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ABSTRACT

When inflation targeting was adopted in Australia is disputed. Some believe it commenced in March 1993 when the Governor of the Reserve Bank (Bernie Fraser) referred in a speech to the desirability of maintaining inflation between 2-3 per cent a year. However, he made a similar remark in a speech in August 1992. Some overseas authorities assert that inflation targeting began in 1994, referring to a speech that Fraser made in September of that year when he declared that 2-3 per cent inflation 'is a reasonable goal for monetary policy'. The year 1994 is also significant because the Treasurer (Ralph Willis) stated in parliament that the government and the Bank had an inflation target of 2-3 per cent. Paul Keating, on the other hand, prefers 1995 as the commencing date, when he and the Secretary of the ACTU (Bill Kelty) included an inflation target of 2-3 per cent in the final Accord agreement between the government and the trade union movement. Another possible starting date is 1996 when the first Statement on the Conduct of Monetary Policy, signed by the Treasurer (Peter Costello) and the incoming Governor of the Reserve Bank (Ian Macfarlane), endorsed 'the Reserve Bank['s]…objective of keeping underlying inflation between 2 and 3 per cent, on average, over the cycle.' In all probability, there is no definitive starting date for the commencement of inflation targeting in Australia. Rather, its adoption was the result of an evolutionary process, like many other developments in the history of central banking.

'…there is no reason why the current underlying inflation rate of 2 to 3 per cent cannot be sustained'. (Bernie Fraser, Two Perspectives on Monetary Policy', Address to a Conference in Honour of Don Sanders, Sydney, 17 August 1992).

'My own view is that if the rate of inflation in *underlying* terms could be held to an average of 2 to 3 per cent over a period of years that would be a good outcome'. (Bernie Fraser, 'Some Aspects of Monetary policy', Address to Australian Business Economists, Sydney, 31 March 1993).

'My own view is that if the average rate of underlying inflation could be held to 2 to 3 per cent over time, we would meet our test. That is the standard which countries often seen as benchmarks have achieved – and which we ourselves achieved in the 1950s and 1960s'. (Bernie Fraser, 'Talk by the Governor', Address to CEDA Symposium, Sydney, 4 August, 1993).

'The "headline" or published rate is expected to rise a little over coming quarters as increases in government taxes and charges show up, along with the impact of the depreciation of the $A on prices of imported goods. But, provided these effects are contained, and second-round increases in prices and wages are avoided, the "underlying" rate of inflation can be held to around 2 to 3 per cent'. (Bernie Fraser, 'Australia – Ten Reasons for Confidence', London, 10 November 1993).

'If…shortcomings…were to threaten to push underlying inflation noticeably above the 2 to 3 per cent range, corrective action would have to be implemented.' (Bernie Fraser, 'Managing the Recovery', Address to Australian Business Economists, Sydney, 10 March 1994).

'In our judgment, underlying inflation of around 2 to 3 per cent is a reasonable goal for monetary policy'. (Bernie Fraser, 'The Art of Monetary Policy', Address to the 23rd Conference of Economists, Surfers Paradise, 26 September 1994).

'The Reserve Bank's objective is to hold *underlying* inflation to an average of 2 to 3 per cent over a run of years.' (Bernie Fraser, 'Economic Trends and Policies', Address to Australian Business Economists, Sydney, 30 March 1995).

Introduction

When it was exactly that the Reserve Bank of Australia adopted inflation targeting has been the subject of sustained conjecture. The Bank's web site states that '[t]his approach to monetary policy in Australia commenced in the early 1990s. The earliest references to it were contained in speeches by the then Governor [Bernie Fraser] in August 1992 and March and August 1993' (https://www.rba.gov.au/monetary-policy/inflation-target.html). Many in the Bank believe that 1993 – rather than 1992 - is the commencement date, citing Fraser's speech in March 1993 (Fraser 1993a), where he referred to the desirability of maintaining inflation between 2-3 per cent a year. In a paper presented at a Reserve Bank Conference in April 2018 on 'Twenty-Five Years of Inflation Targeting in Australia', the Bank's Deputy Governor, Guy Debelle, asserted that 'the inflation target was first adopted by the Reserve Bank in 1993', having been 'outlined in a number of speeches by the then Reserve Bank Governor Bernie Fraser in 1993 and 1994' (Debelle 2018).[1] Yet Fraser's comment in March 1993 was the same as the one he had made in August 1992 (Fraser 1992), when he mentioned the possibility of maintaining inflation at the current rate of 2-3 per cent. It would appear on that basis that 1992 is the starting point, rather than 1993.

However, some overseas authorities contend that inflation targeting in Australia did not begin until 1994, their point being that it was not until Fraser stated in a speech he gave that year that the Reserve Bank had adopted an inflation rate of 2 to 3 per cent as a 'reasonable goal', and outlined the specifications of the target in the form of a policy framework, that it could be said that the Reserve Bank was committed to an inflation target (Bernanke, Laubach, Mishkin and Posen 1999; Ball and Sheridan 2003; Mishkin 1999, 2007; Jonas and Mishkin 2006). The year 1994 is significant for some other reasons. It was then that the Bank began to tighten monetary policy for the first time since the middle of 1989, using the

2-3 per cent inflation target (or 'goal') as its guide. It was also the year when the Treasurer, Ralph Willis, announced in the parliament that both the government and the Reserve Bank had adopted an inflation target of 2-3 per cent (CoA, PD, 8 November 1994, 2788). But the former Treasurer and Prime Minister, Paul Keating, has claimed that inflation targeting in Australia was not introduced until 1995, when his government signed the final Accord agreement with the trade union movement, which specified a 2-3 inflation target (*SMH*, 26 October 2007). It could also be argued that it was not until the 'exchange of letters' between the Treasurer (Peter Costello) and the Governor-designate of the Reserve Bank (Ian Macfarlane) on 14 August 1996, which endorsed the Bank's 2-3 per cent target, that inflation targeting officially commenced.

Rather than attempting to identify a particular date for the commencement of inflation targeting in Australia, this paper suggests that the adoption of inflation targeting was the outcome of an evolutionary process that occurred over a period of several years. Unlike New Zealand's inflation target, the Australian inflation targeting regime was not incorporated in legislation. Nor was it the result – as it was in many other countries – of a joint agreement between the government and the central bank.

The Bank Moves to Target Inflation

The collapse of the Bretton Woods system in the early 1970s left the authorities without a workable monetary framework. After two or three years of discretionary intervention, monetary targeting was adopted by the government in 1976, but it was suspended in early 1985 when it became clear that financial deregulation was distorting the monetary aggregates and creating policy confusion (Cornish 2016). It was replaced by the 'checklist' system, a collection of nominal and real indicators, which, it was hoped, would provide a guide for the monetary authorities to follow when determining policy settings. This system, however, lacked a firm conceptual basis and was abandoned when its ambiguities were soon revealed. The lack of a satisfactory monetary framework was a major reason for the policy errors of 1987/89, when the authorities' attention switched back and forth between an emphasis on stabilizing the current account of the balance of payments and moderating inflation.

As a result of the progressive tightening of interest rates during 1988 and the first half of 1989 economic activity slowed for about a year and then fell from the middle 1990 as the economy moved into recession. Thereafter, non-farm GDP declined until the September quarter of 1991, exceeding the previous peak a year later. Inflation, having averaged 6.7 per cent a year over the four years 1987-1990 (the ABS series for the CPI stripped of volatile items), by 1992 it had fallen to 2.8 per cent, and fell still further to 2.0 per cent in 1993. The Bank, in its Annual Report for 1990/91 was already declaring that 'it is clear that policies have led not only to a fall in recorded inflation but also to a lowering of inflationary expectations. Survey-based measures and financial asset prices which incorporate price expectations both show a marked downward shift. With expectations about inflation shaken from the stubbornly high levels which prevailed for most of the 1980s, we are now in better shape to sustain lower inflation as the economy recovers'. It added that Australia's current inflation rate of 'about 4 per cent compares favourably with the OECD average, but is still behind the best performers'. The 'challenge' now, according to the Bank, was to secure 'the recent improvement and doing rather better than the OECD average' (RBA 1990, 7-19).

Because of the failure to establish a suitable framework to guide monetary policy after the suspension of monetary targeting and the confusion surrounding policy intentions in 1988 and 1989, the Bank began to devote more time and resources to re-examining the objectives of monetary policy and the means by which monetary policy could be conducted (RBA, 1989, 13). The results of this reassessment of its policy priorities were reported by the Bank in various ways, through its annual reports, in conference papers delivered by staff, by speeches given by senior officers and in documents prepared for the Treasurer. In 1989, in the first of its annual research conferences, members of the Research Department presented papers on topics related to the formulation of monetary policy in a changing world. Participants generally agreed that financial deregulation and innovation would continue to distort the monetary aggregates, and consequently there was little enthusiasm for the resurrection of monetary targeting. In contrast, there was widespread - though not universal - agreement that 'an interest rate instrument could, under certain conditions, tie down the price level', and that 'a simple operating rule for interest rates would be superior to a simple monetary control rule if the demand for money were sufficiently unstable'. It appeared, above all, that most of those attending the conference believed that 'an acceptable long-run performance on prices was the best ultimate objective for monetary policy' (Macfarlane and Stevens, 1989, 168).

These meditations upon what the Bank should target when conducting monetary policy, and which instrument or instruments should be used to achieve its goals, were highlighted in the Bank's Annual Report for 1989/90. Rather than the bland - even pedestrian - design for the cover of its annual reports, the Bank's 1989/90 report featured an arresting graph that traced the rate of inflation over the previous ninety years, revealing as it did the dramatic upswing in inflation from the late 1960s. Dispersed throughout the report were quotations from various eminent economists - including one from the Bank's inaugural Governor, Dr H C Coombs – emphasizing as they did the insidious nature of inflation and its harmful economic and social consequences. According to Coombs, a 'persistent tendency for prices to rise may, like the housemaid's baby, be very small at first – but once people get used to it being around, they may well be astonished at how rapidly it will grow' (RBA 1990, 30).

The Governor (Bernie Fraser) and Deputy Governor (John Phillips) in their public addresses at the turn of the 1990s expressed similar sentiments. Highlighted were problems created by inflation and the Bank's desire to see Australia regain the reputation it held as a low inflation country in the 1950s and 1960s when, following the Korean War, inflation averaged 2 ½ per cent a year. In a speech that Fraser gave in November 1989 - his first since becoming Governor - he declared that '[e]very central bank should have as a medium term economic goal the reduction in – indeed, the elimination of – inflation'. He informed his audience that the monetary authorities were seeking 'to achieve this goal without incurring unacceptable recessionary costs'. This was important, he declared, 'not only because if it can be realized, it will help to keep inflation lower', but also because inflation was a major problem which 'perverts investment/savings decisions and the nation's competitiveness, and thereby undermines Australia's efforts to produce its way out of its current account difficulties'. In short, the Bank would 'do what it can to help reduce inflation: we have no intention of taking our eye off that particular ball' (Fraser 1989, 8, 9).

Four months later Fraser devoted an entire speech to the subject of 'Inflation' (the title of the speech), noting that the 'central bank, more than any other public (or private) institution is charged with safeguarding the value of the currency'. As to an acceptable rate of inflation, he thought there was merit in the definition of price stability adopted by the Chairman of the US Federal Reserve (Alan Greenspan), who asserted that, for 'all practical purposes, price stability means that expected changes in the price level are small enough and gradual enough that they do not materially enter business and household financial decisions'. Fraser was to endorse Greenspan's definition of price stability on a number of subsequent occasions. He agreed, however, that it was debatable what this definition might translate to in numerical terms. His hunch was that 'it is probably less than half – and no more than half – the current "core" inflation rate of around 6 to 7 per cent'. He had no doubt that the Reserve Bank possessed the 'fire power to reduce inflation' to this number, but he observed that it was 'not for the Bank unilaterally to announce any explicit medium term objective for price stability' (Fraser 1990a, 61, 63, 64).

Inflation commenced to decline in 1990 as the tight monetary policy of 1988/89 began to bite. In November 1990, Fraser told an audience that there 'is now the very real prospect of Australia joining the ranks of the low inflation countries' (Fraser 1990b, 97). It was important, he said, that we 'must not allow this once-in-a-decade opportunity to slip through our fingers. Only when it is clear that inflation is well and truly under control can we look forward to sustainably lower interest rates. We are not there yet – the petrol price rises [occasioned by the first Gulf War] have still to be absorbed and the December quarter numbers will be less flattering – but we are knocking on the door'. He observed that Australia 'held its own with low inflation countries during the 1960s', and he believed that it was not at all 'fanciful to imagine that we can be in that position again'. By February 1991, he was able to inform a visiting IMF team that 'the current concern about inflation in the policy debate [in Australia] was due to the Reserve Bank hammering away at it' (RBAA ID95-00334, meeting with IMF, 27 February 1991).

Phillips meanwhile was nominating inflation as the major problem confronting monetary policy and downplaying the use of monetary policy as a means of improving the balance of payments. In a speech delivered in September 1989, he remarked that inflation 'is the key objective for the Bank's monetary policy because it is important to the long-term health of the economy and because fighting inflation is what monetary policy does best'. It might well be, he continued, that a tighter monetary policy, aimed at reducing inflation, would assist the balance of payments. This was because, as 'monetary policy is tightened', it would tend also 'to dampen domestic spending; this slows imports, also making more resources available for export production'. The problem was that higher domestic interest rates would tend to raise the exchange rate, and while that would certainly assist in the battle against rising prices, it would weaken the balance of payments through its impact on relative prices. About improving the balance of payments, Phillips argued that, over the longer-term, 'any structural problem in the balance of payments has to do with the community's attitudes towards savings, consumption, investment and debt'. For the most part, these were not matters that could be resolved by monetary policy. Rather, there were other areas of policy more relevant to strengthening the external accounts, while 'the best contribution monetary policy can make to them is to help reduce inflation, since the inducement to save will invariably suffer in an inflationary environment' (Phillips 1989, 328, 329, 330).

Phillips returned to the subject on a number of subsequent occasions. In Melbourne in June 1990, he argued that it was 'blindingly obvious that while tighter monetary policy reduces spending and therefore imports, which is good for the current account, higher interest rates do tend to hold up the exchange rate. That is good for inflation, but not what exporters or those competing with imports would like'. This, he said, 'illustrates the point that monetary policy is not an effective weapon to fight a balance of payments problem' (Phillips 1990, 353). Twelve months later, in a speech in Sydney, he drew attention to the costs of inflation, one of them being high real interest rates. This, he stressed, 'can produce an exchange rate which, on other counts, might be seen as overvalued, i.e. it is higher than would otherwise have been the case, introducing a short-term bias in favour of imports and against export and import-competing industries' (Phillips 1991, 416). In a valedictory speech delivered in March 1992, just before his retirement from the Bank, Phillips summed up some of the conclusions that he had reached after a long career as a central banker. There was a need, he said, 'to be modest about the role that monetary policy can sensibly play'. For one thing, it was 'not suited to dealing with what we used to call fundamental problems in the balance of payments'. This was not to say that it 'has no effect on the balance of payments. Obviously it does, through many doors. By raising or lowering interest rates, it affects the propensity of investors to shift capital into or out of Australia. By influencing the level of domestic demand, it affects the demand for imports and the availability of goods for export. By influencing the exchange rate, it can affect both the current and the capital account of the balance of payments (and, in the process, the returns received by exporters and the level of overseas debt measured in domestic currency).' Still, he had no hesitation in saying that 'combating inflation deserves top billing among the Bank's objectives'. He was careful to add, however, that it had 'to be pursued in ways which contribute best in the medium term to employment and general economic welfare'. That, he thought, 'is the only rational interpretation of the [Reserve Bank] Act' (Phillips 1992, 463, 465).

Attempts by the Government to Formulate an Inflation Target

While the evolutionary process toward the formulation of an inflation objective or 'target' is usually associated with the Reserve Bank, it was senior members of the government who first floated the idea – at least in public - that fiscal and monetary policy should be anchored to a numerical inflation target. In his 1988/89 budget speech, delivered on 23 August 1988, the Treasurer (Paul Keating) argued that since the government now had inflation under control it intended to lock in the lower rate recently achieved. His view was that, 'while the balance of payments deficit is Australia's number one economic problem, inflation remains Australia's number one economic disease'. Having 'infected our economic system for two decades', he declared that its 'eradication is one of the government's fundamental objectives.' As he continued: 'We have conquered the big inflationary surge stemming from the dollar's depreciation and for the first time in twenty years we have inflation locked well into single digits.' It was the government's intention, he stated, to 'push home this opportunity through this budget and the government's unique wage setting arrangements' (Keating 1988, 4).

The government's 'anti-inflation strategy' was to be promoted by a reduction in indirect taxes amounting to more than $400 million over the 1988/89 financial year, and by a wage/tax trade-off to be negotiated with the trade union movement early the following year. It was foreshadowed that this new Accord between the government and the trade unions

would include income tax cuts that would commence from 1 July 1989, the size of the cuts depending on wage growth during 1988/89 and the details of the putative wage/tax trade-off. These measures were to reinforce the wage decision recently handed down by the Arbitration Commission and which, according to the Treasurer, would 'open the way for both higher real incomes and lower real labour costs.' He predicted that success 'in these areas will secure for Australia an inflation rate of three to four per cent in 1990.' That, he reminded the parliament, will 'put us back with the rest of the world, an achievement which has eluded us for a generation' (Keating 1988, 5). Later, when it became clear that his inflation objective would not be achieved in the time that he had specified, the Treasurer was lampooned in the press and criticized unmercifully by his political opponents. Consequently, he regretted that he had mentioned an inflation objective expressed in numerical terms. This experience contributed to the jaundiced view that he maintained for some years about publicly announced inflation targets.

The Treasurer, however, was not the only member of the government to foreshadow an inflation objective or target, and to announce such a target publicly. On 18 March 1991 the *Australian Financial Review* (*AFR*) reported that the Prime Minister (Bob Hawke), in an interview with the paper, 'has set an inflation target of 4 per cent and has indicated a willingness to sacrifice a budget surplus next year for another wage-tax trade-off to achieve this low inflation figure'. According to the *AFR*, the Prime Minister had claimed, in regard to the rate of inflation, that it was his aim to secure the 'magical figure four' in the life of the present parliament and hoped to be able to go to the next election in two years' time with an inflation rate of '4 per cent or less'. The *AFR* reminded its readers that this was 'the first time since the 1988/89 budget speech – when the Treasurer, Mr Keating, forecast that inflation would be down to 3 or 4 per cent by 1990, and for which he received strong criticism when the forecast was not achieved – that anyone in the government has nominated a medium-term inflation target and timetable' (*AFR*, 18 March 1991).

The day after the interview, the Prime Minister met with business leaders in Sydney and later in Melbourne, where he is said to have received favourable responses to the government's 'new objectives', including the 'magical 4 per cent inflation rate'. It was suggested that, by announcing an inflation target, the Prime Minister was attempting to deflect business criticism of the government's economic statement, which had been released the week before. One commentator claimed that, by 'taking the running on such a crucial economic issue, Mr Hawke is again exerting his leadership over the Treasurer, Mr Keating, who has resisted setting firm inflation targets'. Another comment was that focusing attention on inflation 'makes sense when most other economic indicators will be looking sick for some time…With the economy in recession and the balance of payments showing only slight improvement, inflation is the only indicator that the government can turn to'. The Treasurer, perhaps not surprisingly, refused to endorse the Prime Minister's target (*The Australian*, 22 March 1991). While he thought it was reasonable to expect inflation to fall to 4 per cent in the timeframe nominated by the Prime Minister, he rejected the claim that the government had set itself an inflation target. Certainly, he had not agreed to a target. His personal view was that the public would not 'give us a tick for targets or forecasts, [but rather, would] give us a tick for outcomes'. He explained that he had 'always waited for the outcomes to come in and it is the best policy'. He pointed out that the latest national income accounts – for the December 1990 quarter – showed that inflation had increased in that quarter at an annual rate of 3.9 per cent.

Early Discussions in the Bank on an Inflation Objective/Target

In May 1990, between the release of the Treasurer's target in August 1988 and the Prime Minister's target in March 1991, the Bank took a proposal for an inflation target to the Treasurer, who rejected it. The idea was outlined in a paper entitled 'Reducing Inflation' drafted by Ian Macfarlane, the Head of the Bank's Research Department, later Assistant Governor (Economic Group), shortly after the March 1990 election, which had returned the Hawke government to office (RBAA, SD90-03943, 15 May 1990). With the expectation of 'a natural three-year horizon ahead of it', Macfarlane suggested that the government should set itself a medium-term objective to 'roughly halve the current rate of inflation – from around 8 per cent to around 4 per cent – by mid 1993'. This, he argued, 'would represent a substantial improvement on recent inflation rates; it would mean, in fact, the lowest rate since the late 1960s and a rate likely to be comparable with that of other OECD countries'. While he acknowledged that views would differ as to 'what constitutes an appropriate medium term objective for prices', it was important, he wrote, that any 'publicly stated objective should…signify a substantial improvement and be reasonably capable of achievement within the time frame adopted'. Over the longer term, 'the objective would be to do better, but no specific commitment to that end would need to be given at this time'. To be sure, there were 'dangers for governments in such commitments', but Macfarlane thought 'the dangers are arguably as great in not delivering a rate of inflation which the community sees as desirable and achievable'. Halving the rate of inflation was 'feasible', he believed, though he agreed it would not be accomplished easily, requiring as it would 'early and concerted action against entrenched inflationary expectations'. Any anti-inflationary policy, to the extent that it resulted in a tighter monetary policy, would probably involve a higher exchange rate 'than a policy which attached primacy to improving the balance of payments'. Yet, as he explained, in 'the medium term, there should be no conflict between the two objectives: lower inflation would help to improve competitiveness and contribute to higher private savings'. In any event, he asserted that 'it is appropriate that primacy (but not exclusivity) be given to reducing inflation at this time'.

Macfarlane proposed that the inflation target should be made public, there being 'several factors currently in favour of entering into a public commitment to pursue a substantial reduction in inflation'. To begin with, the economy had passed the peak of the business cycle and was now in a downward phase. In addition, the measured inflation rate was expected to peak (on an annual basis) in the March quarter, and 'as it moves down over the quarters ahead it will help to give anti-inflationary policy a "running start".' He mentioned further that 'inflationary expectations are being dented by falling asset prices'; this, he pointed out, was in marked contrast to the last economic slowdown in 1986, when asset prices continued to rise even as activity fell. In brief, as he put it, the government was possessed of 'a rare opportunity to capitalize on these developments and deliver a sustainably lower rate of inflation'. He was convinced that a 'public commitment to an inflation objective, assuming the commitment is "credible", would help to lower inflationary expectations'. To the extent that 'expectations drive actual wage and price-setting behaviour', this would also 'help to lower the costs of reducing inflation'. It was clear to him that, for 'an objective to be credible, the public must believe the government is prepared to endure some pain to achieve it'. To this end, he thought 'the present situation of a contracting economy and tight policies could usefully be presented as a positive development in the government's statements – a

necessary winding back of the excesses of 1988/89, and a necessary precursor to reducing inflation'.

As to policy, Macfarlane thought 'the present policy approach is unlikely to deliver significant, sustained reductions in inflation' and, accordingly, a 'more positive approach is called for'. Action would be needed on the wages front: a comprehensive wages freeze, accompanied by an equally comprehensive price freeze, would reduce inflation dramatically, but such action was considered to be unachievable. A wage-tax trade-off, on the other hand, was 'the best avenue to sustainably lower inflation at least cost'. However, a precondition for success here was for the general economic situation to be 'right'. That, according to Macfarlane, had 'not been the case in the past but it is likely to be so in the period ahead as the economy slows and employment growth stalls'. Beyond that, he thought 'a sustained period of moderate demand growth will be required, and some slack in labour and product markets'. While capacity growth was estimated at 3-3 ½ per cent, he calculated that effective downward pressure on inflation would require product growth 'somewhat lower than that, and growth in GNE lower again (perhaps around 2-2 ½ per cent), at least over the next couple of years'. This, in turn, was 'likely to require a watchful, and generally tight, monetary policy, as well as a continuing firm fiscal policy, notwithstanding tax cuts. It will also mean some lowering of expectations about the rates of growth in output and employment which macro-economic management can deliver over the next couple of years (and acceptance of somewhat higher unemployment).' This, he added, 'would have to be acknowledged publicly, while emphasizing the scope that exists for doing better through accelerated micro-economic reform'.

When he sent Macfarlane's paper to the Treasurer on 15 May 1990 for comment, Fraser referred to discussions that had taken place within the government in recent months directed at reducing inflation. It was these conversations, he explained, that had prompted Macfarlane's paper. The discussions, he told the Treasurer, were 'a step in the right direction'. Fraser then asked what were 'the prospects of, say, halving the current rate of increase in the CPI over the next three years', and what were the policy changes that would be necessary to achieve that result, 'at least cost in terms of economic growth and employment'. Macfarlane's paper, he said, was the first attempt to provide answers to these questions. The Bank's expectation was that, although inflation would slow significantly over the next twelve months, it was likely, at best, to become stuck with increases continuing around the 6 per cent mark. To bring inflation below that rate would require further wage/tax agreements and additional fiscal consolidation. He was aware, however, that 'just to mention public commitments to inflation objectives and negotiations of wage/tax trade-offs is to throw up all sorts of obstacles'. However, he was equally aware that 'existing policies for restraining demand and improving productivity will not be enough to deliver sustained improvements in inflation or the current account over the next three years'. He agreed with Macfarlane that, for reasons expressed in the paper, 'now is a good time for the government to grasp the initiative on inflation and set about ushering in, for the first time in a generation, a period of under 5 per cent inflation' (RBAA, SD90-03943, Fraser to Keating, 15 May 1990).

Although Macfarlane's paper was not discussed at the May 1990 meeting of the Bank's Board, it was raised with the Treasurer at a debrief session following the May Board meeting. The minutes of the debrief meeting record that the Treasurer 'took the paper quite

seriously', with discussion on the paper lasting nearly 1 ½ hours. However, he was not prepared to accept the recommendations, since there were a number of aspects of the Bank's proposals that troubled him. In particular, as the minutes of the meeting noted, he 'did not like the idea of a public announcement of an inflation target, largely because of his experience with the 4 ½ per cent [sic. 3-4 per cent] that had been aimed for in mid 1988'. As well, the Treasurer 'was inclined to think that improvement in the balance of payments was a more pressing need than improvement in the rate of inflation'. Here, he seemed to be particularly worried about external competitiveness, believing as he did that 'the market as a whole was more likely to judge his overall success or failure on the basis of the balance of payments (and debt), rather than on the inflation performance'. He was concerned, too, that the Bank's proposal would result in higher interest rates and a higher exchange rate, with adverse consequences for investment and the current account balance. Throughout the meeting Fraser tried to calm the Treasurer's anxieties by pointing to the proposed wage-tax trade-off: to the extent that it would put downward pressure on inflation, monetary policy would not have to be tightened unduly in order to reach the proposed inflation target (RBAA, SD90-03949, 28 May 1990).

The Treasurer's doubts about a publicly announced inflation target were further revealed in a speech he gave to the Metal Trades Industry Association in Sydney on 25 June 1990. According to press reports, he agreed that monetary policy had some role to play in containing inflation, but he reaffirmed that the balance of payments would remain a 'central target' of the government's economic policy, rejecting as one account of the speech put it, the 'growing push by the Reserve Bank and others for a greater policy emphasis on inflation and for interest rates to stay higher for longer to cut inflation'. He linked the 'erroneous notion' that 'monetary policy was not an effective weapon for correcting the balance of payments to the so-called "Pitchford" argument that foreign debt does not matter'. *AFR*, 26 June 1990; *The Australian*, 26 June 1990). [2]

Following the Treasurer's rejection in May 1990 of a publicly announced inflation target, the Bank seemed to go cold on the idea and only slowly - and very tentatively - resurrected it. It is important to understand, however, that it was not only the Treasurer's repudiation of an inflation target that led the Bank to dismiss for a year or two the possibility of announcing an inflation target. It had been uneasy for some time about the Reserve Bank of New Zealand's (RBNZ) 0-2 per cent inflation target, believing that it was set too low and that its formulation meant that monetary policy would be conducted without the flexibility required to meet sudden domestic and international pressures, especially the latter. There was another consideration about the New Zealand target that made the Bank uneasy. If Australia were to accept a higher inflation target than New Zealand, there would doubtless be powerful critics, both at home and overseas, who would say that Australia was taking a softer line on inflation than its neighbour across the Tasman. There was also the position that had been adopted by the Opposition parties in the federal parliament, who had announced that, should they win the next election - which was expected early in 1993 - they, too, would adopt an inflation targeting regime somewhat along the lines of the one introduced in New Zealand, with its target of 0-2 per cent. This was denounced by the Treasurer, who made it clear that the government would not attempt to match the Opposition's target. In fact, he made it clear that the government had no intention of introducing an inflation target at all.

For more than a year after Macfarlane proposed an initial 4 per cent inflation target that would fall progressively as the actual rate of inflation declined, Bank officials evinced little enthusiasm for inflation targeting. Speaking, for example, in Melbourne in November 1990 Fraser doubted that such a commitment 'would possess sufficient credibility to influence price expectations (Fraser, 1990, 102, 103). At a minimum, he thought it 'would need to be a government (not just a central bank) target, and be backed by all available policy instruments (not just monetary policy).' There was 'no point in having a fixed monetary rule', he argued, 'if it gives the wrong answer – and the evidence of the 1980s everywhere is that there is no holy grail – no simple, golden rule which policy makers can follow in order to avoid inflation. At the end of the day there is no substitute for the exercise of judgment.' Rather than following simple rules or targets, he preferred to continue with the present policy framework. This was one in which 'the authorities emphasize their commitment to reduce inflation in the medium term and back this by firm, credible but non-doctrinaire actions'. For him, the important point was to ensure that monetary policy was credible, for 'the public need to be convinced that inflation can be lowered without putting the economy on the rack'. He took the view that the present strategy followed by the monetary authorities was highly credible, pointing as he did not only to the recent decline in the rate of inflation as measured by the CPI. Perhaps of more importance was the fall in 10-year bond yields, which suggested that price expectations were diminishing, while the wage/tax trade-off announced the previous week by the government and the trade unions was an example of 'a response which can consolidate and build on these expectations.'

Fraser returned to the subject a year later in a speech at a dinner in Sydney. Speaking on the 'Role of the Reserve Bank', he maintained that there were various views about the merits of formal inflation targets. It was clear to him, however, that 'no such target will guarantee price stability'. It was possible in 'exceptional circumstances – for example, where inflation is out of control and emphatic action is required to try to restore future credibility – a formal target may well be helpful'. But he thought there was 'a good deal to be said – from a practitioner's perspective – for retaining a wider margin of flexibility and discretion than is normally available with targets'. This, he said, 'holds in many areas, not least in the area of monetary policy where unforeseen disturbances can arise and where lags and the underlying monetary relationships are only imperfectly understood'. There was, he added, 'a very real and important point here', which he believed could be 'illustrated by posing the hypothetical question: where would interest rates be today if the Reserve Bank had been committed over the past two years to an inflation target – even one with a distant time horizon'. His feeling was that interest rates would be higher. As it was, the Bank had cut the overnight cash rate by a considerable margin, but had it been under 'a different regime where the Bank was committed to pursue an inflation target and was being judged only on its inflation performance', he suspected that it 'would have followed the "safe" course of dragging its feet until the case for an easing was clearer – or until it was overwhelming. In that event, the fall in output in the present recession would have been more pronounced than it was with, probably, little or no additional progress in reducing inflation'. In fact, he thought the Bank might have inadvertently 'created a greater problem in attempting to deal with a smaller one'. He agreed that every central bank should seek to eliminate inflation in the medium term, and he was convinced that Australia had progressed some distance toward achieving that goal. However, it had not 'gone the further step and said that it is our *only* concern, and that we are indifferent about what happens to output, employment and investment.' As 'a

practitioner, rather than a theoretician', he was adamant that 'a central bank has to be concerned about growth as well as inflation objectives', though he admitted that 'its capacity to pursue the former is less than in the case of the latter' (Fraser 1991, 162, 163, 164).

Phillips, in his valedictory address the following year, supported Fraser's concerns about inflation targeting. 'I don't favour an inflation target', he said. He thought it might 'help with perceptions', but he was worried about its tendency 'to limit operating flexibility'. True, too much flexibility might also be open to criticism - and could certainly be abused - but he believed a country 'as exposed as Australia to the outrageous fortunes of external events needs a degree of flexibility in policy administration'. And further, he did not think that explicit targets would be necessary if a central bank 'clearly and credibly demonstrated its commitment to the preservation of price stability'. After all, Germany's Bundesbank had not felt it necessary to adopt an inflation target. His preference was for an inflation objective that was expressed 'in qualitative rather than quantitative terms', and if, 'for some reason, the lawmakers were ever to decide otherwise', he hoped that 'the objective was clearly defined as an on-going, medium-term one, and that the need for short-term flexibility, to deal with external shocks and the like, was adequately covered' (Phillips 1992, 466).

Further Consideration of an Inflation Target

The question of whether Australia should follow New Zealand and adopt an inflation target was taken up by the IMF in its annual consultations with Australian authorities in 1991 (RBAA, ID 95-00334). The IMF team reported that the Australian representatives had mentioned the difficulties of conducting monetary policy without a reliable operating framework, and had highlighted the fact that since financial deregulation in the early 1980s the relationship between the monetary aggregates and the domestic economy had become distorted and uncertain. Nor could Australia, a large exporter of commodities, and subjected to unstable world markets, anchor its exchange rate to that of a low-inflation country. Therefore, a more discretionary approach to policy settings had been followed in recent years, especially since it had become clear that the checklist system was untenable. According to the IMF's [draft] report, the Australian representatives had informed the IMF team that they 'now focused on only a few criteria, essentially on forecast inflation and domestic activity, but without formally adopting a nominal income target which they viewed as impractical'. More importantly, the IMF team was told that the only way to establish credibility for monetary policy 'was through establishing a good track record on reducing inflation', and for this reason 'it was important to emphasize a medium-term commitment to reducing inflation and to back this commitment with firm and credible action'. But as the report disclosed, the Australian representatives saw 'little advantage to gain in the Australian context by setting specific targets for inflation as a means of molding inflationary expectations'. The IMF, on the other hand, disputed this view, stating 'that while not wishing to minimize the difficulty of setting explicit medium-term goals for monetary policy, such a course of action would appear to be a necessary condition for the strengthening of credibility in the authorities' commitment to bear down on inflation.'

Be that as it may, the IMF staff thought it was 'encouraging that the present recession is perceived by the authorities as providing the opportunity to reduce inflation and the external current account deficit, which remains uncomfortably high for this stage in the economic

cycle'. They added that 'the reduction of inflation might require an extended period of economic growth below potential'. The Australian authorities were said to be well aware of 'the costs of inflation in terms of disincentives to savings and productive investment and of undermining competitiveness', and, accordingly, they were 'attaching priority to the reduction of inflation'. All this was well and good, but the report returned to the lack of an adequate monetary framework, noting that the 'conduct of monetary policy in Australia is complicated by the absence of a fixed exchange rate or of a reliable monetary aggregate to provide both guidance and a yardstick for establishing credibility. At the same time, the use of several indicators in pursuit of too many objectives risks a repeat of the earlier errors made in monetary policy implementation.' It noted that the Prime Minister had recently proposed a target for bringing inflation down to 4 per cent a year; this, the IMF suggested, 'would require the careful management of demand in line with the country's productive potential'. An 'inflation target', the IMF argued, would also 'require a modification in wage setting behaviour to ensure that wage growth does not place a floor below which inflation could not be reduced without unduly restrictive policies'.

With all this acknowledged, the IMF team urged the Australian monetary authorities to set 'reasonably ambitious inflation objectives for both the short and the long term'. However, the IMF reported that 'Reserve Bank officials said that they would continue to follow a discretionary approach to policy'. Nor did they foresee 'going back to any single monetary aggregate as the guide to policy'. This was not so much out of 'preference as out of the lack of any aggregate providing adequately reliable information. In effect, they were currently following an approach close to that of targeting nominal income, although inflation was given higher weight than the growth of real income. They believed that their approach to monetary policy was in effect oriented towards the medium-term control of inflation'.

The idea of a 'reasonably ambitious' inflation objective, raised by the IMF team, elicited a critical response from the Bank. The Economic Group, for example, wanted to know what was meant by 'reasonably ambitious'. It wondered whether the IMF staff 'were aware of the 4 per cent inflation forecast of a few years ago', alluding to the target mentioned by the Treasurer in his budget speech in August 1988. That, according to the Economic Group, 'did little to help credibility'. Rather, it thought that credibility 'is not enhanced by announcing targets that no-one thinks can really be achieved.' In a note to Glenn Stevens, Chris Ryan observed that '[w]e would not want to set inflation targets', it being 'unlikely that we would want to raise interest rates in response to anything but a fairly large fall in the exchange rate in the near future' (RBAA, 95-00351, Chris Ryan to Glenn Stevens, n/d, but May-June 1991).

The End of the Great Inflation

While the Economic Group in 1991 saw no pressing need for an inflation target, it nevertheless took every opportunity to draw the attention of the Bank's Board to the opportunities that now existed for Australia to become a low inflation country again. Reporting to the Board in February 1991, the Economic Group considered the 'best way to do this is for the Bank to remain committed to a firm monetary policy even though the economy is weak'. This did not mean that 'nominal interest rates cannot fall below their present level. Indeed, as evidence of sustained lower inflation emerges, nominal interest rates

could be reduced further. It does, however, caution against bringing rates down too quickly'. (RBAA, 91-00500)

For the June 1991 Board meeting, the Economic Group prepared a detailed paper entitled 'Inflation: Recent Trends, Prospects and Implications for Monetary Policy' (RBAA, SD 91-00504). Included for the benefit of Board members was a brief history of inflation in Australia. This highlighted the fact that, for most of the early postwar period, Australia had an exemplary inflation record. Since the mid-1970s, however, its performance had fallen well below that of the major developed countries. These countries had managed to break the back of inflation in the recession of 1982, and Australia might have done so, too, had it not been for the large depreciation of the Australian dollar in 1985 and 1986. Since then inflation had declined slowly in Australia, though it had quickened in the major economies. It was expected that inflation would fall in these countries over the next year or two, which meant that 'if we want to keep up with them, we will have to do better'. Over the past year or two the Melbourne Institute's consumer surveys had shown that inflation expectations were at their lowest level since the surveys began in 1974. But the Economic Group expressed some caution, noting that 'in previous periods of economic weakness there have often been considerable falls in inflation, which were quickly reversed once the economy recovered'. That was probably due to expectations failing to respond to the improvement in inflation, so that once the cyclical pressure on profit margins was relieved, 'inflation driven largely by expectations picked up again'. Even so, the present fall in expectations suggested to the Economic Group that 'we have actually achieved a step down in the core inflation rate', for which it attributed the 'firm stance of policy over the past three years'. As to the future, there appeared to be 'very good prospects for a major breakthrough on inflation', but that 'is not yet assured'. Having reached an inflation rate of between 4 and 5 per cent, the Economic Group asked two questions about the future. The first was whether the improved inflation performance, 'achieved in the midst of a severe contraction in the economy', could be sustained. The second was whether the monetary authorities should be 'trying to make further progress, aiming at international "best practice" of 2-3 per cent inflation, and if so, how'. Here, in the middle of 1991, is the first reference in a Bank document to a desired inflation rate of 2-3 per cent.

The Economic Group was not altogether confident that the rate of inflation could be maintained at these levels. This was because Australia's experience over the previous three decades had been that gains in inflation achieved at times of weak activity were lost within two years. Several factors were considered to be responsible for the resilience of the core inflation rate. One was the fact that recoveries in the past had been quite rapid: the average rate of growth in the first year after a cyclical low in non-farm GDP in the five major upswings since 1960 was about 6 per cent (the periods in question were those following the slowdowns or falls in output in 1961/62, 1974/75, 1977/78, 1982/83 and 1986/87). Taking the first two years of recovery together, output growth had averaged over 5 per cent per annum. The Economic Group concluded that 'growth of this pace suggests that downward pressure on prices and wages probably abated sharply by the second year into the recovery period.' But as well as that, there were likely to be swings in policy settings, as concerns about inflationary pressure gave way during recessions to concerns about unemployment. Yet another reason why the moderation of inflation tended in the past to be transitory was the role of expectations. Here, the expectation that prices would soon rise led workers to

demand increases in nominal wages and encouraged firms to set higher prices, confident as they were that others would do the same.

These considerations suggested that some degree of caution should be exercised in the setting of monetary policy, though there were also grounds for optimism. For one thing, the recovery on this occasion would be moderate compared with earlier experience. The world economy, for instance, was expected to remain sluggish, so there was little prospect of a terms-of-trade boom occurring. There were also areas of the domestic economy that remained deeply depressed, such as non-residential construction. Moreover, the present 'asset-price overhang' would continue to dampen confidence. 'Provided that the temptation to put demand management policies into expansionary mode in a big way is resisted', the Economic Group expected 'a slower recovery than usual'. There was also the evidence of falling inflationary expectations reflected in long-term bond yields, which had declined by 3 percentage points between September 1990 and May 1991. Improvements in expectations were often fragile and could be quickly reversed, but the Economic Group's judgment was that 'a genuine lowering of inflationary expectations has taken place', which could make the difference between 'a cyclical improvement in inflation – which we have seen often in the past – and a structural improvement, which is what we are seeking'. Yet another reason for optimism about maintaining low rates of inflation in the future was that the public debate about monetary policy had shifted decisively to an emphasis on reducing inflation. As the Economic Group explained, by being seen to 'move only cautiously in lowering short-term rates, and by explicitly linking those falls to the outlook for inflation, the Bank had improved its own anti-inflation credibility', which was considered to be an advantage worth having (and safeguarding) when inflationary pressures threatened to pick up again.

This optimism might be dashed, however, were the exchange rate to come under significant downward pressure, or if a wages breakout were to occur. The Economic Group did not elaborate on what might happen were a wages breakout to occur, but it was 'completely opposed to the idea that monetary policy should actively try to *promote* a lower exchange rate' (italics in the original text). Indeed, the Economic Group thought the Bank should be supporting even lower rates of inflation, and offered three arguments to back its case. First, it thought that getting 'inflation down quickly into the range of 2-3 per cent would solidify what has already been achieved, and maximize the chances of a major breakthrough on inflationary expectations. This would offer the chance to set the scene for a decade of balanced economic growth through the 1990s.' The second reason was that, while the rate of inflation over the next year was likely to keep Australia comfortably within the OECD average, the best performers would probably have inflation down to 3 per cent or less in the medium term. If, therefore, 'the international standard on inflation moves increasingly to the 2 to 3 per cent range', there would be pressure for Australia to do likewise in order to maintain its competitiveness. Third, it thought 'the more we can reduce inflation now, the more margin for error is available in dealing with economic shocks which may occur in the future. A starting point of very low inflation gives policy much more room to manoeuvre, in the face of shocks such as changes in the terms-of-trade or large oil price rises.' Of course, the costs of bringing inflation down even further would have to be considered, though there would be difficulties in trying to reach an assessment of where the balance of benefits and costs would lie: while the short-term costs were likely to be obvious, the medium-term benefits would be more difficult to quantify directly, and usually they took time to emerge. Still, the costs involved in achieving a satisfactory inflation outcome would probably be at

the low end of the scale in present economic circumstances, while the benefits of low inflation seemed to be clear. Moreover, it would not make much sense to go into the recovery phase with inflation at 4 per cent or a little higher if the objective was to have inflation in the 2 to 3 range in the medium term. At all events, the Bank should seek to 'take advantage of the present opportunity and make further progress over the next year'.

If the monetary authorities were to adopt a 2-3 per cent inflation objective, and assuming a very low wage increase in 1992, the Economic Group thought the implications for monetary policy were likely to be threefold. First, a 'cautious approach' to demand management would be required over the next few years. This did not mean 'a permanent state of recession', but rather the need 'to avoid the very rapid expansions in demand characteristic of previous upswings'. Short-term interest rates would have to remain relatively high 'until inflation is locked in at the appropriate rate', and the government would have to resist calls for a significant loosening of fiscal policy (taking into account the desirability of wage tax deals). If that resistance were to fail it would mean that monetary policy would have to be set even tighter. Second, firm policy settings would need 'to be backed up by a continuation of the appropriate rhetoric, emphasizing the costs of inflation, the link between low inflation and low nominal interest rates, and the Bank's determination to improve performance further.' Third, the Bank's public rhetoric should make it clear that wage developments were being carefully watched and that the outcome would have a significant bearing on the setting of monetary policy. Microeconomic policies would also be expected to play an important role in the future if inflation were to be kept below 3 per cent. Structural reforms in key sectors of the economy should be prepared and early progress encouraged. Tariff reductions, for example, would enable downward pressure to be exerted on costs and prices, and publicly owned corporations could be made to run more efficiently, easing cost pressures further. And if significant progress was made along these lines, the microeconomic reforms would take pressure off demand management, including monetary policy.

By May 1992 the Bank was reporting that growth in the CPI had slowed to an annual headline average of 1.7 per cent in the four quarters to March 1992. A number of special factors, including mortgage interest rate reductions, had influenced growth in the headline CPI, but even inflation in private goods and services – where the effects of monetary policy were expected to be seen most clearly - had fallen to a rate around 2 ½-3 per cent. In the same month, Macfarlane (now Deputy Governor) in an address to the Sydney Institute asked whether the sharp fall in inflation was 'temporary, or should we conclude that we have finally shaken off two decades of relatively high inflation'. It was the Bank's view, he said, 'that we have made a structural downward shift in inflation and that, with reasonable policies, we should be able to retain it.' While admitting that the recession was an important reason for the fall in the rate of inflation – he knew 'of no country in the post-war period that has achieved a significant reduction in its core rate of inflation without a contraction in output' – he also highlighted the significant fall in inflationary expectations and the moderation of wage demands arising from the Accord between the government and the trade union movement (Macfarlane, 1992, 1).

The Reserve Bank's 2-3 per cent Target

Perhaps the earliest claim to 1993 being the effective date for the commencement of inflation targeting in Australia was made by Guy Debelle and Glenn Stevens in a paper presented to a Bank of England conference in 1995 on the subject of 'Targeting Inflation' (Debelle and Stevens 1995). While they were careful to explain that the 'process of elevating this objective in public discussion has been evolutionary, rather than revolutionary', they asserted nevertheless that the 'first enunciation of the present price inflation objective as such by the Reserve Bank was in 1993' (Debelle and Stevens, 83, fnt 1). Four years later, in a paper covering 'Six Years of Inflation Targeting', Stevens claimed that it was 'reasonable to date mid 1993 as the time when Australian monetary policy-makers began to articulate a medium-term target for inflation' (Stevens 1999, 46). Further, in April 2003, in a paper on 'Inflation Targeting: A Decade of Australian Experience', Stevens mentioned in passing that 'a couple of weeks ago saw the tenth anniversary of a speech by Bernie Fraser, then Governor of the Reserve Bank, in which the outlines of our target can be seen. It was, admittedly, a tentative beginning – there was no drum roll, or breathless talk of a new era' (Stevens 2003, 17). Even so, Stevens was 'happy to claim that inflation targeting in Australia began about ten years ago in the first half of 1993'. Yet again, in an address at the Bank of Thailand in December 2012, he remarked that 'Australia adopted I[nflation] T[argeting] in 1993' (Stevens 2012, 74).

Other senior Bank officers endorsed these claims. Philip Lowe, the editor of the volume of papers presented at the Bank's annual conference in 1997, which was devoted to 'Monetary Policy and Inflation Targeting', asserted that, 'from the late 1980s the system [the monetary-policy framework] evolved into one with a much sharper focus on price stability, with an explicit inflation target being adopted in 1993' (Lowe 1997, 3). At the same conference, Stephen Grenville agreed with Lowe, stating that by '1993, there was a specific final objective ("2-3 per cent inflation over the course of the cycle"). This had been formulated by the Bank and was subsequently endorsed by the Treasurer' (Grenville 1997, 146). Like Debelle and Stevens, Ian Macfarlane claimed in a speech given at the Bank of Mexico in 2000 that the adoption of inflation targeting by the Reserve Bank was 'evolutionary rather than revolutionary'; while monetary policy 'had increasingly focused on reducing inflation for a number of years, a numerical inflation target was not fully articulated in public until 1993' (Macfarlane 2000, 76). In his Boyer Lectures, delivered in 2006, Macfarlane was more circumspect, suggesting that the Bank 'gradually introduced the idea of inflation targeting, starting with a speech in 1993 by Governor Bernie Fraser where he merely opined that maintaining an average inflation rate of 2 to 3 per cent would be a good thing. Over time, in a number of speeches and research papers, this was firmed up sufficiently to be seen as the Reserve Bank's inflation target' (Macfarlane 2006, 82).

In fact, Fraser himself first referred to a desired inflation rate of 2 to 3 per cent in a speech he gave at conference in honour of Don Sanders, the Bank's former Deputy Governor, in Sydney in August 1992. There he mentioned that Australia now possessed one of the lowest inflation rates in the world. Dismissing the argument that the fall in inflation was simply the result of the recession, Fraser claimed that policy had played a major part. While the costs of bringing inflation down to satisfactory levels had been substantial, it seemed to him that price expectations, 'which are now seen as occupying a central role in the inflationary process, have been cracked' (Fraser 1992, 222). Given this development, and with 'continued policy vigilance', he could see 'no reason why the current underlying inflation rate of 2 to 3 per cent cannot be sustained'. Admittedly, there was no mention of an inflation target, or of

any intention by the Bank to conduct monetary policy with the aim of keeping inflation within a 2-3 per cent range.

Soon after the federal election in early March 1993, Fraser gave a speech on 'Some Aspects of Monetary Policy' to an audience of business economists. It is this speech that is usually referred to as signaling the Bank's commitment to an inflation target. Fraser told his audience that the 'appropriate degree of price stability to aim for is a matter of judgment'. But it was his view that 'if the rate of inflation in *underlying* terms could be held to an average of 2 to 3 per cent over a period of years that would be a good outcome' (italics in original). Such a rate, he believed, 'would be unlikely to materially affect business and consumer decisions, and it would avoid the unnecessary costs entailed in pursuing a lower rate'. In the pursuit of such an objective, some degree of flexibility would be required to guard against the impact of shocks. For this reason he was 'rather wary of inflation targets'. A case could be made out for targets 'where inflation is out of control and no credible anti-inflation policy is in place. In those circumstances, a target to which the authorities were totally committed to could help to establish credibility and thereby push down price expectations'. Yet, even in these circumstances, he said 'the evidence suggests that price expectations are shifted more by actions than by words'. To his knowledge, there was no country that had 'reduced its inflation by incantation, rather than by creating some slack in the economy'. In short, his 'reading of the evidence' drew him to the firm conclusion that Australia had 'reduced inflation at least as effectively (in terms of the trade-off between inflation and lost output) as countries like New Zealand, which have an inflation target'. A sympathetic reading of this speech does not suggest an unambiguous commitment by the Bank to an inflation target. And again, as with Fraser's speech the previous August, there was no mention of a 'target', 'objective', or 'goal'. Moreover, there was no fundamental difference between what he said in this speech and what he had said in August 1992; if anything, he was more sceptical of inflation targets, admitting that he was 'rather wary of inflation targets' (Fraser 1993a, 279, 280).

In a press statement issued at the end of July 1993, in which Fraser announced a reduction in interest rates by 0.5 per cent to 4.75 per cent, he noted that inflation remained 'well within a 2 to 3 per cent range', adding that he was confident that inflation would remain within that range, 'notwithstanding possible rises in the "headline" rate over coming quarters' (https://www.rba.gov.au/media-releases/1993-17). Again, on 4 August 1993, in another much quoted speech, this one given in Sydney to a CEDA symposium, he returned to Alan Greenspan's definition of price stability, agreeing that Greenspan's definition might serve as an adequate test. Putting numbers to that definition was likely to be a matter of judgment, but Fraser said his 'own view is that if the average rate of underlying inflation could be held to 2 to 3 per cent over time, we would meet our test. That is the standard which countries often seen as benchmarks have achieved – and which we ourselves achieved in the 1950s and 1960s' (Fraser 1993b, 300). Again, there was no mention of a target, or of a commitment by the Bank to a 2-3 per cent inflation target.

In short, the various references in Bank papers and in speeches given by Bank officers in the years between 1991 and 1993 were somewhat vague and lacked a firm commitment to targeting an underlying rate of inflation of 2 to 3 per cent on average over the medium term. The desire to contain inflation within the 2-3 range was mentioned by Fraser in 1992, but his doubts about a publicly announced 'target' continued throughout 1993. During the next two

years, however, Fraser in his public addresses, and the Bank in its annual reports, expressed a much stronger commitment to the 2-3 per cent inflation objective than previously. For these reasons a number of distinguished overseas authorities have suggested that inflation targeting in Australia commenced in 1994. By then the government appears to have endorsed the Bank's inflation target, the Treasurer, Ralph Willis, informing the parliament in November 1994 that both the government and the Bank were now committed to a 2-3 per cent inflation target. In 1995 the Accord Mark VIII agreement between the government and the ACTU was also based upon an inflation target of 2-3 per cent.

In a speech given early in 1994, and one that has since then attracted considerable attention, Fraser made it clear – for the first time in public – that if the rate of inflation were to exceed 2-3 per cent, the Bank would take action to move the rate back into that range. Addressing a group of business economists in Sydney on 30 March 1994, he remarked that if the underlying rate of inflation was 'noticeably above the 2 to 3 per cent range, corrective action would have to be implemented'. He added that, after 'a 20-year struggle to retain the low inflation key to sustained growth, it would be irresponsible to lose it now' (Fraser 1994a, 362). He was even more forthright in a speech he gave in Tokyo in July of the same year. Speaking on the topic of 'Sustainable Growth in Australia', he referred to the Bank's 'policy commitment to keep inflation in the 2-3 per cent range, which we equate with reasonable price stability' (Fraser 1994b, 395). Some ambiguity arose, however, in September 1994 when, in a speech addressed to 'The Art of Monetary Policy', presented to the annual conference of Australian economists, Fraser suggested that the Bank's 2 to 3 per cent 'goal' was 'similar to the informal goals of the US Federal Reserve and the Bundesbank, and not dramatically different from the more formal targets in the United Kingdom, Canada and New Zealand'. The speech, however, provided more detail about what the Bank had in mind by establishing the 2 to 3 per cent goal for monetary policy, with Fraser himself expressing confidence that such a rate would meet Greenspan's celebrated test, and if achieved, would minimize the costs of inflation (Fraser 1994c, 415).

An article published in the Reserve Bank Bulletin in August 1994 sought to clarify some of the more technical aspects of the 2-3 per cent inflation objective. It was explained, for instance, that the 'underlying rate of inflation, rather than 'the conventional CPI', was 'the primary focus for monetary policy purposes' and, accordingly, it was the underlying concept 'which the Bank has in mind when it talks of limiting inflation to around 2 to 3 per cent a year on average' (RBA 1994, 13). This edition of the *Bulletin* was published on 16 August. The following day the Bank issued a media release in which Fraser announced the first tightening in official interest rates for five years (https://www.rba.gov.au/media-releases/1994-11). He explained that, although inflation was continuing at around 2 per cent in underlying terms, policy settings must be forward looking. With available spare capacity quickly evaporating, and with employment now 'growing very strongly', he warned that 'pressures on prices and wages can be expected to intensify'. This adjustment to monetary policy, he said, was aimed at controlling those pressures, and would 'help to keep *underlying* inflation around 2 to 3 per cent' (italics in original).

Further clarification of the Bank's inflation objective was provided in March 1995. Again addressing business economists in Sydney, Fraser announced that the Bank's 'objective is to hold *underlying* inflation to an average of 2 to 3 per cent over a run of years' (italics in

original). This would 'lead to better investment and saving decisions than would occur in an environment of higher inflation'. Elaborating further, he said the 2 to 3 per cent objective 'was never a narrow band in which we believed inflation must, or necessarily can, be maintained at all times and in all circumstances. This would be too narrow and too constraining a target, given the cyclical and other influences on inflation. Rather the "2 to 3 per cent" specified an inflation rate we would aim for over the medium term: success would be reflected in an average inflation of "2 point something"' (Fraser 1995a, 463). Then in September 1995, speaking again in Tokyo, this time on the topic of 'Progress of the Australian Economy', Fraser informed his audience that 'we too have a clear inflation goal, namely to maintain underlying inflation at an average rate of 2 to 3 per cent over the course of the business cycle'. He drew a direct comparison between the inflation target and the average inflation rate of 2 ½ per cent achieved by Australia in the 1950s and 1960s. It was, he explained, 'with this commitment in mind that monetary policy was tightened quite decisively in late 1994. That tightening has helped to return the economy to a more sustainable growth path, and to check inflationary expectations' (Fraser 1995b, 495,496). And further, in October 1995, appearing before the House of Representatives Standing Committee on Banking, Finance and Public Administration, Fraser explained that, like other central banks, 'we have an inflation objective or "target" to help guide monetary policy. This is to hold underlying inflation to 2-3 per cent on average over a run of years'. That, he said, 'does not mean that underlying inflation should be between 2 and 3 per cent every year; rather, it means that over the cycle the average rate of inflation should be "2 point something". At times it will exceed 3 per cent, just as at times in recent years it was below 2 per cent'. Such outcomes were not 'inconsistent with our objective, although achieving that objective obviously requires inflation to return to 2-3 per cent within a reasonable period of time'. The target had been 'endorsed by the government and the ACTU', he added, and as well as serving as a guide to the Reserve Bank, it 'performs a useful role in helping to focus public discussion and debate on monetary policy' (Fraser 1995c, 520). [3]

After the change of government in March 1996, and before he retired from the Bank in September, Fraser gave three more speeches in which he referred to the Bank's inflation targeting regime. In the first of the speeches, which bore the title 'What is an Optimal Inflation Target?', presented on 10 May 1996 to a symposium marking the 25th anniversary of the Monetary Authority of Singapore, he explained that the Reserve Bank's 'target was introduced about four years ago [that is, in 1992] without any great fanfare'. It was, he said, 'effectively self-imposed by the central bank', in contrast to inflation targets established elsewhere, which had either been introduced by the national government, or by agreement between the government and the central bank'. The Reserve Bank 'had repeatedly espoused the view that underlying inflation should be held to 2 to 3 per cent over the course of the business cycle; this view soon came to be identified as the Reserve Bank's inflation target'. It was then, he explained, 'picked up and endorsed by the former Labor government. It was also supported by the peak trade union body, the Australian Council of Trade Unions (ACTU) …[and]…When the new government came into office last March it was quick to endorse the same target'. The targeting regime had stood the test of being 'a discipline – and a forward-looking one – on policy'. In the second half of 1994, interest rates had been increased 'decisively and preemptively', rising by a total of 275 basis points in three discrete adjustments. These increases were made 'to head off a potential blowout in inflation, even though inflation at the time was still quite low (around 2 per cent) and unemployment was still uncomfortably high (around 9 ½ per cent)'. It was relatively easy, he judged, to hold

down inflation when there was considerable slack in the economy. 'The real test comes', he admitted, 'when pressures start to build in key sectors of the economy. In that sense, the real test of the worth and durability of inflation targets in some countries lies in the future. In our own case, where the target has been held during a period of quite strong growth, we would claim we have passed the first test. Further tests are on the horizon but, to this point, our experience with our inflation target has been encouraging' (Fraser 1996a, 548, 549, 552).

A major theme in Fraser's final two speeches on the subject was that the Bank was not targeting inflation at the expense of employment or activity. Speaking in Perth in July 1996, he explained that the Bank had 'a two-dimensional charter which requires it to take account of trends in growth and employment, as well as in inflation'. That, he believed, was the right approach to conducting monetary policy, that 'monetary policy should be managed in a way which simultaneously keeps inflation under control and helps to sustain good growth in employment'. The Reserve Bank of Australia was said to be 'different in this regard from some other central banks which are more narrowly focused on inflation' (Fraser 1996b, 571). The same theme was pursued in a valedictory address to the National Press Club in Canberra in August 1996, shortly before Fraser retired. Noting that, in the second half of 1994, it appeared likely that inflation would exceed the Bank's 2-3 per cent objective, monetary policy was tightened 'quite decisively to limit the extent and the period of the expected rise above 3 per cent'. Monetary policy, Fraser explained, could have been tightened 'in a more draconian way, with a view to minimizing the period with inflation above 3 per cent'. The Board, however, rejected that possibility, 'saying implicitly that the possible benefits of such action fell short of its potential costs in terms of lost output and jobs'. Similarly, the easing in policy at the beginning of August 1996 could have been delayed until inflation was firmly within the 2-3 per cent band, but the 'judgment was made that the benefits of a little insurance against the economy faltering outweighed any risk that inflation might kick up unexpectantly'. Fraser said he was not attempting here to 'downplay or backtrack on the inflation objective'. He had made 'too big a commitment to lowering inflation over the years to start backtracking now'. On the contrary, he had always taken the view that 'both inflation and employment are important', and that 'both can be progressed simultaneously…It is the job of central banks to worry about inflation, and they are innately inclined to do that. But they should not be fixated solely with inflation, and we should not be loading the dice even more in that direction' (Fraser 1996c, 587).

Inflation Targeting Moves Outside the Bank

From 1994 the government took a stronger interest in the Bank's inflation objective. In briefing notes prepared in January 1994 for the new Treasurer (Ralph Willis), the Bank said it was confident that 'monetary and other policies can maintain an average underlying rate of inflation at around 2-3 per cent'. If that were achieved, it thought the monetary authorities would 'be doing their job'. It explained that the principal goal of monetary policy was to maintain a low rate of inflation while assisting the economic recovery. This strategy had allowed the Bank to ease its monetary settings in the face of weak economic activity, but at 'a measured pace and with an eye to holding on to the gains on inflation'. That this approach had been successful now seemed abundantly clear, since 'we have a conjuncture of macroeconomic fundamentals which has not been seen in Australia for 30 years. Inflation is low, even when compared with most of the countries with good anti-inflation track records'. Another measure of this success, according to the Bank, was the 'dramatic fall in long-term

security yields over the past three years'. To be sure, there were several factors that contributed to the low inflation outcome. But the Bank was convinced that 'monetary policy settings shoulder the main responsibility for keeping a good inflation performance' (RBAA, SD95-00391, 5 January 1994).

When answering a question in the parliament on 8 November 1994, Willis drew attention to the fact that the annual rate of inflation in Australia had fallen to 1.9 per cent, and that for the past three years the average rate had been 2 ½ per cent, the same as that experienced by the OECD as a whole, minus Turkey. Inflation in Australia was now 'clearly below the OECD average'. These figures, the Treasurer explained, were not calculated on the basis of underlying rates of inflation, but were the unadjusted – or headline - figures. As it happened, the underlying rate for the previous twelve months was 2 per cent, which was close to the headline rate. This, the Treasurer emphasized, was the first time since the underlying series began in the mid-1970s that it had fallen below 2 ½ per cent. He then announced that the 'Reserve Bank and the government have established a target of keeping the underlying rate of inflation in the range of two to three per cent over the course of the cycle'. The significance of an inflation target, he said, was that it 'clearly establish[ed] in the minds of investors, particularly investors in financial markets, that Australia is a low inflation country'. It was equally 'important to us', he added, 'that we do not let the opportunity slip'. That meant that 'we cannot just stand still; we have to adjust policy as appropriate to curb the natural tendency of the economy to spiral into a damaging inflationary outcome. That means that, from time to time, policy has to be adjusted', so as 'to keep the underlying rate in that two or three per cent range' (Commonwealth of Australia, 8 November 1994, 2787). Responding to an interjection from the shadow Treasurer (Peter Costello), Willis reassured the parliament that it was the government's intention 'to keep inflation comparable with that of our major trading partners and keep the underlying rate in that two to three per cent range. That has been quite clearly stated by me, by the government and by the Reserve Bank as an inflation objective' (Commonwealth of Australia, 8 November 1994, 2788). He was to refer to the 2-3 per cent target again in his budget speech the following year, saying that wages growth for 1995/96 was expected to be higher than in the current year but, in the context of enterprise bargaining and improvements in productivity, 'it should remain comparable with maintaining an underlying inflation rate around 2 to 3 per cent on average over the course of the economic cycle'. Budget Statement No. 2 (1995-96) reported that '[m]onetary policy in 1994-95 has been conducted in accordance with the government's commitment to keeping underlying inflation around 2 to 3 per cent on average over the course of the economic cycle.' For 1995-96, Budget Statement No. 2 reassured the public that the 'government and the Reserve Bank are committed…to keeping inflation around 2 to 3 per cent on average over the course of the cycle' (Commonwealth of Australia 1995, 2-4, 2-19).

However, the declaration by the Treasurer in November 1994 that both the Reserve Bank and the government possessed an inflation target was refuted in October 2007 by the former Treasurer and Prime Minister, Paul Keating, who told an audience attending an election rally in the Hunter Valley that he was about to disclose some 'real economic history'. Referring to documents of a cabinet meeting held on 30 May 1995, from which he read, he claimed that it was the government and the trade unions who were 'the inventors of the 2 to 3 per cent [target]', and that the then Governor of the Reserve Bank (Bernie Fraser) had merely 'co-adopted' the target. The 'inflation target didn't begin with the Reserve Bank', he contended.

Rather, 'it began with me, as Prime Minister, and Bill Kelty representing the ACTU'. Later, when Fraser was contacted by an incredulous press gallery seeking clarification of what the former Prime Minister had said about the provenance of Australia's inflation target, he is said to have 'disputed Mr Keating's recollection, saying he [Fraser] had conceived the 2 to 3 per cent target in March 1993, floating it as an option during a speech to the Economic Society in Canberra' (*SMH*, 26 October 2007). [Fraser's March 1993 speech, in fact, was to the association of Business Economists, and held in Sydney].

Keating's reference was to a cabinet meeting called to plan for what became the Accord Mark VIII. Dated 22 June 1995, the Accord stated that it was 'based on and consistent with maintaining an underlying rate of inflation of 2 to 3 per cent over the cycle'. Covering what was now well traversed ground, the document explained that this 'does not mean that when underlying inflation exceeds 3 per cent for a short time correct action is always desirable. It does imply, however, that on-going inflation exceeding this level requires a policy response which targets the cause of the problem'. The document explained that the Accord partners – the government and the trade union movement – regarded low inflation as a 'desirable social outcome'. It was claimed that the current decade had 'seen a threshold change in inflation and inflationary expectations', which was 'essential for interest rates remaining at levels conducive to continuing healthy economic and employment growth'. The partners to the Accord were said to attach 'great weight' to the 'significance of this achievement and to the difficulties inherent in re-establishing a low inflationary environment once lost'.

When addressing a Victorian ALP Fundraising Dinner, in Melbourne on 4 July 1995, the Prime Minister referred to the new Accord agreement. He played up the fact that the Accord was based on an underlying rate of inflation of 2-3 per cent over the cycle. Expressing great enthusiasm for the agreement, he said 'you couldn't believe this thing. 12 years ago nobody would have given a snowballs chance in hell of such a document being produced. This is the trade union movement walking up to the government and with the government sitting down and saying 'we will run a wage system which is based on and consistent with maintaining an underlying rate of inflation of 2 to 3 per cent on average…one which says will run an enterprise bargaining system, but will run it essentially in such a way it will produce 2 to 3 per cent inflation'. This, he declared, 'is a revolution in the way we run economic policy in Australia compared to most other OECD countries…we have essentially broken the back of inflationary expectations and high inflation in this country. And we are back onto a growth path and we are now seeing a hugely strong phase of private investment' (*AFR*, 5 July 1995).

International Comments about Australia's Inflation Target

In contrast to those who place great store on Fraser's March 1993 speech as the starting date for inflation targeting in Australia, overseas authorities are more inclined to point to his speech in September 1994, in which he proclaimed that 'underlying inflation of 2 to 3 per cent is a reasonable goal for monetary policy'.[4] This, for example, is the view of Bernanke, Laubach, Mishkin and Posen in their influential 1999 work entitled *Inflation Targeting. Lessons From the International Experience*. They refer to the informal nature in which inflation targeting was adopted in Australia, its 'gradual and incremental' character, and to the fact that it 'was not prompted by a change in the legislative mandate of the Bank'. Nor, they assert, was there 'any attempt to present the adoption of an inflation target as a joint policy of the government and central bank, either in the form of a joint declaration…or as a directive by

the government'. It was possible, they conclude, that the Bank 'did not regard the inflation target as a significant departure from the Bank's previous interpretation of its mandate', as set out in Section 10 of the Reserve Bank Act, which refers to maintaining the stability of the currency (Bernanke, *et al.*, 219).

The authors give due consideration to the view that the Bank had adopted an inflation target as early as 1993. While admitting that there is 'some ambiguity' about when inflation targeting began in Australia, they nevertheless prefer September 1994 as the starting time. This date, they suggest, 'is consistent with our view that inflation targeting begins with the public announcement of a numerical target for a specified measure of inflation and a specific horizon'. For them, the issue was not simply a matter of pedantic hair-splitting. It was important, they argue, 'to distinguish whether the complete inflation-targeting framework, or simply the desire to strengthen control of inflation (which was present in Australia prior to September 1994), is necessary for achieving the maximum benefit'. The important point was that 'the Reserve Bank of Australia made no public commitment to a numerical target for inflation. Instead, over subsequent years it tried to convey to the public that the Australian disinflation, which was largely completed by the end of 1991, was the result of a permanent shift in policy objectives and not just a side effect of the 1990/91 recession'. It was clear that 'policy-makers in the Reserve Bank were unwilling to follow the route of their counterparts in New Zealand and Canada. In their view, the constraint arising from an explicit numerical inflation target would impose inflexibility on policy and would harm the real economy' (Bernanke, *et al.,* 220, 221, 222).

What led the Bank to become more specific about its commitment to an inflation target is said to have been 'economic circumstances'. By early 1994 it was clear that Australia was recovering strongly from the 1990/91 recession and the bond-market was weakening, with 10-year government bond yields rising from 6.4 per cent to 9.6 per cent in the first half of 1994, twice the increase in the level of long-term bond yields in the United States, and one percentage point more than the increase in New Zealand. This suggested that the Reserve Bank's commitment to price stability was not fully credible among financial market participants and that inflation targeting might help to anchor inflationary expectations. It was in these circumstances, the authors argue, that the Bank began to tighten monetary conditions in August 1994, followed shortly after by the Governor's speech in September. Other international authorities appear to support this interpretation. For example, Laurence Ball and Niamh Sheridan, in a paper presented at a National Bureau of Economic Research Conference in 2003, agree that inflation targeting in Australia commenced in 'Q4 1994' (the September quarter of 1994 in Australian terms), the basis for this conclusion being the Governor's September 1994 speech which set out in greater detail the configuration of the target and the Bank's commitment to achieving it (Ball and Sheridan 2003, nd, Table 1). Similarly, Frederic Mishkin has placed the start of inflation targeting in Australia in 1994 (Mishkin 1999, 591; Mishkin 2007, 406, 432).

The Bank commenced to tighten monetary policy in August 1994 on the basis of the 2-3 per cent inflation target. This appears to be a moment of some significance to overseas authorities, declaring as they do that the raising of interest rates demonstrated a decidedly stronger commitment to an inflation target than cutting rates when the rate of inflation approached, or exceeded, the lower bound of the target range. But even more significant for them was Fraser's speech in September 1994. In this speech, Fraser spent more time than he

had on previous occasions outlining the specifications of the target. Thus he said the 'focus is very much on the "underlying" rate of inflation. This, conceptually, is a measure of the trend in the general price level which reflects the broad balance between aggregate demand and supply in the economy. That trend, rather than the published (or "headline") rate which can be affected by "special" factors, is what matters for monetary policy purposes'. He also made it clear that the reference to 2-3 per cent was 'not intended to define a (narrow) range; rather, they [the figures] are indicative of where we would like to see the average rate over a run of years'. He asserted further that there 'is no single and unambiguous measure of underlying inflation…Our preferred approach is to monitor different measures of underlying inflation and reach an informed judgment on the basis of all those measures.' Moreover, he stressed that 'the goal itself has to be pursued in a forward looking way. If policy waits until inflation actually rises, it will respond too late. This means relying to some extent on forecasts of inflation'. Here, he explained that the Bank, when preparing its forecasts, directed attention to 'the forces which drive inflation, including macro demand/supply balance, capacity utilization and the labour market, financial aggregates, wages, and price expectations'. It was only then that the Bank reached 'a judgment about the inflation outlook, and the balance of risks from a policy perspective'. He conceded that this apparent lack of rigour might disappoint some people, especially those who favoured a simple rule. But for him, there 'is no use having a compass if there is no reliable magnetic north. Instead, we have to consider all the evidence and make informed judgments about the likely effects of monetary policy actions on the economy. We obviously hope those judgments are close to the mark, although even good calls will overshoot or undershoot to some extent' (Fraser 1994c, 415, 416).

Towards a Statement on the Conduct of Monetary Policy: the Treasury's Proposal

The 'exchange of letters' in August 1996 between the Treasurer (Peter Costello), on behalf of the government, and the Governor-designate of the Reserve Bank (Ian Macfarlane), on behalf of the Bank – the Statement on the Conduct of Monetary Policy – endorsed the Bank's 'objective of keeping underlying inflation between 2 and 3 per cent, on average, over the cycle.' The idea for such a statement came from the Treasury, and in particular, from the Secretary to the Treasury, Ted Evans.

In the months immediately preceding the general election of March 1996 – and possibly in the expectation of a Coalition victory – the Treasury prepared a document entitled 'Institutional Arrangements for the Operation of Monetary Policy' (RBAA, BM10-Treasury 1996-1999). Dated 22 February 1996, it was sent by Evans to Fraser for comment. The paper referred to criticism over the years about the Bank's inability to conduct monetary policy independently of government influence. 'Irrespective of the validity or force of such criticisms', the Treasury believed that 'the existence of perceptions regarding a lack of "independence" of the Reserve Bank can affect the Bank's anti-inflation credibility and hence the cost of achieving objectives'. Analysis undertaken by the department concluded that while there were 'advantages in retaining the broad institutional structure currently applying to monetary policy, including multiple objectives and the current inflation target, the effectiveness of monetary policy could be bolstered by addressing the above criticisms'. It noted, in particular, that one of the criticisms often made about monetary policy in Australia was that 'the inflation "objective" (or target) has no hard edges and the Bank's performance in terms of the target can only be assessed in hindsight'. The paper then

examined various procedures that could be adopted with 'the aims of increasing the transparency of the operation of policy and addressing perceptions that the Bank is subject to excessive political interference'. It recognized that some of these procedures might require legislative support. (In a marginal annotation, Fraser considered that perceptions of the Bank's lack of independence and transparency were diminishing, if not disappearing altogether, thinking as he did that the credibility argument that ran through the Treasury paper was 'overstated'. This comment was prompted perhaps by the fact that the Bank for some years had been making changes to the cash rate without having to obtain the approval of the Treasurer – as specified in the Banking Act).

It was the Treasury's view that one of the problems attending the present operation of monetary policy was that the Reserve Bank's legislative charter provided no guidance as to which of the three policy objectives set out in the charter had priority. It was true that, in recent years, the Bank had signaled - primarily through its public statements - that it attached the highest priority to inflation, and had adopted an inflation target with the object of maintaining low inflation over the medium term. Even so, criticism of the Bank's conduct of monetary policy continued. In these circumstances, the Treasury thought there could be some advantage were the government 'to make it clear in a transparent form which could be readily referred to that medium term price stability is the prime objective of monetary policy, though to be pursued in ways which recognize the implications of changes of policy on the short term outlook for employment and general economic welfare'. Two advantages that were likely to result from this approach were highlighted. First, it would provide a clear indication that the Bank and the government assigned the same priority to price stability, thereby acting 'as a counter to perceptions that the priorities for monetary policy could change over time'. Second, it would acknowledge that price stability was a medium term objective, rather than one to be pursued without regard to transitional costs. (Here, Fraser annotated that he preferred 'the present emphasis on twin objectives' – price stability and activity/employment - thinking that monetary policy priorities 'should' be expected to change over time).

Of the current inflation target, the Treasury agreed that it provided 'a useful form of discipline in the Bank's pursuit of its policy objectives, bolstering the forward-looking nature of the operation of monetary policy'. As presently formulated, it allowed the Bank 'to take into account the natural dynamics of the cycle, consistent with the Bank's multiple policy objectives'. The flexible nature of the target's design was also considered to be 'a practical recognition of the difficulties which would be associated with a "hard-edged" target band, sufficiently narrow to have some credibility'. Its shortcoming, however, was that 'the Bank's performance can only be judged, with certainty, in hindsight'. This tended to reduce the credibility of the inflation target, 'at least until it has an established track record'. The Treasury thought that current circumstances – with underlying inflation above 3 per cent and likely to stay there – illustrated this particular deficiency. As a solution to the problem, it suggested that the transparency of the link between policy and the inflation target could be enhanced were the Bank to release a report – perhaps twice a year – 'which would provide an in-depth analysis of the consistency of monetary policy settings in terms of the inflation target'. Such a report might then be supplemented by the Governor's regular appearance (perhaps twice a year) before an appropriate parliamentary committee to review the conduct of monetary policy. As the paper explained, the 'inflation report' could aim to expand on the information already included in the economic and financial survey that appeared quarterly in

the Reserve Bank's *Bulletin*, providing 'a more explicit consideration of the medium term outlook for inflation and the implications of this outlook for monetary policy settings in the context of the inflation target'. It might also be desirable for such an assessment to be extended out 18 months to 2 years. (Fraser annotated that he did not have any major problem with providing more information, agreeing that the material presently included in the Bank's quarterly economic and financial market reports could be extended without great difficulty, though he was concerned about the policy and analysis implications of the material supplied in the proposed reports).

This led to the key issue of the Bank's independence. Here, the paper proposed that the 'perception' of independence could be strengthened by the government 'establishing or indicating that the Reserve Bank is responsible for monetary policy and as such the government would generally not make public comments on monetary policy issues, including the future direction of rates (this would include the government not issuing a press release at the time of a change in monetary policy).' (Fraser's annotation indicated that he would support this idea). The paper rejected the argument, often expressed, that the presence of the Secretary to the Treasury on the Board created perceptions that the Bank was insufficiently independent of government. (Fraser again annotated that he did not want to see any change in the composition of the Board).

The Treasury paper noted that the changes it was canvassing could be undertaken either by amendments to the Bank's legislation or by non-legislative means. A non-legislative approach could be framed around 'a public agreement between the government and the Bank covering the operation of monetary policy'. Such an agreement would explain that, 'as part of the overall objective of sustainable economic growth, medium term price stability is the prime objective of monetary policy'. And further, that 'an inflation target to be pursued by the Bank is endorsed by both the Bank and the government'; that the Bank 'will release a regular report setting out the consistency of monetary policy settings in terms of the inflation target; and 'the Governor will appear before Parliament twice a year to elaborate monetary policy issues'. The Treasury suggested that perceptions of the Bank's 'independence' could be reinforced were the government to indicate, as part of the agreement, that the Reserve Bank had responsibility for 'the day-to-day operation of monetary policy and the government would generally not make public its comments on monetary policy, including the future direction of interest rates'. The agreement might also announce that the government would not issue a separate press release at the time of a change in monetary policy. It was recognized that a statement along non-legislative lines might not be seen to lock in the proposed arrangements as firmly as legislation would. Nevertheless, the Treasury felt that, once the changes were publicly announced, it would be difficult for a government to walk away from them. A clear advantage of a non-legislative approach was that it would not require the Reserve Bank Act to be subjected to parliamentary debate, and the inevitable delays that would be involved were that to happen. (In relation to all these suggestions for greater central bank independence, Fraser annotated that he thought legislative amendments would be 'a bit too radical for the kinds of changes contemplated'; that a public agreement would be 'over-dramatic and could be done more low key and just as effective'; that price stability being the 'prime objective of monetary policy' was 'misguided'; and that the government and the Bank had already declared their commitment to an inflation target. He doubted also that any 'self-respecting' government would agree to refrain from commenting

on interest rates and their future direction; and he thought there was a case for keeping the nature and composition of the Board of the Bank as it was).

As to the possibility of amending the Bank's legislation - which the Treasury regarded as a possibility that should not be dismissed lightly – the paper claimed that it 'would entrench the changes, removing concerns that such arrangements would be at the discretion of the particular individuals involved'. That might be considered by some to be an advantage, but it would also have a number of possible disadvantages, including delays. An amended Act would certainly make it clear that the objective of low inflation had 'primacy'; it would require the Bank to publish a regular and detailed report on the medium term inflation outlook linked to policy settings and the inflation target; and would require the Governor to appear regularly before a Parliamentary committee to discuss the conduct of monetary policy. When introducing these amendments, the government could indicate that the Reserve Bank had responsibility for the day-to-day operation of monetary policy and, more generally, that the government would not be drawn into commenting on monetary policy. A legislative approach would also allow the incorporation of more fundamental changes to current institutional arrangements, including changes to the composition and role of the Board, and the government's ability to veto Board decisions. However, the paper agreed that fundamental changes, such as those mentioned, would have to be considered very carefully. (Fraser annotated that he would oppose the legislative route: 'I don't see any need for contemplating legislative changes for the purposes indicated', and, in any case, he doubted that most of the proposals mentioned would require legislative change).

The Treasury concluded that, on 'a pragmatic basis', the advantages of the non-legislative route would probably outweigh the disadvantages. Even if changes were made to the Reserve Bank Act, it was likely that the operational aspects of the conduct of monetary policy would have to be set out in an agreement between the Governor and the government along the lines of present practice in New Zealand. However, such an agreement – which the Treasury thought would be 'very significant in addressing perceptions about a lack of "independence" by the Reserve Bank – would not depend on changing the legislation.' (Of the claim that such an agreement 'would be very significant', Fraser annotated that he 'would dispute this – both whether it would be significant and whether it would be desirable').

Fraser's Reply to Evans

In his reply to Evans on 23 February, Fraser admitted that he was 'attracted to some particular aspects' of what the Treasury was proposing, and was 'relatively relaxed about some others' (RBAA, BM10-Treasury 1996-1999). Even so, he expressed 'a general unease about the main thrusts in the paper, especially the promotion of the primacy of the inflation objective in the conduct of monetary policy, and the preoccupation with "perceptions" of (or lack of) Reserve Bank independence'. He mentioned that there were a number of other comments he would like to make which, he admitted, 'may sound a little heretical coming from a central banker (and will not be shared fully by all my colleagues here), but they do reflect views built up (I think objectively) over the past six years or so'. On the question of the Bank's independence, he thought that while much had been said and written about its role in enhancing a central bank's anti-inflation credibility, he believed that 'the whole credibility argument is overstated; I doubt that credibility as such counts for much unless it is backed consistently by appropriate monetary policy action, which is what really counts'. He

informed Evans that he considered the Reserve Bank to be 'a good deal more transparent and more independent, than is inferred…in your paper'. Above all, he was 'not in favour of attaching explicit priority to the inflation objective. Heresy perhaps, but I like the twin objectives approach; I believe also that the relative priority of objectives does and should change over the course of the cycle, as we have seen clearly in Australia (and elsewhere) in the 1990s.' He agreed that 'price stability should be seen as a medium-term objective – that is why our inflation target is formulated in the terms it is'. But he doubted that 'it will do much to enhance the independence of the Reserve Bank to have the government make "clear" to the Bank what its prime objective should be, i.e. for the government to interpret the Bank's Act for it'.

On the other hand, Fraser was quite relaxed about releasing additional 'in depth analysis' of the factors bearing upon current and prospective inflation. The Bank, he pointed out, had been 'progressively expanding the inflation story in the quarterly article on the economy in our *Bulletin*', and the intention was 'to go on expanding this story whenever we have something worthwhile to add'. But he would 'prefer to follow the route of expanding the story in the *Bulletin* (and in the Annual Report), rather than issue separate inflation reports'. He was similarly agreeable about the Governor appearing twice a year before a 'suitable' parliamentary committee, but one of the difficulties the Bank had encountered in the past was finding an appropriate committee for the Governor to appear before. Another was the labour-intensive nature of the effort that had to go into preparing for such appearances. Furthermore, he was 'strongly against the Bank publishing detailed (e.g. quarterly) inflation forecasts'. Though he thought the Bank's 'track record in this area might be improving', it could 'still get things quite wrong'.

Of the current arrangements regarding the *ex officio* membership of the Secretary to the Treasury on the Board of the Bank, Fraser informed Evans that he would continue to support the inclusion of the Secretary, 'provided, of course, that that position continues to be filled by a person "of decency and integrity", and not by a political appointee (as happens in a number of countries)'. In fact, he wanted the current structure of the Board to be retained. More generally, he saw little benefit to be gained by amending the Bank's legislation. Given that the Opposition had now made it clear that it would not attempt to alter the Reserve Bank Act were it to win government, Fraser thought that 'opening up legislation without good cause risks generating unintended (and even counterproductive) results'. The Opposition had endorsed the inflation target, and he saw 'no need for a public agreement to explain…the "primacy" of the inflation objective and, less strongly, the proposal for special inflation reports'. Nor did he see the 'need for a public agreement to explain that the Governor will appear twice a year before Parliamentary Committees, or that the Bank "had responsibility for the day-to-day operation of monetary policy".'

Fraser conceded that his comments might seem to be 'unduly negative and/or sensitive'. Given the public commitments made recently by the Opposition regarding the Reserve Bank – in particular, that it would not seek to amend the Reserve Bank Act - he repeated what he had already told Evans privately, namely, that he would prefer 'to let sleeping dogs lie. If we were to have a new Treasurer', he said, 'I would like to try to build quietly on the progress that has been occurring'. To that end, he provided a number of suggestions that he thought might be helpful. One was to dissuade the government from issuing press releases at times of interest rate changes, leaving that responsibility solely to the Bank. It would be useful, he

thought, were the government frequently to declare its commitment to the 2-3 per cent inflation target, and acknowledge the existing legislation, which gave the Bank responsibility for conducting monetary policy. He also wanted to see a more 'disciplined ministerial inclination to speculate on interest rate changes'. But it was unreasonable, he thought, 'to expect Treasurers to refrain from commenting publicly on monetary policy', regarding the present Treasurer (Ralph Willis) as having 'carved out a good model during his term as Treasurer which, with a couple of refinements, would also serve us well in the future'. In Fraser's opinion, it was 'not a matter of trumpeting these things in a public agreement, and certainly not in legislation. Rather, it is a matter of quietly doing them'. After all, as he put it, 'performance is what really matters'.

The Statement on the Conduct of Monetary Policy, August 1996

When he attended the Board meeting on 30 July 1996, the Treasurer (now Peter Costello) indicated that it was the government's intention to issue a statement confirming the Bank's independence to conduct monetary policy according to the inflation target of 2-3 per cent. At a press conference on 14 August, he announced that Ian Macfarlane would be the next Governor, taking up the position on 18 September 1996. The Treasurer also mentioned that he was releasing forthwith an 'exchange of letters' – in effect, the Statement on the Conduct of Monetary Policy - between himself and the Governor (designate), the purpose being 'our mutual desire to develop a better understanding both in Australia and overseas of the role of the Bank and its relationship with the government'. Concerning the 2-3 per cent inflation target, he said 'the Bank itself, and I want to emphasize this point, the Bank itself set the 2-3 per cent underlying inflation objective. It started off as an unofficial target, and then it became an official target. I'm not sure that the previous government ever officially endorsed it but certainly Treasurer Willis used to talk about it as something the government itself agreed with. We, as an Opposition, endorsed it, and now what we do is we reduce it to writing in this statement'. (RBAA BM10-Treasury 1996-1999).

Asked why Australia was not adopting the New Zealand model with its hard-edged inflation target, the Treasurer said he thought it 'was too inflexible. I think this is an advance in Australia, but it preserves enough flexibility. New Zealand's is a formal contract. New Zealand has the 0-2 per cent target, and recently when the target was breached and nothing happened under the contract, people were scratching around saying, well what was the purpose of that contract. I think this is more realistic. It allows a little more flexibility but as I say in the, or as we say, in the last paragraph of the statement, "we recognize that it's the outcomes not the arrangements that are ultimately going to measure the quality and the conduct of monetary policy".' The Treasurer was also asked whether the target might be altered in the future and, if so, by whom would it be changed. In reply, the Treasurer said that he hoped 'it's a firm target and it's understood to be a firm target. After evolving to that situation over a long period of time and after actually meeting that target, I hope it's understood that that is the target and we are committing ourselves to it and the Bank is committing itself to it'. He stressed that the target was meant to apply 'over the cycle…and when you get strong growth, you might exceed that target. That's alright, as long as you don't exceed it by too much, as long as you bring it back over the course of the cycle, and it gives you a little bit of flexibility in relation to that'. He added that he did not 'think the Reserve is going to change it…after taking so long to get to this target, I don't think it is

going to change it and I don't think it's going to change it now that the government's actually come on board and formally endorsed it'.

The Statement on the Conduct of Monetary Policy began by expressing the hope that it would 'contribute to a better understanding both in Australia and overseas of the nature of the relationship between the Reserve Bank and the government, the objectives of monetary policy, the mechanisms for ensuring transparency and accountability in the way policy is conducted, and the independence of the Bank'. In short, it was to be regarded as a record of common understanding on key aspects of Australia's 'monetary policy framework', including 'the operation of monetary policy in Australia', and the respective roles and responsibilities of the government and the Bank. Of the three objectives set out in the Bank's charter, the Statement declared that they allowed 'the Reserve Bank to focus on price (currency) stability while taking account of the implications of monetary policy for activity and, therefore, employment in the short term. Price stability is a crucial precondition for sustained growth in activity and employment'. It went on to state that both the Bank and the government 'agree on the importance of low inflation and low inflation expectations. These assist businesses in making sound investment decisions, underpin the creation of new and secure jobs, protect the savings of Australians and preserve the value of the currency'. It observed that in 'pursuing the goal of medium term price stability the Reserve Bank has adopted the objective of keeping underlying inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short run variation in underlying inflation over the cycle while preserving a clearly identifiable benchmark performance over time'. It announced that the Governor (designate) was taking 'this opportunity to express his commitment to the Reserve Bank's inflation objective, consistent with his duties under the Act', and for its part 'the Government indicates again that it endorses the Bank's objective and emphasizes the role that disciplined fiscal policy must play in achieving such an outcome'. It was recognized that monetary policy 'needs to be conducted in an open and forward looking way because policy adjustments affect activity and inflation with a lag and because of the crucial role of inflation expectations in shaping actual inflation outcomes. In addition, with a clearly defined inflation objective, it is important that the Bank report on how it sees developments in the economy, currently and in prospect, affecting expected inflation outcomes. These considerations point to the need for effective transparency and accountability arrangements' (https://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-1-14081996.html).

The Statement acknowledged that the Bank in recent years had taken a number of steps to ensure that the conduct of monetary policy was more transparent. Policy changes involving the cash rate and the reasons for changing it were now publicly announced and explained. The Bank had expanded the range of information it released to the public on the economic outlook and other matters concerning monetary policy, in public speeches by senior officers and in its quarterly report on the economy and financial markets. It noted that the Governor (designate) would lend his support to further releases of information, including information every six months on the outlook for inflation. It was also made clear that the Governor (designate) would make himself available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Financial Institutions and Public Administration. The Treasurer, the Statement noted, had expressed his support for these arrangements, 'seeing them as a valuable step forward in enhancing transparency and accountability in the Reserve Bank's conduct of monetary policy and therefore the credibility of policy itself'. Both the government and the Bank recognized that 'outcomes, and not the

arrangements underpinning them, will ultimately measure the quality of the conduct of monetary policy'. The government would no longer make parallel announcements of changes in the cash rate, the expectation being that this would 'enhance both the perceptions, as well as the reality, of the independence of Reserve Bank decision making'. However, the government would reserve the right 'to comment on monetary policy from time to time'.

Conclusion

The Bank's Annual Report for 1996-97 noted that the Statement on the Conduct of Monetary Policy 'endorsed the objective of keeping underlying inflation between 2 and 3 per cent, on average'. It added that, in 'one sense, the Statement was a continuation of what was becoming apparent under the previous government and hence showed the degree of bipartisan support for the Bank's approach.' All the same, it was 'a very important clarification that has dispelled suspicions about the Australian monetary framework, particularly on the part of some overseas institutions and investors' (RBA 1997, 8).

As for the Bank's inflation target and the monetary framework associated with it, there is general agreement that it has been a success. Between 1992 and 2017 the average rate of underlying inflation has been 2 ½ per cent, the mid-point of the inflation target. Not only has the rate of inflation returned to the low levels of the 1950s and 1960s, but there has been a remarkable absence of price volatility. Nor have these outcomes been at the expense of activity and employment. On the contrary, Australia since the introduction of inflation targeting has not experienced a recession, defined as two consecutive quarters of negative growth. Twenty-seven years have now elapsed since the last recession, apparently a world record. If results, rather than words, is the measure of success in monetary policy, the Reserve Bank's inflation targeting regime must be judged a success. Certainly, in the story of the Bank's transformation over the quarter of a century from the mid-1970s to the late-1990s, the adoption of inflation targeting looms large. Whatever the judgment might be about the Bank's overall performance, the adoption of inflation targeting in Australia was the result of an evolving process stimulated by several forces, among them a firm commitment by the Reserve Bank to put an end to high inflation, once-and-for-all.

Notes

[1] In 1996, however, Debelle wrote that 'in 1994, the Reserve Bank adopted a…soft-edged inflation goal…The goal is to maintain underlying inflation around 2-3 per cent over the course of the cycle.' (Debelle 1996,64).

[2] It might be noted that, in his 'One Nation' statement, released on 26 February 1992, the Prime Minister (Paul Keating) stated that '[k]eeping inflation low, and convincing people that the government is determined to keep it low, is the most effective way of providing the stable and vigorous economic climate that will improve the competitiveness of Australian industry, allow sustainable reductions in interest rates and encourage investment. Locking in inflation is an essential pre-condition if growth is to be sustained over an extended period' (Paul Keating 1992*,* 117).

[3] The question of when inflation targeting was introduced in Australia came under scrutiny in the Bank during 1996. On 15 January 1996 a journalist (Lee Theodoros) contacted the Bank to ask when it first announced a 'specific underlying target of average 2-3% p.a.' The following day the Deputy

Governor (Ian Macfarlane) asked the Bank's Deputy Secretary (Judy Butlin) what information had been supplied to the journalist. Butlin said the Bank's Information Office (K J Broadhead) had referred the journalist to several publications, including the Bank's Annual Reports, Press Releases and *Bulletin* articles. Broadhead, in a diary note, said that he had informed Theodoros that a Press Release of 30 July 1993, which had signalled the last policy easing, 'appears the first in which a target of "within a 2 to 3 per cent range" was suggested, but the tightening on 17/8/94 appears the first in which it was made explicit in a P[ress] R[elease].' Neither of these press releases, however, used the words inflation 'target' or 'goal', though the wording in the 17 August 1994 press release was far stronger than the wording used in the press release of 30 July 1993. In an annotation to Broadhead's diary note, Butlin wrote that Macfarlane 'wants that sort of question referred to EC [Economic Group] (i.e. not a reference to a single BWF [Bernie Fraser] speech') (RBAA, SD96-D0003). In a note headed 'A Brief History of Australia's "2-3" Inflation Objective', dated 29 January 1996, Jacqui Dwyer of the Economic Analysis Department, stated that the 'first articulation of the objective was made in September 1992 [sic. August 1992], in a talk by the Governor in which he stated that since inflation had been reduced faster than predicted, and that inflation expectations had been reduced, with continued policy vigilance there was no 'reason why the current underlying inflation rate of 2-3 per cent cannot be sustained'. With the steady fall in inflation during the early 1990s, Dwyer wrote that 'the Bank and the government emphasised the need to make this reduction a lasting change. Adoption of an explicit objective was considered necessary for this achievement'. The 'process of raising the 2-3 per cent objective in public discussion', she added – quoting the phrase used the previous year by Stevens and Debelle in their paper presented at the Bank of England's conference on inflation targeting – 'has been "evolutionary", rather than "revolutionary".' Dwyer further explained that 'statements [referring to an inflation objective] made during 1994 received increasing prominence and were used in explanations of increases in interest rates in the second half of the year. Since early 1995, reference to the inflation objective has occurred routinely in the [Reserve Bank] *Bulletin*, and in public statements by the Governor' (RBAA 16/1651). Between Theodoros's enquiry on 15 January 1996 and Dwyer's note on 29 January 1996, Charles Goodhart wrote to Macfarlane on 20 January 1996 asking when Australia introduced inflation targeting. Goodhart explained that he was writing a chapter on the international adoption of inflation targeting for a book to commemorate the Banco de Espana's 140th anniversary. Macfarlane answered saying that '[w]e have had one since 1993'. In the chapter of the book, which Goodhart co-wrote with Alvaro Almeida, the text indicated that Australia announced an inflation target in 1993, but in a footnote the authors admit that it 'is difficult to determine precisely the date of the announcement of inflation targeting in Australia'. They conclude, however, that, '[f]or the exercises that require the use of the announcement date, we assumed it to be 1/1/1993' (RBAA 07/10052).

[4] International agencies, however, taking their cue from Australian authorities, have noted that inflation targeting began in 1993. The IMF's dating for the start of inflation targeting in Australia is April 1993 (Roger Scott and Mark Stone, 'On Target? The International Experience with Achieving Inflation Targets', IMF Working Paper (WP/05/163), August 2005. Also Guy Debelle, 'Inflation Targeting in Practice', paper prepared for the Asia and Pacific Research Department of the IMF, March 1997 (IMF Working Paper 97/35, Table 1), indicates that Australia adopted inflation targeting in 'approx. April 1993'. The Bank for International Settlements (Annual Report for 1995/96, Basel, June 1996), also lists Australia as having first announced an inflation target in 1993. The Governor of the Bank of Thailand (BOT), Dr. Prasarn Trairatvorakul, in welcoming Glenn Stevens at the BOT Policy Forum on 12 December 2012, mentioned that the Reserve Bank of Australia was 'considered a pioneer among central banks as it adopted inflation-targeting in 1994.' In his speech at the BOT, Stevens said 'Australia adopted IT in 1993'!

Archival Material

RBAA – Reserve Bank of Australia Archives

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