



# ACCI POLICY STATEMENT

## MONETARY POLICY

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### INTRODUCTION

Monetary policy involves the regulation of banks, money demand and supply, interest rates and the exchange rate to target economic objectives, particularly inflation, unemployment and growth. In Australia, the main discretionary element of monetary policy is the setting of interest rates. The exchange rate is largely left to market forces, while bank regulation largely and appropriately reflects other policy considerations, such as depositor confidence and consumer protection, rather than macroeconomic objectives.

In Australia, decisions about the setting of interest rates are delegated to an independent authority, the Reserve Bank of Australia (RBA). At present, the Government and the RBA have agreed through a memorandum of understanding that the RBA's main goal is to set interest rates to achieve an inflation rate between 2 per cent and 3 per cent on average over the economic cycle. This is the practical way that the RBA meets its legislated objectives of contributing to stability of the currency, full employment and economic prosperity and welfare of the people of Australia.

Australia, along with most developed countries, has experienced low inflation over the past decade, which in turn has helped produce sustained economic growth, reductions in unemployment and greater business and consumer confidence. This suggests that the inflation targeting goal has worked so far.

The inflation goal has been in place since 1993. Before this, the RBA and its predecessors focussed on a range of goals, including inflation, economic growth, external balance and growth in the money supply.

The RBA also has a number of other roles, particularly acting as the banker to the Government, regulating payment systems, printing banknotes and ensuring the stability of the financial system.

### BACKGROUND

Inflation has a significant cost to Australian business and the whole community. It erodes wealth, imposes significant transaction costs, reduces Australia's international competitiveness, encourages excessive borrowing and discourages saving and lending. In the longer run, the efficiency costs of inflation cuts growth rates and increases unemployment. Studies suggest that inflation is regressive, disproportionately harming those that are less well off.

Therefore, it is very important that policies of the Australian Government operate to keep inflation under control. While monetary policy is a vital component in dealing with inflation, there are a number of other tools available, including:

- tariff cuts and reductions in protection, to ensure that domestic price pressures are kept under check by import competition;
- reductions in taxes, charges and regulations, to reduce cost pressures on business and consumers;
- decentralised wage setting and reduced labour market regulation, to keep wage growth consistent with productivity improvements;
- a floating exchange rate, which reduces the impact of external shocks on the local economy;

- government fiscal responsibility;
- microeconomic reforms, particularly reforms to increase competition, which have caused price reductions for many goods and services; and
- avoiding any unnecessary stimuli to asset prices, such as from excessive lending.

Therefore, monetary policy should not be examined in isolation from broader policies that affect inflation.

## **POLICY OBJECTIVES**

As outlined above, inflation has large costs to business and the Australian community. Therefore, ACCI considers that:

- limiting inflation should be one of the key goals of economic policy;
- official interest rates are best set independently of government, taking account of government policy settings;
  - commercial interest rates should be determined by market forces;
- the RBA should have as its primary target the maintenance of sustainably low inflation. Official interest rates should only be used to target other economic goals (such as growth, unemployment, asset prices or external balance) in unusual circumstances;
- the transparency of monetary policy decision making should be maximised; and
- monetary policy decision making should be separated from the other roles of the RBA.

In addition, ACCI considers:

- government and RBA policy should promote the stability of the financial system; and
- the exchange rate should be set by market forces.

## **POLICY FRAMEWORK**

### **Reserve Bank Independence**

ACCI supports official interest rates being set independently of the Government. This provides the following benefits:

- independence of government ensures that political interference in decision making is minimised. Monetary policy should be directed towards overall economic welfare, rather than towards political imperatives;
- it reduces the problem of inconsistency of decision making, because an independent agency is better able to commit to a particular policy; and
- it reduces uncertainty over processes and outcomes and increases confidence in the value of the currency.

The RBA is clearly the best institution to conduct monetary policy independently of the Government. However, the RBA's independence could be improved by having its independence enshrined in legislation (as explained below).

The appointment of outside directors to the RBA board can assist in increasing the Bank's independence. However, there should not be any actual or perceived conflicts of interest for these outside directors.

## Inflation Target

Business agrees that the main target of monetary policy should be the maintenance of sustainably low rates of inflation. Business supports the current target of monetary policy - achieving an inflation rate between 2 per cent and 3 per cent on average over the economic cycle.

However, ACCI considers that there should be greater emphasis on this target. Under the Reserve Bank Act, the RBA actually has three broad objectives of contributing to:

- stability of the currency;
- full employment; and
- economic prosperity and welfare of the people of Australia.

This causes some degree of uncertainty, because it is never completely clear whether the RBA is targeting inflation or another economic goal. This also lowers the level of transparency about RBA decision making. In addition, it is not clear that monetary policy can or should have a direct role in addressing other goals such as asset prices or external balance (it can of course *indirectly* support other policies that address these goals).

To reduce uncertainty, the primacy of inflation as a target should be made clear in the Reserve Bank Act. The use of monetary policy to target other goals, such as growth, unemployment, asset prices or external balance, should only occur in unusual circumstances and be made known publicly at the earliest opportunity. However, it would be appropriate for the RBA to take account of the effect of these other factors (particularly asset prices) on inflation.

## Transparency

Business supports transparency of Government decision making. Increasing transparency reduces uncertainty, encourages debate about policy settings and improves the overall quality of decision making. Monetary policy is no different. ACCI suggests that:

- monetary policy making should be conducted separately from the other functions of the RBA (such as governance of the bank and regulation of payment systems). This is similar to the approach in the USA, where interest rates are set by the Federal Open Markets Committee (FOMC), separate from other functions of the board of the US Federal Reserve;
- the Reserve Bank Act should make it clear that sustainably low inflation is the primary target of monetary policy. Any deviations from this approach should be made public;
- the RBA should publish reasons for all decisions, including the decision to leave interest rates unchanged. This will ensure that the market is regularly and reliably informed about the RBA's thinking on current and prospective economic policy and conditions. Currently, the RBA provides a quarterly statement of monetary policy but other reporting is ad-hoc (such as through speeches and appearances before Parliamentary Committees). It would be worthwhile for there to be more regular reporting;
  - this proposal need not be onerous – it could be a one-page statement;
- the RBA should provide regular briefings in Canberra, similar to the briefings provided in Sydney and Melbourne; and
- at this stage, ACCI does not support proposals to force the RBA to release notes from board meetings. The above proposal for timely publication of reasons will increase transparency without revealing confidential discussions.

Excessive transparency may reduce the quality of decision making.

## Prudential Regulation

ACCI supported the movement of prudential regulation to a separate body, the Australian Prudential Regulation Authority (APRA). This has increased transparency and consistency in regulation across financial institutions. Government and RBA policy should operate to maintain and promote effective prudential regulation of financial institutions.

ACCI does not consider that significant increases in bank prudential regulation are appropriate - they will impose large costs while not improving the stability of the financial system.

## Exchange Rate

ACCI supports the determination of Australia's exchange rate by market forces. This has a number of benefits over less flexible forms of exchange rate management:

- the economy can adjust to shocks more quickly and efficiently;
- monetary policy is more independent and effective;
- it limits speculation against the determination of the Government and RBA in maintaining a given exchange rate;
- it reduces political and bureaucratic involvement in the economy. There is a risk that a fixed exchange rate may be systematically set too high or low, for other reasons; and
- ACCI does not support Government management of prices. The exchange rate is just another price (albeit a very important one).

ACCI believes that the exchange rate should be fully floating – with substantial interventions by the RBA or Government only in exceptional circumstances. “Smoothing and testing” interventions by the RBA may be acceptable as long as they do not become a surrogate for sizeable interventions. Any substantial interventions by the Government, RBA or other agencies in foreign exchange markets should be disclosed publicly (with reasons), within a reasonable period of time.

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