



COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

SENATE

STANDING COMMITTEE ON ECONOMICS

Reference: Reserve Bank Amendment (Enhanced Independence) Bill 2008

FRIDAY, 30 MAY 2008

CANBERRA

BY AUTHORITY OF THE SENATE

INTERNET

Hansard transcripts of public hearings are made available on the internet when authorised by the committee.

The internet address is:

<http://www.aph.gov.au/hansard>

To search the parliamentary database, go to:

<http://parlinfoweb.aph.gov.au>

**SENATE STANDING COMMITTEE ON
ECONOMICS
Friday, 30 May 2008**

Members: Senator Hurley (*Chair*), Senator Eggleston (*Deputy Chair*), Senators Mark Bishop, Bushby, Joyce, McEwen, Murray and Webber

Participating members: Senators Abetz, Adams, Allison, Barnett, Bartlett, Bernardi, Birmingham, Boswell, Boyce, Brandis, Bob Brown, Carol Brown, George Campbell, Chapman, Colbeck, Jacinta Collins, Coonan, Cormann, Crossin, Ellison, Fielding, Fierravanti-Wells, Fifield, Fisher, Forshaw, Heffernan, Hogg, Humphries, Hutchins, Johnston, Kemp, Kirk, Lightfoot, Lundy, Ian Macdonald, Sandy Macdonald, McGauran, McLucas, Marshall, Mason, Milne, Minchin, Moore, Murray, Nash, Nettle, O'Brien, Parry, Patterson, Payne, Polley, Ronaldson, Scullion, Siewert, Stephens, Sterle, Stott Despoja, Troeth, Trood, Watson and Wortley

Senators in attendance: Senators Bushby, Brandis, Eggleston, Hurley, Murray and Webber

Terms of reference for the inquiry:

To inquire into and report on:

Reserve Bank Amendment (Enhanced Independence) Bill 2008

WITNESSES

DAVIDSON, Professor Sinclair, Senior Fellow, Institute of Public Affairs..... 2

KEEN, Associate Professor Steve, Private capacity 14

**McDONALD, Mr Tony, General Manager, Macroeconomic Policy Division,
Macroeconomic Group, Department of the Treasury 26**

**VERSPAANDONK, Ms Rose, Manager, Monetary and Fiscal Policy Unit,
Macroeconomic Group, Department of the Treasury 26**

Committee met at 9.33 am

CHAIR (Senator Hurley)—I declare open this meeting of the Senate Standing Committee on Economics. This hearing has been convened to receive evidence in relation to the provisions of the Reserve Bank Amendment (Enhanced Independence) Bill 2008, which the Senate referred to the committee on 15 May 2008. This bill seeks to amend the Reserve Bank Act 1959 by removing the authority of the Treasurer to appoint, suspend or terminate the positions of Governor or Deputy Governor of the Reserve Bank of Australia, RBA, and placing this authority in the hands of the Governor-General. The bill also outlines that, in the case of the termination of the position of the Governor or the Deputy Governor of the RBA, the Governor-General exercises this authority at the discretion of the parliament. The committee has resolved to table an interim report and present a final report on this bill on 11 June.

These are public proceedings, although the committee may agree to a request to have evidence heard in camera or may determine that certain evidence should be heard in camera. I remind all witnesses that in giving evidence to the committee they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to the committee and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a committee.

If a witness objects to answering a question, the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer, having regard to the ground which is claimed. If the committee determines to insist on an answer, a witness may request that the answer be given in camera. Such a request may, of course, be made at any other time.

[9.34 am]

DAVIDSON, Professor Sinclair, Senior Fellow, Institute of Public Affairs

CHAIR—I welcome Professor Sinclair Davidson, who is Professor of Institutional Economics at RMIT and who is giving evidence on behalf of the Institute of Public Affairs. Professor Davidson, we have a submission from the IPA, which we have received as submission No. 4. Are there any alterations or additions that you wish to make to the submission, or is there any opening statement that you wish to make?

Prof. Davidson—No additions at this time, thank you, Chair. Just for the formalities, I am Professor of Institutional Economics at RMIT University, I am a senior fellow of the Institute of Public Affairs and I am on secondment from the university to the Institute of Public Affairs for this academic semester.

Thank you for this opportunity to address you, Senators, on the Reserve Bank Amendment (Enhanced Independence) Bill 2008. The Institute of Public Affairs first of all wish to make it very clear that we are firm believers in sound money. We believe that inflation is a scourge in our society and should be restrained at every opportunity. We do not wish this to sound as if we are somehow encouraging governments to follow policies that encourage inflation or that the Reserve Bank should follow policies that allow high levels of inflation to persist for long periods of time. So we set out in our document very briefly why we think that fighting inflation is important and the benefits to our society of having low levels of inflation. We also believe that the Reserve Bank should have the agenda or certainly have the objective of keeping inflation low, subject to the constraint that the economy should not be allowed to disintegrate or that economic growth should be compromised for sustained periods of time, and we believe that that argument is consistent with a whole range of economic literature that is around.

Turning specifically to the issue of central bank independence, we differentiate between two types of independence—political independence and economic independence—and we discuss some of the literature that relates to independence. Broadly speaking, the economic literature is in agreement or shows a consensus that central banks that are more independent are more likely to be associated with low levels of inflation. The literature also indicates quite clearly that those central banks that are associated with higher levels of economic independence as opposed to political independence are, again, more likely to be associated with lower levels of inflation.

This bill, in our opinion, will enhance or attempts to enhance the political independence of the Reserve Bank and does not actually point to anything that will enhance the economic independence of the Reserve Bank. The Reserve Bank of Australia is already very highly economically independent, and we totally approve of that situation.

We have also produced a diagram that sets out the general sort of relationship for industrialised economies, and we can see Australia performs quite well in an overall index of independence. There is some ambiguity as to whether or not there is what is called, in the economic literature, endogeneity bias: does independence cause low inflation, or are there economies that are simultaneously more likely to have low inflation and independence at the

same time? That is an interesting debate, and we point to some literature that is about to be published in the *Oxford Economic Papers* which points to a range of industrialised economies where inflation has been brought under control without an independence event, which they describe in their paper as a legislative change. Australia is one of those economies that do not have a defined central bank independence event; nonetheless, inflation here is under control—or, certainly, it was under control for a long period of time.

So our argument is, by and large, that Australia already has high levels of economic independence. This bill goes to changing political independence, and in our third section we discuss why we are not convinced that what the bill purports to do is actually what will happen. Our argument is largely around sections 24 and 25 of the Reserve Bank Act. We note that this bill will change section 25 of the act but not section 24—certainly not section 24(1)(c), as far as we can determine.

We are not at all convinced that changing section 25 is appropriate. We think that having a Treasurer terminate the employment of a Reserve Bank governor who is bankrupt, incapacitated or taking paid outside work is entirely appropriate. We cannot imagine what additional information the parliament will bring to bear. We are not convinced that it is good public policy to have the parliament agreeing to having a bankrupt or incapacitated person, for example, as the Reserve Bank governor. We believe that, if the parliament does wish to enhance the political independence, section 24(1)(c) should be modified to make it the case that the parliament must be consulted. There would be some details around that that would need to be considered. For example, what happens if the government is in caretaker mode? But these are minor details that can be dealt with.

Finally, we make the argument that the Reserve Bank governor is in different category of public official to, say, the tax commissioner or the government Statistician. The tax commissioner is going to be an unpopular person by definition and special protections are appropriate to protect him or her from populace backlash. I would say that the government statistician is almost certainly unknown to the general public. I think it is Alex Pink, but I am not even sure. I cannot say for certain who this person even is. Again, there might be good reason why this person is in need of special protection. The Reserve Bank governor, on the other hand, is a highly visible person not only to the electorate, the media and the opposition but to the international financial markets. It is the media, the international financial markets, the opposition and the electorate at large who provide the Reserve Bank governor with all the protection that he actually really needs. So we are not at all convinced that the Reserve Bank governor is in the same category as the tax commissioner, for example.

Overall, our opinion is that this amendment will actually be a lot of form with very little substance to it. We do not believe that it should be enacted. It is our opinion that this will not actually enhance the battle against inflation in any way; it will create a situation whereby undesirable policy outcomes can actually result. Consequently, we have written in our submission that we are not in favour of the amendment.

CHAIR—Thank you. Professor Davidson, you were saying that this measure does nothing to enhance the Reserve Bank's status or to raise the status of the governor. Don't you think that by making it a parliamentary appointment the bank, the governor and the deputy governor will be seen to be independent and subject to parliamentary control on a multi-party

basis rather than an appointment of the Treasurer? You mentioned that the tax commissioner is likely to be unpopular, for example, and needs that protection, but recently one of the tabloid papers attacked the Governor of the Reserve Bank of Australia on its front pages as a result of interest rate rises, so perhaps it is quite comparable.

Prof. Davidson—It is not at all inappropriate for the Governor of the Reserve Bank to be called to account by the tabloids or any other newspaper or any other private citizen of the country. The tabloids, the newspapers and the rest of the media have a role to play and the citizens of the country pay the taxes which allow the Governor of the Reserve Bank to enjoy a very comfortable lifestyle. Attacking the Reserve Bank governor should not be inappropriate at all. As a matter of fact, the independence that he enjoys is so that he can be attacked and there can be robust debate around interest rate policies in this country.

In terms of whether it is appropriate, I think the current institutions which revolve around the Governor of the Reserve Bank have evolved over a period of time. They already involve a series of checks and balances that are entirely appropriate. We do not necessarily want to have the Reserve Bank governor appointed by whoever popularly controls the balance of power in the Senate. We necessarily want to have a person who is going to do the job of maintaining interest rates at such a level as to keep inflation under control while at the same time not stalling the economy. I think having the government of the day, who are ultimately responsible for economic policy in Australia, be accountable for the Reserve Bank governor's appointment and removal, if he or she becomes incapacitated under section 25, is entirely appropriate. The government is, after all, responsible for the actions of economic policy.

CHAIR—Isn't that a contradiction in terms if the government is responsible for an economic policy but, as you say, there is already some independence in the Reserve Bank?

Prof. Davidson—It boils down to ultimate responsibility. The government can overrule the central bank at any time under section 11. The fact that a government chooses not to do so actually points to the credibility of the government itself in its conduct of monetary policy. So there is a nuanced argument in terms of the line we need to draw between how much independence the Governor of the Reserve Bank should have, and the accountability that the governor has to the government and that ultimately the government has to the electorate.

Senator EGGLESTON—Professor, reading through your submission I note that you have a chart that rates the political independence of the reserve banks of various countries. Your chart shows that the Reserve Bank of Australia is rated as being less politically independent than the reserve banks of Germany, the Netherlands or Switzerland. But, in practice, are you able to quote any examples of any political interference in the operation of the bank since it was made independent?

Prof. Davidson—In Australia?

Senator EGGLESTON—Yes, in Australia.

Prof. Davidson—Since I came to Australia in 1995 I cannot think of any events that have occurred. The governor has been criticised from time to time in the media but that to my mind is not an attack on the independence of the Reserve Bank governor per se. The Reserve Bank governor raised interest rates last year during the election period. He was criticised. As I say, criticism of the Reserve Bank governor is not at all inappropriate, to my mind.

Senator EGGLESTON—I suppose one would expect that in a democracy with free speech, and the kind of open democracy we have in Australia especially, the decisions of the Reserve Bank might be criticised by the politicians but not necessarily interfered with.

Prof. Davidson—That is correct and as I indicated that is entirely appropriate, to my mind anyway.

Senator EGGLESTON—You mentioned the processes of the Senate and the parliament. I would have thought that subjecting the processes of appointment and dismissal to parliamentary approval is surely more likely to open decisions to being affected by political game playing, particularly since the agreement of both houses is required. Would you agree with that?

Prof. Davidson—I would agree with that to the extent of the appointment of the Governor of the Reserve Bank. I do have an open mind in terms of terminating the Governor of the Reserve Bank but I think that would be in relation section 24(1)(c). The parliament should be consulted. I would imagine that the parliament would be advised. Such an extraordinary event would certainly be discussed at length, I would imagine, in the parliament in any event. I certainly do not think so in terms of the appointment but certainly in terms of the dismissal of the Governor of the Reserve Bank, it is not inappropriate that it be discussed in the parliament.

Senator EGGLESTON—Ten years before you came here in 1985, as you said, in 1975 we had a deferral of the budget by the Senate. A scenario very similar to that one could imagine might occur in political processes of the Senate in relation to the appointment of the governor or the deputy governor or their dismissal if the political parties in opposition in the Senate decided that it was in their political interests to embarrass the government in some way by deferring the appointment or dismissal of either of those office-bearers. I would have thought that was a major flaw in practice in this proposal because we do have that precedent that in 1975 the opposition parties in the Senate deferred the budget and that could well happen, as I have said, with the appointment and dismissal of either the governor or the deputy governor. Would you agree that such a scenario would be a major factor to consider in terms of the usefulness of going down this pathway of parliamentary approval?

Prof. Davidson—For the record, I arrived in 1995 not 1985.

Senator EGGLESTON—I am sorry. That means it was 20 years before you arrived.

Prof. Davidson—Yes, 20 years. I am familiar with the dismissal. That is a possibility. I imagine it would be extremely unlikely. I would have thought that, for both government and opposition, playing politics with the Governor of the Reserve Bank would be a very risky consideration, both politically and economically, for the country. But it is a possibility, and in the case of dismissal of the governor it could well happen. The probability would be low; I would not want to say it is likely.

Senator EGGLESTON—I am not suggesting that it would be likely, but in 1975 we had an extraordinary set of circumstances and it is possible that an extraordinary set of circumstances could exist again in which the Senate decides to act in the same way. As you have said, that would paralyse the workings of the bank and have adverse economic impacts on the country.

Prof. Davidson—Yes.

Senator BUSHBY—Senator Eggleston mentioned the chart you have in your submission showing the different levels of political and economic independence of comparable countries. We currently stand at No. 3 for political independence on that chart. What is your understanding of why we are relatively low?

Prof. Davidson—That data was taken from a study that was published in the 1990s. Australia would probably score four or five now on that scale. We would score higher if all of the board were not appointed by the government, for example, so that the entire Reserve Bank board were appointed by non-government parties. That would improve our political independence. If the governor were not appointed by the government, that would also improve our political independence. It is factors like that.

Senator BUSHBY—What about the fact that there are a number of positions on the board that are there as a right of the position that they hold—for instance, the Secretary of Treasury?

Prof. Davidson—If the Secretary of Treasury were to be removed from the board, that would enhance our political independence as well. We did not address that issue in the paper, but it is not inappropriate that the Treasurer be there; although, some of my colleagues would disagree vehemently and say he should not be there.

Senator BUSHBY—But that would be one of the factors that affect our rating on political independence.

Prof. Davidson—That would be one of the factors, yes.

Senator BUSHBY—We had a discussion after questions by Senator Hurley regarding the parliament's involvement in the appointment process. As I understand it, the bill does not contain anything that introduces parliament into the appointment process but it certainly does for termination.

Prof. Davidson—That is my understanding, yes.

Senator BUSHBY—It has been noted in a statement by the Treasurer and again in the second reading speech, and also in the Treasury submission to this inquiry, that one of the purposes of the bill is to raise the level of independence of appointments and terminations of governors and deputy governors of the board to that of the Statistician and the tax commissioner. But what the bill proposes, particularly for termination, is quite different. For termination, the bill requires parliament to look at what are essentially issues of fact—the three things that are listed separately there. Whereas, for the Statistician and the tax commissioner, the issues that are referred to parliament basically revolve around misbehaviour, which is far more subjective than the three items listed there. And, in both cases, the Governor-General is still required to dismiss in certain cases which basically cover those which under this bill are being referred to parliament. Do you think, given that, that a statement that this is elevating it to the same level of independence is an accurate statement?

Prof. Davidson—It is not misleading. It is not the same, but the ATO and the RBA are different institutions. At the micro level that you have described, it is not correct. But, at a more macro level, it does not worry me to say that it is not the same.

Senator BUSHBY—In terms of that statement, I want to explore this is a little bit further. In the case of both the Statistician and the Australian tax commissioner, there remains a mandatory requirement that the Governor-General dismiss people holding those positions—for example, the Governor-General shall dismiss if the commissioner becomes bankrupt. That is a requirement; there is no discretion; it does not go before parliament. Would you agree that that is—

Prof. Davidson—Yes, that is entirely appropriate and that is the current legislation regarding the Reserve Bank Governor and the Treasurer.

Senator BUSHBY—That is right. Do you think that changing the situation actually enhances the independence of the Reserve Bank?

Prof. Davidson—No. It is inconceivable that a bankrupt would remain as Reserve Bank Governor.

Senator BUSHBY—But theoretically under the—

Prof. Davidson—Yes, under the amendment, that could happen.

Senator BUSHBY—Under the proposed bill it is quite conceivable that, for whatever reason—whether political or otherwise—one of the houses of parliament could elect to not—

Prof. Davidson—That is correct.

Senator BUSHBY—move the address to the Governor-General. Similarly, with the Commissioner of Taxation, the Governor-General must remove them if they engage in paid employment. Do you think that moving that requirement from the Reserve Bank enhances independence?

Prof. Davidson—Absolutely not—no.

Senator BUSHBY—Similarly, if he is absent from duty, but that is not as relevant. The same applies for the Statistician. If the Statistician becomes bankrupt, the Governor-General shall remove them. So he is required to remove them and, once again, we have established that, in the case of the proposed bill, you do not believe that enhances the independence of the Reserve Bank board at all.

Prof. Davidson—No.

Senator BUSHBY—Was it the intention to amend the Reserve Bank Act 1959 such that the automatic termination for permanent incapacity, paid employment outside the RBA or bankruptcy now becomes optional, such that the parliament might decide. Do you think that they are intending to make it optional by doing this in those circumstances?

Prof. Davidson—If I read the bill correctly, it actually looks like the parliament could agree to have a bankrupt, for example, as the Governor of the Reserve Bank. I do not think that is at all wise and, if the government thinks that it is wise, it is up to them really to explain to us why that would be the case. I have not heard those arguments. I have heard the argument that this will enhance the independence of the Reserve Bank. I suspect that what might be happening is that it is believed that somehow section 24(1)(c) has been modified and that these become the only conditions under which the Reserve Bank Governor could be removed, but that is not the opinion that is in the Treasury submission, for example.

Senator BUSHBY—The Treasury submission suggests that you can still do it by going to court. Do you think that, where there are allegations of a governor or a deputy governor misbehaving, requiring a person of sufficient standing to have to go to court to remove them, is an appropriate way of dealing with it?

Prof. Davidson—I was very surprised when I read that. Obviously the Government Solicitor is a lawyer and I am not, but I cannot imagine why any member of the public should be able to go to court. If, for example, the Reserve Bank had just published its inflation forecast for the next three years outside of its target range and, as an economist, I think that that is misbehaving and irresponsible, and, if I could go to a court to get the Reserve Bank Governor sacked for not doing his job, that is rather extraordinary. But that is my reading of what their submission was suggesting. My reading of section 24 is that the Treasurer can remove the governor for misbehaviour. That is my understanding.

Senator BUSHBY—And what about issues of timing? That leads on to it, in a sense. If you have a governor in respect of whom there are allegations of misbehaviour, obviously a court process to remove them would be a lengthy process which would not necessarily be wrapped up quickly and could be subject to challenges, presumably—at least theoretically. Similarly, the proposed changes—with the three statutory grounds for termination—would require you to go to parliament. If, for example, one of those occurred, say, in three weeks time, when parliament is about to go into recess—we have a lengthy period of some months before we come back at the end of August—how do you think that delay could impact if the Governor became incapacitated or bankrupt early in that period?

Prof. Davidson—I would have thought that, depending on the circumstances of what happened to the Governor, if he became incapacitated a delay is not important. But, under any other circumstances—if he became bankrupt or had outside paid work or engaged in some sort of atrocious misbehaviour—I would imagine that removing him quickly and appointing a new or at least an acting Reserve Bank Governor in the interim would be an appropriate way to go. Bear in mind that the Reserve Bank Governor holds a very important role in our financial system and people look to that person to be a fine and upstanding citizen. So I would imagine that a more timely process would be more appropriate than a long and drawn out process.

Senator BUSHBY—Do you think that, given what you have just said, the consequences of a Reserve Bank governor standing in those positions, with a lengthy period before the issues could be dealt with, potentially could have more serious consequences than the Statistician or the tax commissioner in a similar circumstance?

Prof. Davidson—Yes. I would have thought that the role which the Reserve Bank governor plays in the economy is very different from the role of those other two government officers and is a very important role. Our standing in financial markets, our inflation forecasts and expectations all play a role. These things are very important and could be very deleterious to the economy in a drawn-out lengthy process.

Senator BUSHBY—Legislation surrounding the appointment and termination of the New Zealand governor sets out in some detail circumstances where a governor can be terminated because he is not performing.

Prof. Davidson—Yes.

Senator BUSHBY—Do you think that would be advisable for Australia?

Prof. Davidson—No.

Senator MURRAY—Some of the instances under which somebody may no longer be able to keep a job or carry out their functions need to be dealt with in an almost mechanical way and I am not sure we need to get overexcited about it. Take the issue of incapacitation. The governor of the Reserve Bank is hit by a motor car and is in hospital for what could be a very lengthy stay. Great surgery could eventually turn it around or the worst could be expected. We have a simple mechanism whereby the deputy governor just steps in and nothing changes. The question is: if such a person was on life support, for instance, at what stage are the salary and entitlements cut off and the family left without that financial prop and become forced to rely on their own safeguards, as in the normal way in the community? To my mind we need to unpick each of the grounds for dismissal and decide where and in what circumstance it is appropriate that a particular body gets involved. Let us start with incapacitation. Do you not think the board should be able to take that decision?

Prof. Davidson—The board of the Reserve Bank?

Senator MURRAY—Yes, as a normal board would do.

Prof. Davidson—In a corporate entity, the board would be appointing the chief executive officer and the board would probably take advice from the CEO's medical staff. The board of the Reserve Bank, however, does not appoint the governor. So I would have thought that the person making the appointment should be making the decision. In a case of incapacitation, I would imagine that the deputy would step up, as you suggested, and the government and the Treasurer would take advice from the governor's doctors as to the state of affairs and make a judgement call as to whether or not he was incapacitated.

Senator MURRAY—Yes, but that sounds bureaucratic to me. I cannot see why a competent band of men and women who assemble monthly cannot receive advice which is generally incontrovertible and make the decision. I think that is the sort of discussion we need to have. If it is normal practice for somebody who is incapacitated and who holds a particular role to be dealt with in a particular way, my view is that we should possibly consider that.

Let us go to bankruptcy. What would you expect a normal situation to be in a major organisation if the managing director is found to be bankrupt?

Prof. Davidson—Generally speaking, I would imagine that that person would lose their job. The difficulty that comes up is what happens if the managing director or the CEO is also the founder of the organisation, because we had the kerfuffle over Opes Prime a while ago where these people were having their asset shares sold out from underneath them.

Senator MURRAY—Sorry to interrupt. My impression, without going back to precedent, is that it is generally at the discretion of the board. I do not think that that instance should be at the discretion of anybody. If you are bankrupt, it is entirely improper that you be the head of the Reserve Bank.

Prof. Davidson—Yes, we are in agreement on that point.

Senator MURRAY—That is my view. So we have to decide who would exercise that power. If statute says that if you are bankrupt you cannot be the head of the Reserve Bank, it seems to me that it then really becomes the mechanics again. Somebody has got to do the paperwork—

Prof. Davidson—Yes.

Senator MURRAY—which is the board, frankly, in my view. He is already dismissed; somebody just has to make sure that the pay is settled, the leave is rolled up and the strings are tied, as you normally do when you dismiss somebody. To my mind, the statute needs to say that with bankruptcy it is good night and that it should be handled by the board, because that should be their responsibility. Do you see a problem with that? Do we have to go all the way to the Governor-General?

Prof. Davidson—I certainly do not think you should go to the Governor-General. In terms of whether the board should do it, I do not think that the Reserve Bank board operates in the same way as the board of a company does. The Reserve Bank board would set the conduct of monetary policy, but it does not actually manage the bank itself, to my understanding, whereas a board of a company sets the strategy overall. The board of the Reserve Bank does not even set the strategy overall; the government sets the strategy to maintain inflation between two and three per cent, on average, over the cycle.

Senator MURRAY—You are getting away from the mechanics. Who manages the entitlements, the payments and so on and so forth? As far as I am aware, it is not the Department of Finance and Deregulation and it is not the Treasury. As far as I am aware, the Reserve Bank has its own department that does that, so the body that runs the Reserve Bank would do that. Let us keep moving. What I am trying to do is really to disaggregate these things and come down to what is mechanical—which I think bankruptcy and incapacity are or should be—and what is really discretionary.

A third area of concern is mental incapacity. That is a bit more dangerous, in that we all know that some people have been put away who should never have been put away, simply because they found a compliant doctor. But, assuming that you have first, second and third opinions and that the person in charge is nuts, if it is a ground in statute—which I think it should be—then it seems to me that it is, again, the mechanics. Who ties the bows? You may or may not agree, but I am just giving you an opinion.

We really come down, I think, to the nub of it. Where is the concern over political interference and not enabling somebody to be absolutely and truly independent? To my mind, that is performance. That is the performance ground. The question, to me, is: who should make the decision on performance grounds? That is the question. As I understand your evidence, you think that the political executive, who have a political stake in that decision—a conflict of interest—should make that decision. That is your evidence as I understand it.

Prof. Davidson—I do not know that I would go so far as to say conflict of interest. I would say there are checks and balances in the system that prevent the government from opportunistically sacking the Reserve Bank governor. There are checks and balances throughout our entire society where we manage and deal with conflicts of interest. This is one of them. Certainly, the amendment bill does not, to our mind, at all enhance those checks and

balances. As a matter of fact, it weakens them to the extent that a bankrupt could remain as a Reserve Bank governor, which you and I are both in agreement is untenable.

Senator MURRAY—Professor, the solution may not be the right one, but the first thing we have to do is decide whether there is a problem. The present government have said there is a problem—that is my reading of what they have said. The present government have said, ‘There is the potential for a conflict of interest situation, and we have developed a bill which we think lessens that.’ The first question to you is: do you accept that there is a conflict of interest situation and greater independence needs to be ascertained? If you do, what do you think would be the solution?

Prof. Davidson—To unpack that: yes, there is a conflict of interest; no, there is not a problem.

Senator MURRAY—So you would leave it as it is?

Prof. Davidson—I think we have evolved a series of institutions which deal with the situation very satisfactorily and we should allow them to continue to deal with them satisfactorily. Ultimately, we need to have faith in institutions that we have already evolved.

Senator WEBBER—Senator Murray has taken you on a bit of the journey that I was planning on going on, and so I will not take as much time as I had originally planned. To my mind, there are a couple of issues here: there is the advice that is given on sound economic policy by the Secretary of the Treasury and then there is the role of the Reserve Bank, particularly when it comes to fighting inflation and other issues to do with monetary policy. There has been a lot of discussion recently about frank and fearless advice that the Treasury may have given in the past, and in fact there has been some discussion about advice they may have given in the very recent past about policy decisions that government want to make and the economic impact that that will have. And because the Secretary of the Treasury is absolutely a political appointment, government can feel free—although the advice can be frank and fearless—to ignore, dismiss or not disclose that advice. Surely we therefore need as much independence as we can with that other arm of influencing monetary policy, which is the Reserve Bank, and to enshrine that independence and make sure that they will absolutely be frank and fearless and have nothing to fear from one side of politics or the other, so that any action that we take along the lines that Senator Murray was outlining needs to be by the parliament and not by the government of the day.

Prof. Davidson—Yes, I agree with almost everything you have said, except to say that we already have that independence of the Reserve Bank governor. It is already in place. The current Reserve Bank governor raised interest rates during an election period. That is not nothing; it is a remarkable act of frank and fearless advice, if you like. You will recall that there was a huge debate leading up to that: was it appropriate, inappropriate or what have you? I agree, we need to have an independent Reserve Bank, and I put it to you that we have one.

Senator WEBBER—But to absolutely enshrine it so there is no way that there can be any political pressure and that there is no way that people can ignore their advice.

Prof. Davidson—Well, people can ignore their advice. The government can already, under section 11, overrule the Reserve Bank governor, if they so choose. The difficulty that comes

with your argument that the person is absolutely entrenched in place is this. Let us imagine that a seven-year appointment is made and the Reserve Bank governor decides to go off on a frolic of his own and that the Senate is hostile to the government. For seven years we might have a situation where every month the government is overruling the Reserve Bank under section 11. That would not be appropriate at all either. I think we need to have a series of checks and balances which are not absolute, that is always true, but the checks and balances have worked so far. They continue to work. In a parliamentary democracy, where people are accountable, those are the checks and balances that we look to to establish credibility. To put one person absolutely beyond the touch of accountability, I do not believe would be adding to the independence of the Reserve Bank.

Senator WEBBER—But it is not putting them beyond the touch of accountability. Isn't the ultimate mechanism of accountability in our democracy the national parliament? Isn't that the highest form of accountability that we have? Each and every one of us elected to this place is accountable to our constituency. Isn't that more accountable than the executive government of the day?

Prof. Davidson—I put it to you that the most accountable institution in our society is the electorate.

Senator WEBBER—And we are the ones directly put there by the electorate—each and every one of us.

Prof. Davidson—Yes, but it is not quite the parliament. The electorate are the people who ultimately hold accountability. That is the ultimate check and balance. That should be allowed to continue as it currently is. The government is accountable for public policy; the government is accountable to parliament; parliament is accountable to the electorate.

Senator WEBBER—This bill brings the Reserve Bank governor one step closer to that ultimate accountability?

Prof. Davidson—Does it? It brings the—

Senator WEBBER—In certain aspects.

Prof. Davidson—In aspects that, for reasons we have set out here, we are not convinced are wise. If the bill proposed to make section 21(c) subject to the parliament, that would be a more sensible approach to that which the bill currently offers, which is to modify section 25. To our mind, section 25 is fine as it is. We might disagree over whether the board should or the Treasurer should, but section 25 is fine as it currently stands.

Senator BUSHBY—I commend Senator Webber's unerring belief that parliament is so pure. Professor, would you agree that there are times that parliament does tend to make decisions for political reasons rather than for the purest of reasons?

Prof. Davidson—I have no doubt. As Senator Eggleston told us, the events of 1975 are an example. Parliament makes all sorts of decisions for all sorts of reasons and ultimately the electorate decides what is or is not appropriate. That is how our system is designed to operate.

Senator BUSHBY—Do you think that, given the potential for parliament, whether one house or both, to make decisions for political reasons rather than for reasons of good policy—

whether it is an obscure potential or otherwise—handing the decision on termination to that forum would add to the independence of the Reserve Bank in any way?

Prof. Davidson—As the bill is currently formatted, no, it would not.

Senator MURRAY—You said 21(c). Did you mean 24(c)?

Prof. Davidson—Sorry; yes—24(1)(c).

Senator MURRAY—The one that refers to good behaviour—that is what you are referring to?

Prof. Davidson—Yes.

Senator MURRAY—I think that is a very important point that you made, so if the *Hansard* picks up the correction that would be useful.

CHAIR—Thank you, Professor Davidson. The committee will now adjourn for a short private meeting.

Proceedings suspended from 10.18 am to 10.33 am

KEEN, Associate Professor Steve, Private capacity

CHAIR—The committee welcomes Associate Professor Steve Keen of the School of Economics and Finance at the University of Western Sydney. We have a submission from you, Professor Keen, which we have numbered No. 3. Before we commence, are there any additions or alterations you wish to make to your submission?

Prof. Keen—No, I would just comment that, despite my submission taking a different perspective than, say, the other one you have had a discussion on before from Sinclair Davidson, I was quite intrigued to find that not just his submission but the other two as well all, from very different angles, argued that this bill is not a sensible proposal. There is something, I think, in that—that four people would take quite different approaches to how they analyse the economy and nonetheless agree that this particular bill should not be proceeded with.

CHAIR—Thank you, Professor Keen. Would you like to continue with an additional opening statement.

Prof. Keen—Just to read you through what I have argued, I think in a lot of ways the debate about central bank independence is focused upon the impact this has had on the rate of inflation. If that is the sole way you measure how effectively the period of central bank independence has been, then it looks like a fairly good story. You can really date the spread of the concept of central banks' independence as being the way one in general should manage monetary policy.

Go back to the aftermath of the 1990s recession, which of course was not just an Australian experience; it was something that occurred across most of the OECD, in particular in America as well. Since that time inflation rates have come down quite dramatically. I highlighted that in the first chart that I put into my submission. It shows the dramatic plunge in the rate of inflation from 1990 through to now and the equally dramatic plunge in the rate of interest set by the RBA over that time, though now it is trending up.

That looks like a good story but, at the same time as we are seeing lower inflation, I think it is obvious to all the members of the committee that there has also been an increasing scale and increasing frequency of financial crises. We can go back to our first major crisis, being the Asian financial crisis in 1997, which was followed rapidly by the Russian financial crisis, which led to the crash of Long-Term Capital Management. We then saw the internet bubble in America, which fortunately was not reproduced to the same scale in Australia as the 1980s bubble was. It was just a huge bubble in asset markets in America. And of course there is the subprime crisis which we are now dealing with the aftermath of here.

So, at the same time as we are seeing a period of low inflation, we have seen a period of accelerating asset prices and financial crises associated with bursts in various asset bubbles. The overall responsibility of the monetary authority is not just to contain the rate of inflation; it is to ensure the soundness of the financial system. I think you would be in for a very hard time having anybody argue that we are seeing a sound financial system these days.

So if we are looking at how successful central bank independence has been I think we have to say ‘Yes, the inflation record looks good but the financial record looks extremely bad.’ This could be blamed on central banks or it could be seen as a continuation of a trend that pre-dates them. I tend to subscribe to the latter. I do not think I would blame the reserve banks for what is happening now, but I think the philosophy that has been followed about how one manages monetary policy ignores the role of debt and it ignores the importance of asset prices in how monetary policy should be managed, and the combination of that—whether you have central banks setting monetary policy or politicians setting monetary policy—ends up with the same outcome of an asset bubble and a serious financial crisis. And I think we are in the worst we have experienced since the end of the Second World War.

In that circumstance, I do not think it is time to be handing over policy or making policy even less accountable to the public than it currently is. I strongly am not of the opinion that politicians would have done a better job of managing monetary policy, but I think in general we are going to look back on this as a period of very poor management of the financial side of the economy. I would rather have the people who are answerable for that have some degree of accountability to the public. This act, in a sense, continues making those decisions less accountable.

In substance, the act, I think, is quite a silly piece of legislation because, if you really want to enhance the actual functional independence of the act, you would not be changing the sections that are being changed here. You remove the capacity that still exists in the act for the government to direct the monetary authority about how to undertake monetary policy if there were a disagreement. This does not touch that side; it simply changes the manner in which the governor and deputy governor can be removed from office. When looking at those circumstances, and I completely agree with Sinclair Davidson on this point, you would want to remove people. If any of those three cases apply—the ones under which the bill would allow the Governor-General on the advice of both houses of parliament—you would want to remove the governor or deputy governor. You would not want somebody who was in a coma and unable to carry out the job to be the governor of the bank; you would not want them to be there if they were bankrupt; and you would not want them ever getting paid work from another institution. So those are not grounds on which you should make it an option; it should remain compulsory.

So, from my point of view, there are two problems: it understates the importance of the other aspects of the responsibility of the financial managers, which is to maintain the integrity of the overall financial system, where I think the banks, just like every other system beforehand, have failed that, with systems that have become more unstable over time; and, it is a silly amendment. I think it should be left alone. If anything, send it back to the drafters and ask them to come up with something more interesting than this current bill.

CHAIR—You are saying that this legislation does not address the problems, and people should go back if they want to make changes. What kind of changes would you envisage might achieve some of the aims that you are talking about?

Prof. Keen—I would see something that got the bank to consider more the importance of monetary growth as affecting asset prices and asset volatility. I think there is ‘under attention’ being paid to that, but I do not think this is something that can be addressed by legislation. In

some ways there is a philosophy afoot in economics that has underplayed the importance of the asset side of the financial system. This dates right back, in terms of government policy, to the Wallis and previous hearings which have downplayed the importance of monitoring asset prices as well as monitoring inflation.

I do not think this language can be amenable to legislative change. I would simply leave the act as it is and then hope that at some point the weight of economic change which is hitting us now leads to a change in the philosophy about how one should manage monetary policy in general. In many ways I see this as not so much irrelevant but a silly piece of legislation that is not worth continuing with. Leave things as they are and then give us time—in the next four or five years I would say—to reassess the nature of monetary policy and that may lead to a major shift not just in the political approach to what monetary policy should be but also for the economists themselves.

CHAIR—So you do not see any difficulty—which this legislation is a response to—with having the Treasurer of the government of the day appointing the Reserve Bank governor or the deputy governor for a period longer than that of the government? Do you see that there might be some problem there?

Prof. Keen—No, I do not. Take a look at where the Reserve Bank governor has come from with the last three or four appointments. He has come from the previous staff of the Reserve Bank. There has been no sense in which there has been a truly political appointment to this position for a long time. I think in many ways politicians ran away from this area in the aftermath of the 1990s recession where they copped the opprobrium for the downturn that occurred. It is seen as Paul Keating's recession rather than a recession caused by economic forces beyond the ken of the government.

I see in some ways that, while it looks good to see that this is giving independence and handing over policymaking to the experts, in a lot of ways I think the motivation was, 'This is just too hot a potato for politicians to want to handle.' There is no real way in which people are seeing the troubles now as being due to political interference. Politicians, if anything, have retreated from this area. There is no way in which a further retreat is seen as necessary by either the public or the economics profession in general or the finance sector. Nobody is saying that the current circumstances are because the government has too much control over the appointment of the Reserve Bank and its behaviour—anything but.

CHAIR—And you do not see that circumstance changing at any time?

Prof. Keen—I think at some point if we go into a serious economic downturn—I am obviously on record as having said I expect that to happen, courtesy of the levels of debt that have been accumulated—then in that situation there will be certainly a public backlash against monetary authorities and the economic managers in general. That is something that the politicians are going to have to cope with, but it is not something which can be done by simply removing a Governor of the Reserve Bank—nor do I think that you can blame the Governor of the Reserve Bank for the situation that we are in. Because it has been an overall accepted perspective amongst finance economists and the finance industry in general to approve further deregulation, to approve developments like the securitisation of loans and so on. This has been the overall ethos of everybody in the sector with, I am pleased to say, the

exception of me—I made a submission to the Wallis committee opposing securitisation back in 1996—and a few other non-orthodox economists. In general you cannot say it is the Reserve Bank governor's fault that this is happening and so on.

If we go into a serious economic downturn where the monetary side of the equation has caused that downturn then there will be political pain to go through. I do not think this is the time to make the monetary authorities less accountable; I think it is time to say we have to reassess our whole approach to monetary policy. This act would be something you might find yourself having to reverse at some stage rather than go further in the direction of independence. It is not the right time, on the record, to be adding to the apparent independence of the Reserve Bank.

Senator EGGLESTON—The issue here seems to be one of independence, and the purpose of this legislation is supposedly to increase the independence of the Reserve Bank. You just said that the failure to remove sections providing for direction to the Reserve Bank by government means that the Reserve Bank of Australia is not genuinely independent. Are there those provisions for direction in other reserve bank legislation in OECD countries around the world? Which countries' governments have the capacity to direct their reserve bank?

Prof. Keen—I am not sure. I am not a lawyer, so I have not read the acts of other countries carefully. But I would not be at all amazed if the Reserve Bank Act that we currently have was based on references by the legislators to what exists in other countries. We tend to follow the British lead on that sort of thing. I imagine you would find a similar thing in the British and American legislation. I do not think it is a bad thing. If you are ever going to act on the legislation that enables that sort of direction to be given, then it is going to be in a serious crisis. We would be talking about something as severe as in the 1930s before any government would dare undertake a move like that. It is sitting there for serious emergencies and not for political fiddling. You would have to be somebody who believed they had the backing of a Roosevelt to undertake a change like that. That is why I see this bill as fairly silly. It is being trumpeted as though it is going to enhance the independence of the Reserve Bank but it is doing it in a silly way and it is leaving the only substantive one which would actually be increasing the independence untouched. I think it should be left untouched in case something quite unexpected comes our way.

Senator EGGLESTON—In a way, you have given the answer to my follow-up question. If the government was really serious about making the bank independent, they would remove that legislative ability to direct the bank, I presume—and they have not done that. As has been said, it is very hard to identify any instance of political interference in the operations of the Reserve Bank of Australia since it was created, so it seems to me that the idea of placing dismissals in the hands of the parliament is surely an action which is likely to increase the political process impacting on the Reserve Bank more than anything else because of the kind of situation we discussed with the previous witness. If dismissals are in the hands of the parliament, they become potentially subject to political game playing, especially in the Senate where the minor parties and the opposition might see it as a political advantage to defer or delay the dismissal of a governor or deputy governor.

Prof. Keen—I agree completely with that statement. It is being portrayed as a way of increasing their political independence but it would actually make them more politically exposed.

Senator EGGLESTON—Thank you. That succinctly summarises my own views.

Senator BUSHBY—You say in your submission that central bankers do not on the whole understand the monetary system but rather they understand a model of how it works. Would you say that in general is a fair statement for the Australian central bank as well?

Prof. Keen—Yes, I would. The trouble with the economy is that we tend to use analogies like ‘step on the accelerator’ and ‘foot on the brake’ to understand how it functions. That is because we understand how cars work; you can try something out in a car and see what happens. With the economy, you are necessarily working with an abstract concept, and people work with models in mind about how it functions rather than the real thing. There are several problems with models but one of the major ones is what I call omitted variable bias—that is, that your model can leave out something which turns out to be crucial. The models that dominate conventional economic thinking about how one should manage monetary policy ironically enough—and this might sound bizarre to anyone who has not done an economics degree—argue that money does not matter. In other words, they argue that the real side of the economy—the performance of the GDP, the level of employment and so on—is unaffected by monetary issues and all that monetary policy changes is the rate of inflation.

As part of that mindset, it also means that they completely leave the level of debt out of their models. If you look at the Reserve Bank’s website and its working papers, you will find it has about seven or eight mathematical models that it uses to discuss what might be the impact of monetary policy. The major models in that set do not include the level of private debt at all, that component is completely absent from the mathematical models where they represent the impact of changing the rate of interest or the rate of inflation.

The main generic type of model is known as the Taylor rule. This is not something that the Reserve Bank follows rigidly but, certainly, there is a tendency to believe that increasing the rate of interest will reduce the rate of inflation over time. The model leaves out the way that that can act through the level of debt on the economy. My feeling is that is the real problem in the way that monetary policy around the world is operated right now. The level of debt is ignored by these models. It is dramatically rising around the world compared to incomes and therefore the impact of interest rate changes is far greater than these models allow because they are not taking into account that debt is now two or three times what it was compared to incomes back in the 1990s. With that omitted variable bias, the models that the banks are following around the world may well be proved to be seriously wrong in the future.

Senator BUSHBY—Thank you for that. Do you think that the line that you are talking about there is something that is a new school of thought or is it something that is a well-known school of thought that the people in positions of control in central banks have rejected in the past?

Prof. Keen—It is one they have rejected in the past. If you go back to the 1950s, you can find two schools of thought developing about the nature of the finance system. One is called the efficient market hypothesis and the other is called the financial instability hypothesis. The

profession went with the efficient market hypothesis and argued that that was the way that the finance markets operated so that the markets were efficiently pricing both risk and return. The financial instability hypothesis, on the other hand, said that there was a tendency for the economy to get caught up in a set of euphoric expectations that led to rapid accumulation of debt as people were leveraging gains on asset markets and that would lead to a bust. Each time you survived a bust, you would then have another return to a bubble, which would lead to a higher level of debt, and you would get a ratcheting up of debt over time leading ultimately to a very serious crisis. The latter hypothesis was developed by Hyman Minsky and I have been probably one of the main people around the world trying to turn it into mathematical models of the behaviour of the economy. The efficient market hypothesis has dominated the other 90 per cent of the profession.

Therefore there have been, if you like, two views of how you could look at the economy, one which has been the dominant view that has been followed by both financial market players and regulators and then a minority view that says that this is a cyclical system that is going to lead to a crunch. The former view, as it happens, is now being disowned by those who developed it. One of the main people who developed that view was called Eugene Fama and he published papers in 1969 and from that stage on he trumpeted efficient markets as being the way that finance markets operated. In 2004 and 2006, in conjunction with his colleague Kenneth French, he basically said the model has failed empirically.

Senator BUSHBY—Do you think that the model that you are espousing is increasing in acceptance, given the events of the last 12 months or so?

Prof. Keen—Yes, it certainly is. If you look at writings in the financial press, more so than in the academic literature, you will find people talking about this being what they call a ‘Minsky moment’. What they are referring to there is the crisis that we are seeing. The subprime crisis is a classic instance of the financial instability hypothesis as Minsky outlined it. A major part of what I am doing in the public profile I have taken over this issue is because I saw a Minsky moment approaching when I saw the levels of debt in Australia becoming as extreme as they were and decided two years ago that I simply had to raise the alarm about it. That is a view which put me in a minority some time ago but, increasingly, people are saying that Minsky’s perspective, which is the one that I am putting forward, is the accurate description of how the finance markets actually behave.

Senator BUSHBY—If that is a trend which continues and economists in general are more accepting of that particular view, do you think that there is a need to ensure that the Reserve Bank has members on it who understand that better and have an ability to apply the modelling that will come out of that side of things?

Prof. Keen—I would very much like that if it happened. I have been seen as a critic of the Reserve Bank; I am more a critic of the philosophy of economics it has followed than of the bank itself. I have great time for the individuals I have met in the bank and I believe they try to carry out their roles responsibly, but I think they are looking at the wrong model. I would like to see the bank—and I will be approaching it at some stage about this—to start developing models which look at the other perspectives, simply on the basis that if you are managing something as complex and as important as a financial system it is important to look at all potential perspectives. Whether or not one thinks they are strong, one should consider

other views. I would love to see the bank have appointments with that perspective, and I would also like to see the bank develop models which do not simply follow the consensus view but also look at some of the well-founded but non-consensus views on how the financial system operates.

Senator BUSHBY—Are there any changes needed to the appointment process that would improve the prospects of those outcomes being delivered?

Prof. Keen—That is a difficult one. I am very wary about political interference in economic policy. But, at the same time, by having a dominant philosophy selecting who gets appointed to the board, it gets very hard to get a minority philosophy put forward. I cannot actually think of the system, but it would be very worthwhile for the legislature to think about this. I would like to see a system that gives a range of views that are intellectually well founded, even if some of them are in the minority academically. I would like to see some change in that sense to enable a contrarian philosophy to at least be heard by the Reserve Bank board.

Senator BUSHBY—Changing tack slightly, I understand from the submission of what you said this morning that you are suggesting that any move to increase independence is ill advisable because it decreases accountability, in a general sense.

Prof. Keen—Accountability is my main concern, yes.

Senator BUSHBY—You may have already answered this, but I will ask it again: despite this, do you agree that the bill as written would achieve increased independence?

Prof. Keen—No, I do not. I think the bill as written is silly. Looking at the bill, changing from the Treasurer to the Governor-General is not necessarily a bad thing. I am not opposed to that particular part of the bill. But the following grounds for removal of the governor or deputy should not be optional: if they are bankrupt, comatose—'incapable of performing his or her duties'—or working for another organisation. They should be compulsory, as the current act says. It is the classic, old expression, which you have heard many times, I am sure: it is rearranging the deck chairs on the *Titanic*.

Senator BUSHBY—So you would agree that, if the bill as proposed were passed, it would make those three grounds for dismissal optional on two levels: one, at the parliamentary level; and, two, at the Governor-General level, who 'may' dismiss on those grounds?

Prof. Keen—I certainly want to see a change to 'shall' dismiss and take it out of the hands of parliamentary debate.

Senator MURRAY—That was very interesting evidence on markets. My assessment is that the efficient markets theory is always capable of being undercut because markets are imperfect and, as you know, game and risk theory have indicated behaviour models—or have produced behaviour theory—which attack the idea that efficient markets can be realised in a perfect sense.

Prof. Keen—In the real world, yes.

Senator MURRAY—And that then inclines one towards a recognition that the financial instability propositions have merit, at least in particular circumstances. That was very interesting; thank you for that. One of the things that the electorate does with the parliament is

throws up a natural, creative, internal tension which is very productive because you get competing and contesting philosophies and ideas. What you are suggesting is that the Reserve Bank also needs that mechanism within it to keep it up to the mark and keep it sufficiently alert to alternative views and alternative prospects. The only way in which I can see that happening—I cannot see it happening from a staff point of view—is at the board level. One of the options we as senators always face with bills is whether to suggest a better way to proceed, and it seems to me that most of the criticisms we have heard about Reserve Bank independence over the last decade have concerned board members, not the governor himself.

Prof. Keen—That is true.

Senator MURRAY—I wonder if perhaps you have some thoughts as to how the appointments mechanism for the board could be improved.

Prof. Keen—That is very good point. I think it is possible for there to be a call for submissions about who is to sit on the board to come. I think up till now it has been mainly recommendations made to the Treasurer—is that correct?

Senator MURRAY—Yes, they are.

Prof. Keen—Yes. I think it would be a case of perhaps requiring a call to other community groups, which would include trade unions as well as lobby groups of the nature of the consumer choice group, the Australian Consumers Association, to get a range of representatives and realise that really economics is more of a debate than it is a science. This is the point that I try to teach my students—that I wish economics was a science but I think we are at almost a pre-Galileo level in some ways. So you do need to have a range of perspectives being put forward and, therefore, know that at the board level you have a range of philosophies being represented.

I would love to come and talk about this and try to work out a decent mechanism, because I want to achieve that outcome, that range of debate and views. And they have to be well founded; you do not want cranks on the board. This is one of the reasons you select professionals. But, if you have a particular ethos in terms of how the finance markets are thought about—the efficient market hypothesis being the dominant way people think—then that could be the only view that gets represented there, when you do want people to say, ‘Hang on—what about a behavioural perspective on how the markets operate? What about what’s known as the inefficient markets hypothesis? Let’s think about that.’ What about people who think that there is a way in which money does affect our set markets and therefore monetary policy should be considering not just CPI inflation but also asset price inflation? So you do need to get that mechanism there.

I would not want to think on my feet about how that could be done but I certainly think it is a very, very good objective that the Senate should have, and maybe I should sit down over the weekend and try to think about how one could do that in a way that did not leave you exposed to political jousting. What you really want are people who are intellectually aware of a range of philosophies about how monetary policy should be implemented. It is a very good question and, I think, a very good objective for the Senate.

In thinking mainly about coming from the point of view of saying, 'Don't do this particular act,' I have not come prepared to think about how one can get that debate at the board level, but certainly that should be the objective that the Senate has in mind.

Senator MURRAY—Professor, the chair will tell you how much time you have but, if further thoughts do occur to you, you are more than welcome to put in an additional submission. We would be very happy to receive it. We have to write the report, obviously, and there is a time limit—but, if you do decide to stay awake at night and give us some thoughts, we would be grateful!

Moving on to the broader issue, when I discuss these matters with concerned individuals, I ask them two questions: is independence important; and, do conflicts of interest exist and need to be managed? They always answer, 'Yes, of course.' If one starts from that proposition, the question is whether we can improve the act to enhance the independence of both the governor and the board, or either of them; and, secondly, whether we can better manage the inherent conflicts of interest which exist.

The difficulty we have is that the act itself contains political interference or would allow that. What we know, of course, is that governments past and present have restrained themselves. They have not gone to the full powers that the act actually gives them. That is the concern: at some stage in the future you might have a government, a Prime Minister or a Treasurer who does not behave as people have in the past. That is why we should be careful about the statute. Have you looked at the precautionary principle, if I may put it that way?

Prof. Keen—I think the precautions are well covered, because the political opprobrium of making a move like that where you did not have overwhelming public support would be disastrous, I would think. For example, there is nothing in the Constitution stopping the Governor-General from sacking the Prime Minister. The fact that that event back in 1975 was effectively sanctioned by the populace afterwards was a sign of how extreme the circumstances were seen as being by the public. So, even though from one point of view of politics that was a classic case of political interference, it did not have the consequence people thought it might have. 'Maintain the rage' certainly was not the way things worked out.

Again, here in this act, if any government did actually decide to direct the Reserve Bank on how to carry out monetary policy, then I think the belief that that was necessary would have to be overwhelming in the community. It would not be something which was a case of a rogue Treasurer or a rogue Prime Minister or even a rogue government making a decision. It would have to be extreme economic circumstances where the bank was seen not just by the government but by the population in general as maintaining entirely the wrong course and something had to be done to bring it into line. That is such an extreme situation that I think would ever come to pass only if it were true.

So I am not concerned about the legislative checks and balances of that part of the act. I think your comment earlier about the need to get a better range of robust debate within the board of the bank is a far more important principle of reform.

Senator MURRAY—I would suggest to you with respect to the board that the board would really be vital in a situation where the governor was at odds with, let's say, the political

establishment, not just the government. Therefore, to have people of independence, strength and intellectual rigour is important in that respect. Do you agree?

Prof. Keen—I do indeed. I must applaud the Reserve Bank for the decision recently to start publishing its minutes so we actually see what range of debate is taking place there. Of course, my concern is that the debate is still too narrow.

CHAIR—I have a question regarding board membership. In the United States I understand the Federal Reserve board is elected by the nominees of the government going before one of the Senate committees for ratification. I think we all know from other examples, not necessarily the Federal Reserve, that that can be subject to a political process. But it does mean that there is discussion among different parties from different parts of the United States about who should be on the Federal Reserve board. What do you think of that?

Prof. Keen—I think that is possibly a mechanism to go with. As you say, if you think about the way in which the Senate is elected, that is not a bad model for the government then deciding who goes onto the board. There might be, say, 10 nominees, and then the nominees get a proportional representation voting effect. That might well give you the possibility to have a minority perspective being supported by minority parties in a Senate type arrangement. Then, as well as the mainstream being the dominant perspective, you would also get a couple of people who represent the non-orthodox philosophy and therefore you would get the robust debate you would like to have on the board. So a mechanism of that nature, where nominees go before parliament and there is a non-party-political vote followed by selection on the basis of the number of votes with a quota system, may well be a way to get that debate going on the board itself.

Senator EGGLESTON—Following up on that, I agree that in a perfect world the Senate committees, as they do in the United States, might well recommend appointments for a variety of positions—which in that country goes from ambassadors to Supreme Court judges. But we do not live in a perfect world, and that is not the system in Australia. In fact, when one looks at the United States the appointments to the Supreme Court and even their ambassadorships are very much a reflection of the political majority on the Senate committee concerned with their appointment. In reality, in the Australian system that political perspective would come into any consideration of a dismissal of governors and deputy governors of the Reserve Bank. Would you not agree with that?

Prof. Keen—I agree that that is possible and I would not want to see that happen. What I am thinking more about is a form of the Hare-Clark voting system being applied not to the governor and deputy governor at all but to the membership of the board. I am just, again, extrapolating on that invitation to think about how one might have a mechanism to get better debate at the board level. It is like a Hare-Clark approach to the voting in, by the houses of parliament together, of a set of nominees for the positions on the board, it being at the level of the overall parliament that the vote is taken as to who becomes a member of the board of the Reserve Bank. Carefully worked out—you would certainly want to be very careful in how you devise this mechanism—that might be a way of getting the level of debate one would want at the board level while maintaining the independence of the governor and deputy governor and the current appointment and removal provisions of the act.

Senator EGGLESTON—I understood that you were speculating on a possibility. I was just bringing us all back to reality, because—

Prof. Keen—Yes, I do agree.

Senator EGGLESTON—in fact, you mentioned a free vote, which is quite unusual.

Prof. Keen—Agreed. I was just trying to consider how it could be done. You want to have a range of views; you do not want to have cranks. That is the combination you want in this area. How do you go about achieving one without getting the other? I agree, looking at the American situation—where you have the level of political appointees and one party dominating the Senate committee being the one that determines the type of candidate who gets it—that you do not want that outcome. But you are saying that you would be very careful about how you went about it. In some ways, it has similarities to trying to select a Governor-General, if we had a republican system, without having the appointee itself being a political one.

Senator EGGLESTON—When and if!

Senator MURRAY—The British Attorney-General and now the Australian Attorney-General, and their respective governments, have looked to improve the appointment of judges. That has been a fascinating debate over many, many years. Essentially, what they are going to is a broader advertisement mechanism and nominations, and then an expert panel puts forward a short list of nominees. Do you think that, since that works for another arm of government in which we demand and need absolute independence, that sort of mechanism for improving judges could work for improving the variety and calibre of the board of the Reserve Bank?

Prof. Keen—It is feasible. One of the dangers about economics is that, because it is such an inherently and yet at the same time unconsciously political area, you get people who are dismissive of other philosophies in economics. Sinclair Davidson, for example, follows an Austrian philosophy of economics. I follow what is called a post-Keynesian philosophy. The majority follow what is known as neoclassical. The neoclassical majority would dismiss both Sinclair Davidson and me because we belong to minority schools. In law, of course, people are aware that you want to have people who range from those who are strict literalists in how they interpret the Constitution through to those who go to what they see as the inherent intention of the legislature and others who try to bring in the principles of the common law. So there is more respect in law, in general, for a range of views and for diversity. That is where you get the Kirbys appointed standing up to the bank as well as the Callinans, and that is a good thing about the way law operates. I wish economics were as good as the lawyers are on that front. So it is something which is a feasible way to go, but we need to be aware of the way in which the economics profession differs from—and, in my estimation is somewhat inferior to—the legal profession on that respect for a range of perspectives. But yes; it is certainly something that could be a way of achieving the aim you are looking at.

Senator WEBBER—My question is sort of along those lines, but not discussing the appointment of judges. Surely one of the aims within this thrust has to be not just frank and fearless advice and independent policy, but also stability of economic management. We have to have a framework for the appointments of the governor, the deputy governor and the board,

if we are going to expand the debate. So yes, we need more openness and accountability, but we also need to keep front and centre in our minds that we need economic stability and security, not just a free-for-all robust economic debate that we can all participate in and all think we are experts in when setting our monetary policy.

Prof. Keen—I agree, and you would want to have that sense of stability. Anybody who gets appointed, you want to have someone who has that as their objective and not some political agenda and so on. Even though I am coming as a critic of the philosophy that dominates central bank policy around the world and the way we think about economics, I still want to have a system which is economically robust. I get accused of being ideological by some; I try to be as nonideological as I possibly can by just having a different analytical approach. That is what you want, you want people who have analysis rather than ideology as their dominant perspective ending up in those positions and then having political stability for them for a long time. I would not want to see them being kicked out because interest rates rose by half a per cent and people did not like it. You need some sense of stability there as well, definitely.

Senator BUSHBY—Following on from Senator Webber's question, I think we all agree on the need for economic stability in terms of board appointments and surety et cetera. But do you think a situation where one of the three grounds for dismissal that currently exist, and which have been transferred in different ways for dealing with them under the current bill, occurred with the governor or the deputy governor of the Reserve Bank in a period when parliament was not due to sit for a couple of months would add to or detract from the economic stability that the nation would face in those circumstances?

Prof. Keen—It detracts, definitely. This is a bit of a joke, but imagine the Reserve Bank governor writing for the *Daily Telegraph* and being paid for it and you had parliament not sitting three months, it would be absurd—or going bankrupt or being run over by a bus and you have a comatose person as Governor of the Reserve Bank. It is simply ridiculous to have that level of instability being generated by the act, so I think it is one of those cases where although the intention of those drafting the bill may have been to achieve greater political independence and stability, unfortunately what they have written would end up giving us more instability.

CHAIR—Just to go back to Senator Murray's comments: if you did want to put any additional submission in, the final report on the bill is due by 11 June, so we would need to have any additional comments by early next week.

Prof. Keen—It looks like I am doing even less sleeping next week than I would normally do!

CHAIR—Thank you, Professor Keen.

[11.18 am]

McDONALD, Mr Tony, General Manager, Macroeconomic Policy Division, Macroeconomic Group, Department of the Treasury

VERSPAANDONK, Ms Rose, Manager, Monetary and Fiscal Policy Unit, Macroeconomic Group, Department of the Treasury

CHAIR—Welcome. Before we commence, I want to recap a couple of matters for the benefit of officers. First, if a witness objects to answering a question, the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer having regard to the ground which is claimed. If the committee determines to insist on an answer, a witness may request that the answer be given in camera. Such a request may, of course, be also made at any other time. Any claim that would be contrary to the public interest to answer a question must be made by a minister and should be accompanied by a statement setting out the basis for the claim. The Senate has resolved that an officer of a department of the Commonwealth or of a state shall not be asked to give opinions on matters of policy and shall be given reasonable opportunity to refer questions asked of the officer to superior officers or to the minister. This resolution prohibits only questions asking for opinions on matters of policy and does not preclude questions asking for an explanation of policy or of factual questions about when and how policies were adopted. I note that the committee has received a submission from Treasury, which we have received as submission No. 6. Are there any additions or alterations you wish to make to that submission?

Mr McDonald—I have no additions to the submission but we do have an opening statement. Thank you to the committee for inviting Treasury to appear at today's hearing. Our submission to the inquiry was intended to provide some context to the measures in the bill. In short, we believe that Australia has been well served by the granting of operational independence to the Reserve Bank of Australia, to pursue an agreed objective of keeping consumer price inflation between two to three per cent on average over the cycle. The measures in this bill seek to build on the established principle of the Reserve Bank's independence. I understand that there is a view the amendments have the effect of nullifying the operation of section 24(1)(c) of the Reserve Bank Act. That is not our view or the view of the Office of Parliamentary Counsel in preparing the amendments.

As noted in our submission, on this issue being raised in the debate, we sought advice from the Australian Government Solicitor on this question. I understand members of the committee have expressed interest in obtaining that advice. As members are aware, the government's position is that it will not generally reveal the contents of its legal advice. However, in this instance and in the interests of promoting an informed debate on the amendments in the bill, I am happy to table the consolidated written advice Treasury has received on this matter from the Australian Government Solicitor.

I understand a concern has been raised as to whether parliament would need to be recalled to dismiss the governor or deputy governor under section 25(1). I note that in these instances we would expect section 25(2) to apply, enabling temporary suspension by the Governor-

General. These provisions mirror those that apply in the case of the Commissioner of Taxation. We are pleased to take questions.

CHAIR—Thank you. Mr McDonald, you have alluded to the fact that the government still expects section 24(1)(c) to apply, which states that the office is held subject to good behaviour. You have advice from the Australian Government Solicitor which deals with that advice. Could you elaborate on how you expect that might operate in practice if the Reserve Bank governor or deputy governor were found to be not operating with good behaviour?

Mr McDonald—In our view—and this is covered under question 3 of the advice—the Australian Government Solicitor notes that a court would need to determine whether or not the governor or deputy governor had failed to exhibit good behaviour for the purposes of section 24(1)(c) for termination to occur. In accordance with that section, it would be necessary for legal proceedings to be brought in appropriate courts by a person having sufficient standing alleging that the governor or deputy governor had failed to fulfil a condition of his or her office as to good behaviour and seeking a declaration as to when that failure occurred.

CHAIR—Who would you see as a person of sufficient standing? What kinds of people would have sufficient standing to bring a court action?

Ms Verspaandonk—We are aware that the Treasurer would be considered to be a person of standing, but I would have to take on notice a list of any further people. I am not sure who else would have that—

CHAIR—Thank you

Mr McDonald—That question is also covered to some degree in the advice from the AGS.

CHAIR—In what sense?

Mr McDonald—Its says at paragraph 21 that the executive government would have necessary legal standing. It canvasses whether or not the parliament would have sufficient standing as well. It notes in paragraph 22 that it would be open to a house to pass a resolution to the effect that executive government should institute such proceedings but considers that such a resolution would not be binding on the executive government.

CHAIR—Thank you, Mr McDonald. Are there any questions?

Senator BRANDIS—I have questions on that very issue. What you are telling us, with the advice from the AGS, is that, if the Governor or Deputy Governor of the Reserve Bank engage in conduct which is considered by the Treasurer to be a breach of the requirement of good behaviour under section 24(1)(c), the Treasurer would have to institute legal proceedings—presumably in the Federal Court—to remove that person.

Mr McDonald—Yes. It is not the opinion of the Treasurer that matters in this instance, according to our advice. A court would need to reach a sufficient standing on that.

Senator BRANDIS—I can understand why the legal advice says that, but surely that is an extremely complex and cumbersome way in which to go about this. If you institute legal proceedings in the Federal Court—and, let us say, for argument's sake, that the governor is a person of sufficient financial substance to be in a position to defend those proceedings; one

imagines a person in that office would be of sufficient substance to defend those proceedings—it might take years, might it not?

Mr McDonald—That is the law as it currently exists. This provision is summarised in paragraph 15 of the advice.

Senator BRANDIS—For the purposes of this discussion, I am not going to assert that the legal advice is wrong, because I have just seen it and I have not had an opportunity to consider it carefully. In fact, let us assume for the purposes of this discussion that the legal advice is right. If the legal advice is right, it seems to be the government's position that it is prepared to rest content with the situation in which the only way of removing the Governor of the Reserve Bank in a case of, let us say, misbehaviour—which is a shorthand way of expressing failure to observe the requirement of good behaviour—is to sue in the Federal Court in proceedings which, if contested, will without any doubt take months and could conceivably, allowing for appeals and so forth, take years.

Mr McDonald—I suppose the policy intent of this bill is to enhance the independence of the Governor and Deputy Governor of the Reserve Bank by making it more difficult for them to be dismissed from office, not to make it easier for them to be dismissed from office, because that would be regarded as reducing rather than enhancing the independence of the bank.

Senator BRANDIS—I do not think that that follows, frankly. I can understand why you say that, Mr McDonald, but surely the removal of the Governor of the Reserve Bank would be such a dramatic thing to do that no government, regardless of its political complexion, would even dream of doing so lightly, because to do so for no sufficient reason just would not withstand the test of public scrutiny?

Mr McDonald—We would hope that that is the case. I suppose that in this particular instance these amendments do not amend section 24(1)(c) because the government's policy is that those provisions are sufficient as they stand.

Senator BRANDIS—And yet, in the bill, in the schedule 1 amendments, item 3, there are provisions for suspension by the Governor-General, are there not?

Mr McDonald—There are.

Ms Verspaandonk—That is correct.

Senator BRANDIS—Why is it prejudicial to the independence of the Governor of the Reserve Bank to have a provision which enables him to be removed for cause by the Treasurer giving advice to the Governor-General but it is not prejudicial to the independence of the Governor of the Reserve Bank to have a provision that enables him to be suspended?

Mr McDonald—The grounds for suspension under section 25(2) are limited to those that are outlined in section 25(8).

Senator BRANDIS—So they do not include misbehaviour?

Mr McDonald—They do not.

Senator BRANDIS—All right. What about the fact that the Governor of the Reserve Bank, because of the sensitivity of the position which he or she occupies, is a person upon

whom public confidence in the entire financial system depends? Can you imagine what harm would be done to the integrity of the currency and to the financial system if there were a prolonged dispute in a court about the fitness for office of the Governor of the Reserve Bank?

Mr McDonald—There is an assumption there that the court proceedings would take an extended period of time, which I am not in a position to—

Senator BRANDIS—They would take an extended period of time if they were contested.

Mr McDonald—I am not in a position to assess—

Senator BRANDIS—I am. I ran dozens and dozens of Federal Court trials in my earlier career, and I can tell you that a contested Federal Court proceeding is not something that can happen quickly. It is not in the nature of the process. What effect do you think it would have on the Australian financial system if public confidence in the Governor of the Reserve Bank was undermined by prolonged proceedings in the Federal Court?

Mr McDonald—There are a couple of aspects to that question. Firstly, of course public confidence in the Reserve Bank as one of our most important institutions is very important—

Senator BRANDIS—Absolutely.

Mr McDonald—not just to the financial system but across the board. The question that comes in there is a counterfactual: do you think public confidence would be enhanced by making it easier to remove the Governor or Deputy Governor of the Reserve Bank from office or—

Senator BRANDIS—The proposition that I am putting to you—

CHAIR—Senator Brandis, would you kindly allow the officer to finish. You had quite a long question.

Senator BRANDIS—I am sorry, Mr McDonald. I did not mean to cut you off. Have you finished?

Mr McDonald—That is okay.

Senator BRANDIS—What I am putting to you is this: because of the extremely dynamic nature, in the technical sense, of currency markets and the criticality of confidence in the Governor of the Reserve Bank, if there were sufficient reason to consider that that person was not meeting the good behaviour requirement, any decision to remove that person would have to be executed swiftly and he or she replaced swiftly. That is a different issue from the question of independence. Nobody questions the independence of the governor. No government of whatever political complexion would dare remove a governor for insufficient cause. They would never get away with that. But if a government or a Treasurer concluded that the governor was behaving in such a way as to breach the good behaviour requirement of the act, wouldn't you agree that that decision, having been made, would need to be executed swiftly, rather than delayed through a prolonged process?

Mr McDonald—I bow to your superior experience on the length of the legal process but if the evidence of misbehaviour was so compelling and so overwhelming I find it hard to see that the courts would take a period of years to elaborate on it.

Senator BRANDIS—Well, at least a period of months.

Mr McDonald—As I say, you clearly have more experience in this matter than I do. I come back to the premise of the question: that everyone is agreed on what would constitute misbehaviour. I suspect that that may well not be the case. People may well have differing points of view. But, as I said, the amendments in this bill do not alter the existing law in this respect.

Senator BRANDIS—Indeed, but the bill addresses the general issue of the circumstances of removal but omits to address this particular one, which is why I am asking these questions. Do you recall that some years ago when Mr John Moore was the Minister for Defence he lost confidence in the man who was at that time the head of the Department of Defence, Mr Paul Barratt—thank you, Senator Bushby—and had him removed. Mr Barratt contested his removal on various grounds by proceedings against the Commonwealth of Australia in a Federal Court. Do you remember that occasion?

Mr McDonald—I do have some recollection of that but I did not pay a great deal of attention to it at the time. I may well have been doing other things.

Senator BRANDIS—Indeed. The point I make is that that is the most recent case I can think of of the removal of a senior official of the Commonwealth and that was an occasion when Mr Barratt did contest his removal—ultimately unsuccessfully—by proceedings which he himself commenced in the Federal Court. I cannot tell you how long they went for but they went for a long time, certainly many months if not for more than a year. That is what is involved here. How long does it take to destroy confidence in the financial system? In a sufficiently severe case it could be destroyed within hours, could it not?

Mr McDonald—I would not like to speculate on what particular case you have in mind. Obviously, confidence is an important element of the financial system and the economy.

Senator BRANDIS—Of course, and my point to you is that confidence is fragile. It is always fragile, and if we ever got—and I am not saying that we ever would—to the sorry state in this country that the government publicly declared that it had no confidence in the Governor of the Reserve Bank, which by commencing proceedings to remove him it would do, and yet was unable to effect his removal and replacement immediately, and, indeed, the governor and the government were at odds with each other over a period of many months, do you not agree that that would have a devastating impact on the financial system?

Mr McDonald—Senator, we clearly would not want to get into that position. I suppose the question you come back to again is counterfactual: would we be better served by a system that made it easier rather than harder for the governor to be removed in those circumstances?

Senator BRANDIS—My point is that it is a given that such a step is a grave step that would never be taken lightly or for insufficient cause. My point is not so much whether it should be easier or harder but, the decision having been made, it is surely of necessity a decision that must be implemented and executed swiftly. Do you agree with that?

Mr McDonald—I would think so, and I would imagine that if you reached such a position then the legal system would work swiftly.

Senator BRANDIS—The legal system is not going to work within a matter of hours or days, is it? It is contrary to the experience of mankind that in the legal system, particularly, as

I said before, if the proceedings were contested by the person in question—just as when Mr Paul Barratt contested his removal as the head of the Department of Defence—it could be disposed of in less than months. Anyway, you agree that it has to happen swiftly; that is good.

Senator MURRAY—You are not referring to Jarndyce and Jarndyce? I saw that on the television the other night and I thought of it as you made your remarks.

Senator BRANDIS—Senator Murray, Jarndyce and Jarndyce was an estate case and it was based on an actual piece of litigation, about which Lord Eldon observed, when he ultimately did deliver judgement: ‘Having reflected on this matter for the past 26 years I do not think that there is any cause for further reflection.’ Thank you, Senator Murray. We are agreed that, if such a grave thing is to happen, it has to happen swiftly to protect confidence in the financial system?

Mr McDonald—Yes. There is a premise in your question as well that everything else would be equal and that proceedings would only be instituted in any alternative arrangements under the same test as would apply under a court, and I am not sure that that premise is well grounded.

Senator BRANDIS—I think you can safely assume that proceedings in a court, if contested, are going to take quite a while.

Mr McDonald—I was making a different point, and that was—and I do not know what alternative approach you may well be proposing—whether an approach that enabled a more timely removal of a governor would be limited to the same grounds of misbehaviour that a court would require.

Senator BRANDIS—What about the proposed section 25(8) simply adding as one of the grounds of termination—and you could follow the language in section 72(2) of the Constitution about judges: ‘has engaged in proved misbehaviour’? You might not need to use the word ‘proved’. I point out to you that there are such provisions in relation to the Commissioner of Taxation and the Auditor-General, and to federal judges in the Constitution. Why shouldn’t the same grounds apply to the governor or deputy governor of the Reserve Bank?

Mr McDonald—I come back to the point I was saying before that the effect of that section amendment would be to enable the governor and deputy governor of the Reserve Bank to be dismissed in situations where they currently cannot be.

Senator BRANDIS—That is true, but there are other officers of the Commonwealth, including—following the decision of the Federal Court in Barratt against the Commonwealth—the head of every department of the Commonwealth who can be dismissed.

Mr McDonald—I suppose the question is whether or not you are equating the secretary to the Department of Defence, as important as that position is, to the governor of the Reserve Bank in their impact on the operation of the financial system.

Senator BRANDIS—You make my point for me very well, Mr McDonald. One can imagine that the economy of the country would not be severely damaged if there were a dispute about the termination of, for argument’s sake, the public service head of the Department of Defence. But I think we agree with each other that any deadlock or delay in the

termination of the appointment of the governor of the Reserve Bank over a period after which the government publicly declares it has no confidence in him would be devastating.

Mr McDonald—I suppose we come back to the counterfactual: is it preferable to make it easier and, with due respect to the parliament, more engaged in the political process, for either house of parliament to be able to move such a motion on the grounds of misbehaviour?

Senator BRANDIS—I am not suggesting that at all. My point is that, if the Treasurer or the government loses confidence in the governor of the Reserve Bank, the advice to you by the Australian Government Solicitor contemplates that the sole mechanism for his involuntary removal necessarily involves two things—both of which are highly prejudicial. First of all: be a public declaration by the government that it has no confidence in this person, because you could not commence proceedings for his or her removal without that being regarded as a public declaration of no confidence and, indeed, in instituting the proceedings, the government would have to advance that very proposition to the court. So the process would involve, firstly, the public declaration by the government that it had no confidence in the governor of the Reserve Bank, and secondly, a reasonably prolonged legal case. Now, we can quibble about whether it might be years or months, or perhaps in an urgent case it could be disposed of in weeks, but even weeks is too long to leave a person in whom the government has no confidence in command of the financial system, isn't it?

Mr McDonald—The test in the legislation is not whether or not the government has confidence in the person.

Senator BRANDIS—No, the test is good behaviour.

Mr McDonald—The test is that the person holds office subject to good behaviour. At least that is what section 24(1)(c) says. Therefore the test would not be whether the government had lost confidence or not but whether there were sufficient grounds to show that there had been misbehaviour. As you said earlier, that is a decision that no government, you would hope, would take lightly.

Senator BRANDIS—Absolutely.

Mr McDonald—Therefore you would think that the evidence would already have been collated and would be, you would think, overwhelming. Now, I am not in a position to know exactly how long such a case would take before the courts. You referred earlier to a possible amendment to section 25(8) of the proposed amendments. In those instances you would be looking at a lesser test of what would be required than what is currently before the courts, I would have thought.

Senator BRANDIS—Not at all. I am not looking at a lesser test. What I am looking at is a swifter procedure—the same test. With all due respect, Mr McDonald—and I do not want to bully you; I know you have a hard case to argue here—it seems to me inevitable that, at the moment the government concludes that the misbehaviour of the governor of the Reserve Bank is so serious that it would seek to institute proceedings in a court to remove him, that could only be interpreted by the financial markets and the public in general as a declaration that the government has no confidence in this person. For goodness sake, they are trying to dismiss him! Would you not agree?

Mr McDonald—I suppose we come back to the alternative: what actually happens if you have a different test—if you amend section 25(8)? In that instance it is the parliament that needs to be convinced that the governor or deputy governor is guilty of misbehaviour, and not a court. Again, with respect to the parliament, that is a lesser test than exists at the moment.

Senator BRANDIS—Nobody is suggesting a different test; what is being suggested is that the application of the same test—that is, failure to fulfil the obligations under section 24(1)(c) to observe good behaviour while holding office—if it is breached, should be able to be dealt with by a more efficient procedure than the one that the Australian Government Solicitor has advised you is the only possible way of giving effect to section 24(1)(c) as it stands under your proposal.

Mr McDonald—I suppose we come back to whether it is the same test or not. It is a question of who applies it. I would have thought that there is a significant difference between a court applying a test and the parliament doing it. Again, you would have more experience of parliamentary matters than I would, but there are some parliamentary matters that have dragged on for more than months or years as well. It can be a question as to whether it would be more efficient, but I am not in a position to judge that either.

Senator BRANDIS—What I am putting to you is that it should be able to be done by the advice of the government to the Governor-General in Council. The AGS's advice to you, which I have not had an opportunity to think about carefully, is that because of section 49 of the Constitution it would not be possible to have this trial, in effect, in the parliament so that is why the AGS appears to say it would have to be done in the Federal Court. My point is: the moment the government is of the view that it has no confidence in the governor of the Reserve Bank—and this would not ordinarily be a party political issue, I might say—you would think the first thing that the Treasurer should do is secure this person's removal so that confidence in the financial system can be restored.

Mr McDonald—Again the question is: are you looking at like factual situations? There would be situations conceivably, such that if you had the same test under section 25 applied by the parliament, where a governor or a deputy governor would be able to be removed where a court may not currently remove them.

Senator BRANDIS—I am not talking about the parliament, I am talking about removal by the Governor-General in Council on advice from the Treasurer. That is the only way in which this could be effectuated immediately. Can I suggest to you, with all due respect, if ever there were a case in which the removal of an officer was an urgent matter and needed to be effectuated immediately, it would be the officer upon confidence in whom the integrity of the financial system depended.

Mr McDonald—I suppose then again you come back to the fact that that would allow removal of the governor or deputy governor in situations where they currently may not be removed.

Senator BRANDIS—No, I am not saying that at all. I am talking about the process. You keep saying I am lowering the test. I am not lowering the test. The question is who is to apply the test and if the test of good behaviour is not satisfied then by what process the consequences of that can be put into effect. My point is that if a Treasurer or a government

were to make such a grave decision then they would need to operationalise or put into effect that decision effectively instantly because any delay would undermine confidence in the financial system.

Mr McDonald—I suppose it comes back to the point of political independence. I think we would all accept the proposition that a court is going to be more politically independent in applying a test, albeit the same test, than a Treasurer would be.

The **Senator BRANDIS**—With respect, I do not think you are right because, given the gravity of such a measure, no government would dare make it unless there were very, very powerful and almost self-explanatory reasons to do such a thing. But, even if you were right about that, what is the greater mischief? That or a public declaration by the government that it has no confidence in the man who runs the financial system which would drag on for, let us say, even weeks if it were dealt with in an extremely urgent way by a court. What is the greater mischief?

Mr McDonald—Ultimately, of course, that is for the parliament to decide. If you have a situation where a governor or deputy governor were removed—in the situation where they currently cannot be—and if you place a greater emphasis on enabling the governor or deputy governor to be removed more quickly, then you have to address the question: what happens if there is not general agreement that the grounds of misbehaviour were well founded? You could imagine that, with all the points that we have talked about so far—and I have mentioned the far greater risk—there would be a perception in financial markets that the governor or the deputy governor had been dismissed for real reasons that were other than misbehaviour.

Senator BRANDIS—That is why I say to you, Mr McDonald, that, given the gravity of such a step, no government in its right mind would even contemplate it unless the reasons were compelling and, as I said before, almost self-explanatory. I do not think I can take it further. I have explored the legal dimensions of the issue with you as far as I can. I think Senator Bushby has some questions.

Senator BUSHBY—Following on from what Senator Brandis has been asking about, do you acknowledge that a delay in the dismissal of a governor or his deputy governor once the process has commenced, whether it be a court process, as Senator Brandis was discussing, or whether it be a process as a result of the proposed grounds for dismissal in the proposed section 25(8), is good for public confidence? Once that becomes public, there is a process that commences to dismiss the holder of either of those positions—but particularly the governor's position—and that would actually be a good thing for public confidence.

Mr McDonald—As I said in my opening statement, section 25(2) provides that the Governor-General can immediately suspend—

Senator BUSHBY—Only for those three grounds.

Mr McDonald—For those three grounds—that is right. In the case of section 24(1)(c), you come back to the points that I was discussing with Senator Brandis—the question: what is the greater mischief that you—

Senator BUSHBY—Regardless of what the government is trying to achieve with this bill, if the process were commenced—and, repeating what I said, under the three grounds in

proposed section 25(8) or in a court process—it is not going to be good for public confidence in the financial system, is it? I think it is a fairly important question.

Mr McDonald—Given the importance of the governor and the deputy governor, and indeed the whole intent of the bill, were the occupants of these positions to be dismissed, that would be a very serious matter.

Senator BUSHBY—It is fairly apparent that the people involved in the financial system would have some concerns. Even the general man on the street may take a greater interest in what is going on.

Mr McDonald—Yes. It would depend somewhat on the context in which it all occurred, of course.

Senator BUSHBY—You have mentioned that the policy underlined in this bill is to make it harder to dismiss governors—

Mr McDonald—Yes.

Senator BUSHBY—but how does this enhance public confidence? That is really what I am getting at. By taking a mandatory requirement to dismiss persons in those positions when certain matters of fact occur and turning that into an optional matter at the discretion of parliament and then ultimately at the discretion of the Governor-General, how does that enhance public confidence? The three grounds are matters of fact, effectively, and, once they occur, currently the Treasurer has no choice—there is no discretion, there is no lack of independence there. The Treasurer has no choice: he must remove the governor or deputy governor from those positions by deliberately delaying, as you said—which is the policy intention—the dismissal of government and putting it in the hands of parliament, which could also take a matter of months. Firstly, how does that actually enhance independence? Secondly, what effect is that going to have on public confidence of the financial system?

Mr McDonald—The first point is that, as I said before, section 25(2) provides for the immediate suspension in those circumstances. The second point is that it is not quite the case that these three grants—and it may well be the case for bankruptcy—take the ground of permanent incapacity. I know that in earlier testimony people said, ‘If the governor was comatose’, and various other grounds can be put forward, but that is not something that would just be a question of pure opinion; the Treasurer of the moment would need to have a basis for forming that opinion. There is more than one ground, and the test of incapacity is one that requires some judgement.

Senator BUSHBY—It certainly does but, ultimately—and Senator Brandis could probably help us with this if he were still here—there is a fairly well defined meaning within the legal context for a situation of permanent incapacity. It is generally accepted that if a medical practitioner provides a certificate stating that a person is permanently incapacitated, then that is a test that would be accepted. That would then become a matter of fact, at that point. Similarly, if a governor was engaged in external employment and evidence was adduced that they had a contract of employment or that they were being paid for work that they were doing, then it would become a matter of fact. I do not imagine that action would be taken to invoke any of that until evidence was actually before the government and to then put that in front of parliament. Once that evidence is in their hands then it does become a matter of fact.

Mr McDonald—The section refers to being permanently incapable of performing his or her duties, and of course—

Senator BUSHBY—That is certainly broader, but in cases—

Mr McDonald—If I could finish the sentence, what that means is that there are situations that may result in a person being incapable of performing some duties but which may well not result in them being incapable of performing other duties. So that is a question that involves some degree of judgement. When you have some degree of judgement or discretion on a question on something as sensitive as the dismissal of a Governor or a Deputy Governor of the Reserve Bank, then there is a risk that by allowing that to be entirely in the discretion of the executive government, people could well infer that the dismissal was not in fact made for those grounds but was made for other grounds.

Senator BUSHBY—Okay. That is fine. I hear what you are saying. Are you contending that in handing it to parliament to make a decision, parliament will always make that decision on the purest of motives? Do you concede that there is a potential for parliament to also make a decision on the dismissal—if it goes to them in the circumstances you outlined—on political grounds, particularly when you look at the make up of the Senate and how that tends to fall.

Mr McDonald—Of course, I have the utmost confidence in the parliament to make the decision in the interests of the Australian people.

Senator BUSHBY—I commend you for your confidence.

Mr McDonald—Exactly! In that situations, under the act, the parliament needs to base the termination on those three grounds, so it would need to be able to show and demonstrate that it is following those grounds. But we come back to some of the points that Senator Brandis was making before. No government would bring forward a provision for misbehaviour unless they had very strong grounds for doing so. That goes to the points that Senator Murray was making before when talking with Professor Keen. No government would seek to use section 11, given the political opprobrium that is attached to it. That is in contrast to a situation where an executive government could make that decision unilaterally and without having to put their reasons before the public and the parliament.

Senator EGGLESTON—I was going to pick up on your fundamental rationale, and that is that these changes would give the Reserve Bank more political independence. Can you quote any examples of political interference in the operation of the bank since it was established?

Mr McDonald—Since the Reserve Bank was established in 1959?

Senator EGGLESTON—Yes.

Mr McDonald—As you may recall, there used to be a monetary policy committee of cabinet before the 1990s and monetary policy was effectively set by the government rather than by the Reserve Bank.

Senator EGGLESTON—But since then the Reserve Bank has been made independent; that is long ago.

Mr McDonald—That is right. The bank was granted operational independence in the early nineties, and that was formalised in 1996 by the former Treasurer, and last December the

current Treasurer reached the fourth Statement on the Conduct of Monetary Policy. At the moment, the Reserve Bank enjoys a degree of operational independence and, as I said in my opening statement, that has served the Australian people and the Australian economy well. The measures in this bill seek to enhance that.

Senator EGGLESTON—In fact, there is not any recent political interference with the operations of the bank, is there?

Mr McDonald—No. Nor indeed is there any current intention to do so. But the point in all of this is that perceptions matter.

Senator EGGLESTON—Public perception does matter. Politicians comment on decisions of the bank but they do not seek to interfere. That is the culture of Australia. Would you agree with that as the political culture of Australia in relation to the operations of the Reserve Bank?

Mr McDonald—I would not want to be seen as a political commentator, but I suppose—

CHAIR—That is very wise indeed.

Senator EGGLESTON—But you are a citizen and a conclusion open to every Australian is that, while politicians do comment—on interest rates, for example—they do not seek to direct the bank to not follow its own decisions. Is parliamentary approval of dismissal decisions more likely to be open to political game playing in the parliament, especially since decisions are required in both houses? As I said to earlier witnesses, we have to think about what happened in 1975 when the Senate decided to defer the budget and some members of parliament regarded that as a very capricious and political act.

CHAIR—Indeed.

Senator EGGLESTON—One could imagine a similar situation occurring in relation to the dismissal of a governor or deputy governor of the Reserve Bank. It is unlikely to be a common event, but nevertheless it could occur. I would have thought that, through the process in the Senate in particular, the whole question of dismissal becomes more open to political influence than it would were the decision to remain, as now, simply with the Treasurer, when, as George Brandis and Senator Bushby have both pointed out quite often, swift decisions are required. Would you agree with that?

Mr McDonald—On the later point of swift decisions, we have previously discussed the operation of section 25(2). On the question of which would be the more political process, the existing provisions provide for the Treasurer, who is of course also a politician, to be able to make these decisions. I suppose the bill is predicated on the basis that transparency in these matters is all. The key thing in relation to any dismissal of a governor or deputy governor is that there is public and market confidence that it was being done on appropriate grounds and not on inappropriate grounds.

Senator EGGLESTON—We agree with that, but the reality is that the political process, especially in the Senate, is a political process and that sometimes—quite often, in fact—actions are taken for purely political reasons. I have a grave concern that placing this power in the hands of the Senate in particular may mean that political game playing comes into decision making about dismissal of a governor or deputy governor, because that is the reality of politics in the Senate. I do not think that, in considering this matter, we should ignore the

political reality of the way the Senate operates, where the government does not always have a majority and where an opposition may see it as being in its political interests to embarrass the government by not proceeding with a dismissal regardless of the grounds. I would just ask you to consider that. I do not think you can appropriately answer it, but it is something which I think should be taken into consideration.

Mr McDonald—I suppose the question that comes there—and it is not for me to make any political judgement—is whether or not either house of parliament would feel it appropriate to not dismiss a governor or a deputy governor when there was a clear-cut case of any of the three matters that are outlined in section 25(8).

Senator EGGLESTON—The last thing I would say—it is only brief—is that it is claimed by the government that the bill gives effect to its announcement to raise the statutory independence of the Reserve Bank governor and deputy governor to that of the Commissioner of Taxation and the Australian Statistician. I put the question to you: does the Australian Bureau of Statistics Act 1975, the Taxation Administration Act 1953 or the Auditor-General Act 1997 provide that the dismissal of a bankrupt officer, statistician, commissioner or Auditor-General will go to the parliament? If you do not know the answer, as time is short I will give it to you. The answer is no.

Ms Verspaandonk—Is there a question?

Senator WEBBER—He asked it and answered it!

Senator EGGLESTON—I asked the question, but I said that time was short and that I would provide the answer if Mr McDonald did not know.

Mr McDonald—Perhaps I could refer you to the Taxation Administration Act, which provides in section 6C for the suspension or removal from office of the commissioner or a second commissioner. The grounds are laid out in section 6C(6), and it provides, in subsection (1):

The Governor-General may remove the Commissioner or a Second Commissioner from office on an address praying for the removal of the Commissioner or the Second Commissioner, as the case may be, on the ground of proved misbehaviour or physical or mental incapacity being presented to the Governor-General by each House of the Parliament in the same session of the Parliament.

Senator EGGLESTON—I cannot see that, but it does say ‘the Governor-General shall remove’, whereas the parliament—

Mr McDonald—I am sorry; you are making a different point. The section says ‘the Governor-General may remove’. I am reading from section 6C, subsection (1), of the Taxation Administration Act 1953.

Senator EGGLESTON—We said ‘bankruptcy’, though, which is subsection (6). That was the example I quoted to you, and it says:

... the Governor-General shall remove ...

So it is an obligation which has to be followed, without reference to the parliament. Under your system, reference to the parliament would be required, and, as we have said, the parliament may delay the decision for political reasons.

Senator BUSHBY—And the government has drawn a comparison with this.

Senator EGGLESTON—And you have drawn a comparison with that.

Ms Verspaandonk—I think that in what has happened there the important word is ‘raise’. The bill is raising independence to a certain level, but if independence is already above it then it is not reducing it.

Senator EGGLESTON—Personally, I think it is reducing it.

Senator BUSHBY—Are you drawing comparisons with these other positions?

Ms Verspaandonk—They are different.

CHAIR—Senator Webber.

Senator WEBBER—First off, I thank you for the way that the hearing has been conducted and for the interesting lesson in law that we have had from Senator Brandis. We have missed him on the economics committee. Usually it is about trade practices law rather than about independence, though.

I want to come back to the central point about enshrining independence. It seems to me—and you are a part of it—that government gets its economic advice in terms of monetary policy from two arms. We have Treasury—and your secretary is a political appointment and is at the discretion of the government—and then we have the key, important role of the Reserve Bank in terms of monetary policy.

I do not understand—and I wonder if you can give me any feeling for this—the fear of actually making the governor and any move to remove his independence a parliamentary thing rather than it being at the whim of the executive government of the day. I do not understand how that threatens the independence of the frank and fearless advice that he would give his board and the decisions that that board would make, versus what happens now. There is a big discussion in public policy about frank and fearless advice, and it would seem to me that parliament would be naturally conservative in terms of any moves that were made against any governor—unlike what has been alluded to—as opposed to it being at the political whim of the executive government. Has there being any feedback about why it is thought parliament would be more volatile and how this would in any way compromise the independence of the Reserve Bank?

Mr McDonald—Just trying to draw the question out of that, I suppose the judgement that the government has made implicitly in the bill and, I think, probably explicitly as well is that any decision about the removal of the Governor or Deputy Governor of the Reserve Bank being made in as open and transparent a manner as possible will assist in ensuring the confidence of the broader community and financial markets that that decision was made on appropriate grounds and not on inappropriate grounds and thereby assist in maintaining confidence in the independence of the Reserve Bank generally and attaining macroeconomic stability as well as the stability of the financial system.

CHAIR—Thank you, Mr McDonald. Thank you to all the witnesses that have appeared here today. I declare this meeting adjourned.

Committee adjourned at 12.17 pm

