

Statement on the Conduct of Monetary Policy

The Treasurer and the Governor of the Reserve Bank

30 September 2010

This statement records the common understanding of the Governor, as Chairman of the Reserve Bank Board, and the Government on key aspects of Australia's monetary and central banking policy framework.

Since the early 1990s, inflation targeting has formed the basis of Australia's monetary policy framework. Since 1996, this framework has been formalised in a Statement on the Conduct of Monetary Policy. The inflation targeting framework has served Australia well and is reaffirmed in the current statement.

This statement should continue to foster 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 Reserve Bank.

This statement also records our common understanding of the Reserve Bank's longstanding responsibility for financial system stability.

Relationship between the Reserve Bank and the Government

The *Reserve Bank Act 1959* (the Act) gives the Reserve Bank Board the power to determine the Reserve Bank's monetary policy and take the necessary action to implement policy changes. The Act nominates the Governor as Chairman of the Reserve Bank Board.

The Government recognises the independence of the Reserve Bank and its responsibility for monetary policy matters and will continue to respect the Reserve Bank's independence as provided by statute.

New appointments to the Reserve Bank Board will be made by the Treasurer from a register of eminent candidates of the highest integrity maintained by the Secretary to the Treasury and the Governor. This procedure removes the potential for political considerations in the appointment process and ensures only the best qualified candidates are appointed to the Reserve Bank Board.

Section 11 of the Act prescribes procedures for the resolution of policy differences between the Reserve Bank Board 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 Reserve Bank's independence in the conduct of monetary policy. Safeguards like this ensure that monetary policy is subject to the checks and balances inherent and necessary in a democratic system.

In addressing the Reserve Bank's responsibility for monetary policy, the Act provides that the Reserve Bank Board shall, from time to time, inform the Government of the Reserve Bank's policy. Such arrangements are a common and valuable feature of institutional systems in other 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.

Objectives of Monetary Policy

The goals of monetary policy are set out in the Act, which requires the Reserve Bank Board to conduct monetary policy in a way that, in the Reserve Bank Board's opinion, 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.

The first two objectives lead to the third, and ultimate, objective of monetary policy and indeed of economic policy as a whole. These objectives allow the Reserve Bank Board 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 Reserve 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 jobs, protect the savings of Australians and preserve the value of the currency.

In pursuing the goal of medium-term price stability, both the Reserve Bank and the Government agree on the objective of keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short-run variation in inflation over the cycle while preserving a clearly identifiable performance benchmark over time.

Since the adoption of inflation targeting in the early 1990s, inflation has averaged around the midpoint of the inflation target band. The Governor takes this opportunity to express his continuing commitment to the inflation objective, consistent with his duties under the Act. For its part the Government indicates that it endorses the inflation 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. A forward-looking focus is essential as 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 Reserve Bank continues to 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.

The Reserve Bank takes a number of steps to ensure the conduct of monetary policy is transparent. The Governor issues a statement immediately after each meeting of the Board, announcing and explaining the Board's monetary policy decision, and minutes of each meeting are issued two weeks later providing background to the Board's deliberations. The Reserve Bank's public commentary on the economic outlook and issues bearing on monetary policy settings, through public addresses and its quarterly *Statement on Monetary Policy* and *Bulletin*, have been crucial in

promoting increased understanding of the conduct of monetary policy. The Reserve Bank will continue to promote public understanding in this way.

The Governor has also indicated that he plans to continue the practice of making himself available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Economics.

The Treasurer expresses support for the continuation of these arrangements, through which the transparency and accountability of the Reserve Bank's conduct of monetary policy are in line with international best practice. These arrangements enhance the public's confidence in the independence and integrity of the monetary policy process.

Financial Stability

The stability of the financial system is critical to a stable macroeconomic environment. Financial stability is a longstanding responsibility of the Reserve Bank and its Board, and was reconfirmed at the time of significant changes made to Australia's financial regulatory structure in July 1998. These changes included the transfer of responsibility for the supervision of banks to a new integrated regulator, the Australian Prudential Regulation Authority (APRA), and the establishment of the Payments System Board within the Reserve Bank.

The Reserve Bank Board oversees the Bank's work on financial system stability. Without compromising the price stability objective, the Reserve Bank seeks to use its powers where appropriate to promote the stability of the Australian financial system. It does this in several ways, including through its central position in the financial system and its role in managing and providing liquidity to the system, and through its chairmanship of the Council of Financial Regulators, comprising the Reserve Bank, APRA, the Australian Securities and Investments Commission and Treasury. In addition, the Payments System Board has explicit regulatory authority for payments system stability. In fulfilling these obligations, the Reserve Bank will continue to publish its analysis of financial stability matters through its half-yearly *Financial Stability Review* and will be available to report as appropriate to relevant Parliamentary committees.

The Reserve Bank's mandate to uphold financial stability does not equate to a guarantee of solvency for financial institutions, and the Bank does not see its balance sheet as being available to support insolvent institutions. However, the Reserve Bank's central position in the financial system, and its position as the ultimate provider of liquidity to the system, gives it a key role in financial crisis management. In fulfilling this role, the Reserve Bank will continue to co-ordinate closely with the Government and with the other Council agencies.

The Treasurer expresses support for these arrangements, which served Australia well during the recent international crisis period.