth was going through its most sluggish phase in the post-war period. Today's economic environment is extremely benign in comparison to those days, even though, like then, we have the threat of an external shock hanging over us.

When my account starts, not only were monetary institutions inadequate, but monetary policy was not held to be very important. Fiscal policy was given precedence, and monetary policy played a subsidiary role. In those circumstances, it is not surprising that the monetary framework was not well developed, and that little public attention was focused on it. By the time monetarism arrived on the Australian scene, this all changed. Monetary policy became regarded as extremely important and much attention was focused on it. As we have seen, this attention eventually increased so that by the late 1980s-early 1990s, monetary policy had become an intensely political subject. Not only was the conduct perceived as political, but the design of its institutions had become important enough to form a major part of the electoral platform of one of the major political parties.

Finally, we have entered a phase where a measure of peace has returned. The day-to-day conduct of monetary policy is still closely scrutinised by the markets and the media, but attitudes to the underlying institutions and framework have reached a measure of bipartisan support. With the reduction in controversy, monetary policy has gained a degree of credibility that seemed out of the question a decade ago.

Of course, it is not only the bipartisan acceptance of the framework that has contributed to the increase in credibility. The larger reason is that Australia has returned to the

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[33] Under the Fraser Coalition Government (1975 to 1983), monetary policy decisions were taken by the Monetary Policy Committee (MPC) of Cabinet - the opposite of central bank independence.

ranks of low inflation countries, so the underlying grievance of the majority of the Reserve Bank's critics has been removed.

Economic historians who look back over the past quarter of a century may well be surprised by the huge role played by inflation in shaping our attitudes to monetary policy. They should not be surprised. Just as the deflation of the thirties was the dominant macro-economic event of the first half of this century, the rise of inflation in the 1970s was the dominant event of the second half of the century. So much of recent monetary policy thought has simply been a response to that event, just as Keynes provided the response to the earlier event. What will be the next challenge? Already, monetary thought is recognising that there are more things to central banking than a single-minded pre-occupation with inflation. The recent events in Asia have taught us that the avoidance of financial crises is as important. In Japan, we are confronting the spectre of deflation, which we all thought had been left behind after the war. It would be fascinating to know what the defining event will be in the next quarter of a century.