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Reserve Bank Review

Submission

Adam Smith argued for strict control of banking with strong bank supervision. He knew that "a small group of bankers with corrosive moral sentiments could ruin the entire economy".[1]

David Richardson

October 2022

[1] Vandemoortele J (2013) “inequality and Gresham’s Law: the bad drives out the good” *Background paper prepared for the UN Country Team in China*. https://www.un.org/en/development/desa/policy/news_events/dps_paper_vandemoortele.pdf

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Summary

The Australia Institute is pleased to make a submission to the review into the functions and operations of the Reserve Bank of Australia (“the RBA”).

Subsection 10(2) of the *Reserve Bank Act 1959* (hereafter “the Act”), which sets out the objectives of the RBA, specifies:

> It is the duty of the Reserve Bank … to ensure that the powers of the bank … are exercised … as will best contribute to:
>
> (a) the stability of the currency of Australia;
>
> (b) the maintenance of full employment in Australia; and
>
> (c) the economic prosperity and welfare of the people of Australia.

In the 63 years since the Act was passed, the role of the RBA has evolved and changed to the extent that we believe these objectives need reinforcing, updating, and expanding. It is worth stressing that there is no explicit mention of inflation in the objectives above. The phrase “the stability of the currency of Australia” could be interpreted as including inflation, but even if one accepts this argument, there is nothing to hint at a specific inflation target.

Despite its legislation, the RBA’s main objective today is fighting inflation and our assessment is that the outcomes have been poor. Its target of 2 to 3 per cent have been consistently missed over the last decade. We submit that the RBA has been using the wrong tools to fight inflation. It acts as if there is excess demand, especially in the labour market, and assumes that the appropriate approach is contractionary policy.

In that respect it has adopted features of neoliberalism including the use of the non-accelerating inflation rate of unemployment concept, a rate of unemployment to which the economy is automatically headed. In practice this amounts to assuming the economy is not far from the equilibrium rate of unemployment. From this the RBA can then claim it is not worth targeting unemployment and can instead concentrate on inflation. Another aspect of this approach is being overly concerned about inflation expectations taking off among the workforce. Neoliberal models stress inflation expectations when business and workers are assumed to have more equal bargaining power.

The economic power enjoyed by big business is ignored in the RBA’s thinking. This suits the business interests that dominate the board of the RBA. Indeed, we argue that an important reason for the RBA’s bias towards business is the composition of the Reserve Bank board. The perception is that, under the guise of independence, business interests have captured the RBA. A good example was the RBA acting as apologist for big bank profits. Reforms to

the RBA are needed to overturn its undemocratic nature. There is also a case for limiting senior staff movements between the private finance sector and government, including the RBA.

There are important issues involving the RBA's strategic management of the banking and payments systems. A big part of change in the RBA culture includes ending the dominance of business interests in the board of the RBA. Business interests are never going to accept that Australia's uncompetitive and concentrated industry structure is part of the problem in transmitting inflation to Australian consumers. To achieve this the RBA board, which is currently dominated by business representatives, should be reconstructed to better reflect the community.

We point out that interest rate changes hurt ordinary households and so recommend that the use of monetary policy based on interest rate movements be used sparingly, rather than being a first-line method to impose austerity or provide economic stimulus. In addition, effort should be put into mitigating the effects of inflation rather than just fighting inflation. Simple indexation protects most people who receive government support and similar arrangements could apply to other income recipients.

The RBA sits on top of a banking structure that is uncompetitive and making excessive profits at consumer's expense. This is in part because the banks dominate the payments system. The RBA has made minor gains against the power of the banks, for example, it reduced the interchange fees on bank cards, but the RBA should be exploring and reporting on alternative models such as structural separation of the payments system and lending functions. The RBA offers banking facilities to government and the banks and there is no reason why those should not be extended to individuals as argued by the *Economist* magazine.

The conservative bias of the RBA is also evidenced by the almost complete lack of interest in international financial arrangements and whether these are fit for purpose. There are a host of calls for reform of a system which has the US dollar at its centre, and which is biased towards hurting deficit countries and ignoring surplus countries. The RBA, representing a medium power economy, should be leading discussion about the Washington consensus and how it might be reformed. An urgent topic is the appropriateness of monetary arrangements in the South Pacific economies and the challenge of the belt and road initiative.

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Introduction

The Australia Institute is pleased to make a submission to the review into the functions and operations of the Reserve Bank of Australia (RBA).

Sub-section 10(2) of the Reserve Bank Act 1959 reads in part:

> It is the duty of the Reserve Bank Board… to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia and that the powers of the Bank … are exercised in such a manner as… will best contribute to:
>
> (a) the stability of the currency of Australia;
>
> (b) the maintenance of full employment in Australia; and
>
> (c) the economic prosperity and welfare of the people of Australia.[2]

Those objectives have been in place since 1959, about the time when television was introduced in Australia and well before the Beatles. Indeed, the targets themselves, subsection 10(2) paragraphs (a), (b) and (c), were expressed in exactly the same way in the *Commonwealth Bank Act* 1945, 77 years ago.[3] We think these objectives may need updating and expanding as we suggest below. However, the important point is that the RBA has drifted a long way from these objectives.

Arguably, the RBA's most prominent role today—or, at least, the public perception of its most prominent role—is fighting inflation, and since the early 1990s, specifically, keeping inflation between 2 and 3 per cent. However, it is worth stressing that there is no explicit mention of inflation in the objectives above. The phrase "the stability of the currency of Australia" could be interpreted as including inflation, but even if one accepts this argument, there is nothing to hint at a specific inflation target.

We argue below that, in practice, the full employment objective has been replaced by an unobservable variable, the so called "non-accelerating inflation rate of unemployment" (NAIRU). This submission shows how pursuit of the NAIRU concept has resulted in cruel economic policy with high unemployment in our recent past.

Sheila Dow has pointed out that there has been a "major rethinking of the role of central banks, with attention shifting from inflation targeting to financial stability and further to

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[2] Austlii (no date) *RESERVE BANK ACT 1959, Compilation October 2020*, http://classic.austlii.edu.au/au/legis/cth/consol_act/rba1959130/

[3] The RBA was created from the central banking activities of the Commonwealth Bank.

economic stability and social stability."[4] However, that shift in emphasis is perhaps less evident in Australia. Arguably there should be a greater emphasis on financial, economic and social stability which would be more in keeping with the original objectives of the Act.

The conventional wisdom is that central banks have a comparative advantage in fighting inflation while other policy levers/mechanisms may be better at addressing other objectives. This view about inflation fighting likely reflects old and outdated theories such as the quantity theory of money.

In a world of administered prices, industrial concentration, "sticky wages" (down and up)[5] and endogenous money (mediated by private financial institutions) it is certainly not clear that central banks have the advantage as inflation fighters. In this regard we note that it is interest rate changes that are now the major policy tool, and, in practice, these tend to operate similarly to tax changes.

Earlier textbooks put the view that interest rate changes would influence investment which was thought to be sensitive to interest yields on alternative assets. Now we are used to thinking of interest rate changes as chiefly affecting the cash flows of homeowners/buyers and so changing consumption. The RBA's own research suggests investment is not responsive to interest rate changes. Rather there is acknowledgement that monetary policy works through its impact on the cash flow of indebted lower and middle income households.

In this submission we stress the dangers in monetary policy in terms of its impact on lower and middle income groups. We do not share the confidence in monetary policy as the preferred inflation fighting tool. Indeed, in some circles monetary policy is seen as the preferred method of short-term stabilisation policy generally. For all the reasons outlined here we think it best monetary policy be de-emphasised, and stabilisation policies take other forms such as counter-cyclical spending on infrastructure and other public works and services.

Our submission will elaborate on these and related views and draw out their implications for how the RBA might be restructured. There is a lot to be discussed and some issues will inevitably be given less treatment than they deserve in this submission. However, the Australia Institute would be prepared to follow up with oral evidence if the Review so wishes. Having said all that, this submission first turns to discuss the recent experience with inflation targeting.

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[4] Dow S (2020) "Money, finance and the role of the state", in Dunn B (ed) *A research agenda for critical political economy*, Cheltenham: Edward Elgar, pp47-60.

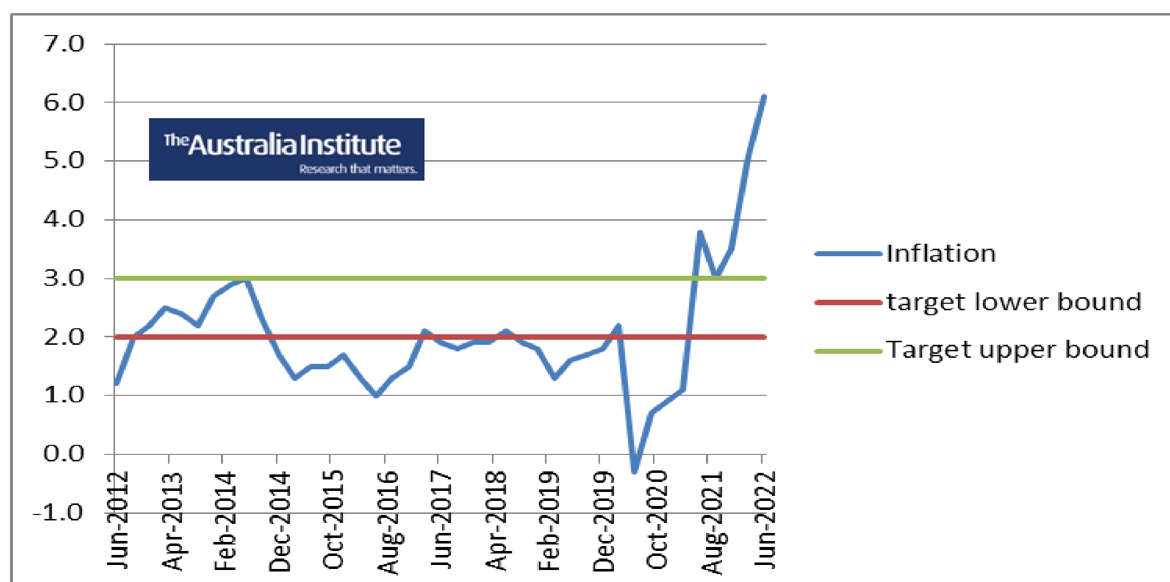
[5] "Sticky wages" refers to the tendency for wages to resistant to change in the short term. For example, wages are subject to three year agreements with incremental changes that are not due for renegotiation until the duration has elapsed.

Hitting targets

The introduction mentioned that the main function of the RBA is still regarded as one of fighting inflation. The monthly press releases following board meetings have been making it clear that inflation is the dominant concern of the RBA.[6] As is well known, in recent decades the RBA has been given a target of two to three per cent inflation. As mentioned in the introduction, this target is not in the legislation but an additional feature in recent decades. There is perhaps some acknowledgement of the full employment target when the Governor of the RBA, Philip Lowe, said "without price stability, it is not possible to achieve a sustained period of low unemployment."[7]

In Figure 1 we attempt to see how well the RBA has performed in terms of achieving the inflation target. Figure 1 shows the annual increase in the all-cities CPI since June 2012.

Figure 1: Inflation and the RBA target range, % annual change.



Source: ABS

Figure 1 shows that the target has been consistently missed, especially since late 2014. This indicates one or more of the following

- The targets are irrelevant because the RBA would rather aim for other targets,

[6] As this is being written the most recent is Lowe P (2022) "Monetary policy decision", Media Release, 1 November at https://www.rba.gov.au/media-releases/2022/mr-22-36.html.

[7] Lowe P (2022) "Inflation and the Monetary Policy Framework", *Speech to the Anika Foundation,* Sydney, 8 September.

- The RBA does not have the appropriate tools or skill for giving effect to inflation targets, and/or
- The real world does not behave the way the RBA thinks it does.
- Forecasts are wrong and
- The expectations of how the economy reacts to the RBA's actions are wrong.

Our view is that all of the above are interrelated and confirm the impression that the conventional wisdom of the central bank being the "best" at fighting inflation is no longer correct, if indeed it ever was. While the RBA consistently missed the target, we do not think it any consolation to say that the average inflation was within the target over a lot of the period shown in Figure 1. That is what the Governor, Philip Lowe, suggested when he said: "Delivering medium-term price stability is fundamental here. Since the early 1990s, our operating definition of 'price stability' has been that inflation averages 2 point something per cent."[8] It is not much help to say the average position of a pendulum is vertical. But if the average is important then it is worth asking why the RBA seems so concerned about the current spike in prices following the invasion of Ukraine.

For all those years when inflation was below the target range, we would have to say that the RBA failed to meet the target. This may confirm the observation of Sir John Hicks that using monetary policy to stimulate things is like pushing on a piece of string. Hicks said "you cannot push on a string—an increase in the supply of money cannot be relied upon to cause real or inflationary expansion".[9]

While the RBA target has been expressed as a range, one cannot help feeling that the real objective is to keep inflation as low as possible but tolerate outcomes within the stated range. RBA behaviour suggests this is a more accurate description of its actions. There is never the same urgency about missing the target when inflation comes in too low compared with when it comes in too high. It has to be added that the press and other commentators have rarely complained when the inflation results fell below the target.

This interpretation of the RBA target is consistent with the original objective when, in 1993, then Governor Bernie Fraser said:

> Ideally, we would like…to see inflation kept low enough so as not to bias behaviour in these costly ways. Putting numbers on that definition is a matter of judgment… My

[8] Lowe P (2022) "Inflation and the Monetary Policy Framework", *Speech to the Anika Foundation,* Sydney, 8 September.

[9] Cited in Harris L (1969) "Professor Hicks and the foundations of monetary economics", *Economica*, Vol. 36, No. 142, May, pp. 196-208.

> 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.[10]

Thirty years on it is not clear what Mr Fraser might think now.

The reference to biasing behaviour reflects the view that inflation changes people's behaviour and so should be kept as low as possible. In 1993 Australia was suffering the aftermath of the 1991 recession and the history of inflation of around 10 per cent in the decade prior to the recession. Hence the passage can be interpreted as a target of inflation as low as possible but tolerating 2 to 3 per cent. But of course, the conditions today are vastly different from those in 1993 and the thinking then should be no guide for the present.

We might add that the early 1990s experience was one of engineering a severe recession in the fight against inflation—something that should never happen again.

The inflation target needs to be rethought. Is it still appropriate to go for inflation as low as possible but tolerate 2 to 3 per cent? How should targets adapt to or respond to other developments in the economy? If targeting is still warranted why not legislate them? Moreover, have the right tools been used to fight inflation? What about the collateral damage with respect to unemployment, the income distribution, and so on?

Recommendation: The RBA should adopt a policy of low inflation subject to success in delivering its other legislated targets including, of course, full employment. The RBA's key performance indicator should be the performance of the economy overall.

[10] Cited in Jericho G (2022) *Inflation: A Primer*, Centre for future work, October.

Central bank guidance

There was once a debate on the sort of guidance that central bankers should provide about their plans for the future. There had been a lot of focus on the assurance by the RBA that interest rates would not rise until 2024. In the monetary policy decision of 2 November 2021 Philip Lowe said:

> The Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. This will require the labour market to be tight enough to generate wages growth that is materially higher than it is currently. This is likely to take some time. The Board is prepared to be patient, with the central forecast being for underlying inflation to be no higher than 2½ per cent at the end of 2023 and for only a gradual increase in wages growth.[11]

That form of words and, importantly, setting the date before any increase in interest rates at 2024, or late 2023, had been used by the governor since at least the December 2020 monetary policy statement.[12]

In a 2021 speech to business economists Philip Lowe elaborated on the words in the monthly monetary policy statements and said

> In terms of the cash rate, the Reserve Bank Board has said that it will not increase the cash rate until inflation is sustainably in the target range. It is hard to precisely define what 'sustainably in the target range' means. But we want to see underlying inflation well within the 2–3 per cent range and have a reasonable degree of confidence that it will not fall back again. …
>
> our central scenario is that underlying inflation reaches the middle of the target by the end of 2023. If this comes to pass, it would be the first time in nearly seven years that we will be at the mid-point. This, by itself, does not warrant an increase in the cash rate. As I have said, much will depend upon the trajectory of the economy and inflation at the time. It is still plausible that the first increase in the cash rate will not be before 2024.[13]

Lowe did leave himself some wiggle room when he said "It is therefore possible that faster-than-expected progress continues to be made towards achieving the inflation target. If so,

[11] Lowe P (2021) "Statement by Philip Lowe, Governor: Monetary Policy Decision", Media Release No 2021-24, 2 November.

[12] Lowe P (2020) "Statement by Philip Lowe, Governor: Monetary Policy Decision", Media Release No 2020-32, 1 December.

[13] Lowe P (2021) "Recent trends in inflation", *Address to the Australian Business Economists*, Sydney, 16 November.

there would be a case to lift the cash rate before 2024." Nevertheless he reiterated his main point

> Finally, I would like to repeat a point I made a couple of weeks ago – that is, the latest data and forecasts do not warrant an increase in the cash rate in 2022. The economy and inflation would have to turn out very differently from our central scenario for the Board to consider an increase in interest rates next year. It is likely to take time to meet the condition we have set for an increase in the cash rate and the Board is prepared to be patient.[14]

All of this seems to be a pretty blunt set of statements about future intentions. Just as inflation changes people's behaviour so too do statements from the Governor of the RBA. The likely fall out from any future increase in interest rates was obvious given this background. We might have even expected that with such a background the Governor might have expressed some sort of regret at upsetting those expectations. Instead the Governor blamed his audience for not reading the qualifications—the fine print.

Those who suggest central banks should provide more guidance believe that signalling future intentions can ensure that the participants in the market are less likely to be surprised and so more likely to make the best decisions about deploying long lived capital, employing staff and so forth. A good analogy is the need for carbon emissions targets so that business knows what to expect and their plans can be more confidently implemented.

The infamous misguidance from the Governor during the course of the pandemic has to be regarded as an instance where no guidance would have been preferable.

It is likely that there are large differences in the reactions of money market operators compared with ordinary people including those wishing to purchase a house. A serious RBA watcher would have noticed that inflation has rarely been within the RBA's target range of 2 to 3 per cent as was seen earlier in Figure 1. The implied suggestion of a smooth and slow move to the target mid-point was unrealistic as it turned out.

Given that people have made their commitments based on RBA advice there may have been a case for delaying any increase in interest rates until 2024 as promised. If there were persuasive reasons to act earlier those should have been spelt out earlier. For example, if inflation would have been materially worse if monetary policy were delayed a year, that should have been spelt out to Australians. Any cost of delaying should then have been weighed against the costs of upsetting people's plans.

[14] Lowe P (2021) "Recent trends in inflation", *Address to the Australian Business Economists*, Sydney, 16 November, emphasis added.

Recommendation: In making any guidance to the market the RBA should make it clear that it does not know the future and that anything can happen. When commitments are made they should be honoured.

Banker to the government

One of the core functions of central banks is to act as banker to the government. In many respects the government's dealings with the RBA are little different to the dealings most of us have with banks with one big exception. At the present there is a convention that the government does not borrow from the RBA which means the government does not have any credit facilities at the RBA. Hence, the government has to keep large positive balances at the RBA "just in case". For example, at 31 August 2022 the RBA held Australian Government Bonds worth $286.0 billion (Table A3.1) but these are not available for the government to draw on or use as security by the government. So the Australian government still needs positive at-call deposits which were $78.4 billion at 25 May (table A1.1, the most recent dates available for each as this part is being written).[15] Simultaneously the government is borrowing from and lending to the RBA. It would seem more efficient to use deposits to buy back bonds in this case and borrow from the RBA when there is the need. Perhaps overdraft facilities should be provided for that purpose.

Under the present arrangements it is the Australian Office of Financial Management's (AOFM) role to ensure the Australian Government can meet its spending, investment and debt payment obligations. The AOFM forecasts daily government cash flows using advice from agencies such as the Australian Taxation Office, the Department of Finance, and large spending departments (such as Treasury and Defence). These forecasts are the basis on which the AOFM plans its annual issuance (borrowing) program. They are also used to ensure the government always has enough money to make payments. The AOFM must manage all of its operations to account for a range of potential financial market scenarios.[16] As suggested above, there is a case for allowing the government to establish overdraft facilities at the RBA so that the government does not have to plan for the worst in its borrowing program and end up with an unnecessary large deposit with the RBA.

Rationalising government and RBA financial relationships seems to conflict with the present practice of denying credit to government. The Governor of the RBA said: "I want to make it very clear that monetary financing of fiscal policy is not an option under consideration in Australia, nor does it need to be."[17] In saying that, the Governor was ruling out creating money to finance government spending. This is how it might seem to the people in the RBA. But ordinary Australians have no need to worry about the niceties of these institutional arrangements. What they see is that the government (fiscal side) issues government paper

[15] RBA Statistics Tables A1.1 and A3.1 at https://www.rba.gov.au/statistics/tables/ accessed 29 September 2022.

[16] AOFM https://www.aofm.gov.au/about accessed 30 September 2022.

[17] Lowe P (2020) "COVID-19, the labour market and public sector balance sheets", *Address to the Anika Foundation Online*, 21 July at https://www.rba.gov.au/speeches/2020/sp-gov-2020-07-21.html#r2

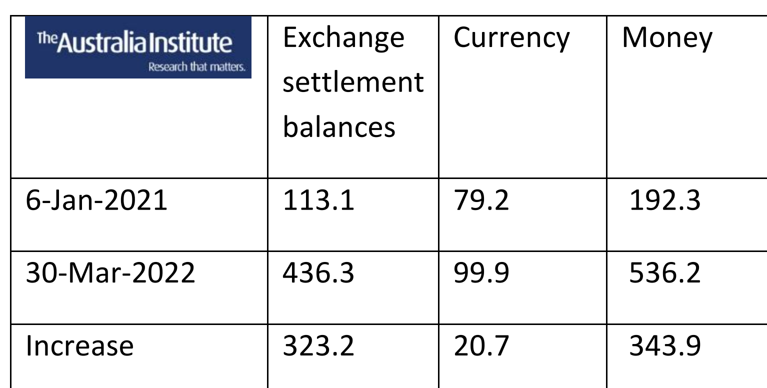
in the form of T bonds and notes. At the same time the government (monetary side) also issues cash. Most of the "cash" happens to be interest bearing deposits that the private banks hold at the RBA.

T bonds and notes and cash are all very liquid and, indeed, the RBA's liquidity management ensures the bonds and notes are liquid, just like cash. Meanwhile all of these debt instruments earn interest, except for physical cash held outside the banking system. So the traditional model that sees some assets as cash and some as not cash breaks down. Indeed, this point goes back at least to the 1959 *Report of the Committee on the Working of the Monetary System* in the UK.[18] The implications are important. From outside government and the RBA, it just looks like the public sector issues liquid liabilities to fund its deficit. It is a bit of sophistry to suggest this is not "monetary financing of fiscal policy".

The idea that the central bank should not lend to government is interesting. It reflects a view that the central bank should be independent[19] and not allow the elected government to do things that the central bank might disapprove of. Elsewhere in this submission we argue that central banks should not be independent and should certainly not thwart the actions of a duly elected government.

Printing money is seen as an alternative to borrowing but the two can be regarded as very similar. For example, money might be defined as currency plus bank deposits with the RBA. We do not have exact figures for bank deposits with the RBA but these are the bulk of the RBA category "exchange settlement balances". Hence the total "money" in Australia is given as exchange settlement balances plus currency as given in Table 1.

Table 1



The Australia Institute Research that matters.	Exchange settlement balances	Currency	Money
6-Jan-2021	113.1	79.2	192.3
30-Mar-2022	436.3	99.9	536.2
Increase	323.2	20.7	343.9

Source: RBA Statistics tables A1 and D3.

The interesting thing here is that what we used to think of as money, central bank liabilities, is mainly held as bank deposits with the RBA. The RBA pays interest on these deposits which

[18] Committee on the Working of the Monetary System (1959) "Report", London: HM Stationary Office.

[19] "Independence" in this context is not absolute. For example, the Treasurer has instructed the RBA to pursue the 2 to 3 per cent target while the government has the legislative power to overrule the RBA in the event of a dispute.

raises the question as to what is the difference between these and the government bonds held by the financial sector. These also attract interest and are highly liquid. These assets can be seen as so similar that the distinction between money and other government paper starts to evaporate. If the only real distinction is the issuer, Treasury or the RBA, then the distinction is barely relevant to holders in the private sector.

Table 1 suggests that the increase in government deficit spending over the pandemic showed up in a $343.9 billion increase in hard money with $323.2 billion (or 94 per cent) of that being the increase in bank deposits with the RBA. So clearly liabilities of the RBA which are considered money are being issued but have not been showing up as increases in currency holdings by the public.

Recommendation: The RBA (and Government) should acknowledge there is no real distinction any more between money and government debt. Old processes and arrangements need to be rethought. The RBA should renounce any outdated notion of denying the government access to funding from the RBA.

Investment banker/funds manager?

At the moment the RBA acts as an investment bank to some extent but mainly confines itself to investing in government securities, not only the Commonwealth government bonds but also securities issued by the States and Territories as well as foreign governments. Foreign exchange reserves are held as government securities issued by foreign governments and the IMF.

At present investment banking and funds management functions are undertaken by the Future Fund (FF) while a number of corporate bodies (NBN Co, Post Office) are independent statutory bodies nominally residing in various government departments. At 30 June 2022 the FF had assets of $242.4 billion.[20]

The Singapore government also has a number of state-owned enterprises (SOEs) but has collected them all into one organisation Temasek Holdings, Singapore's main state holding company, is often held up as a potential model for state-owned firms for other countries.

During the pandemic the RBA's holdings included state government securities as part of a deliberate strategy of keeping them liquid and so making state and territory fund raising more readily acceptable in the market. During times of crisis the RBA and government tend to assist by making sure banks and other authorised deposit-taking institutions remain liquid. That generally involves some sort of lending to the institutions concerned. But we note that other organisations are not favoured by lending from the RBA yet are often hit with instability. Corporate debt is a good example. Those markets almost dry up in uncertain times and that raises the issue about whether the government or RBA should be assisting to keep those borrowers viable and their debt markets liquid. Some of the other central banks acquired private debt during the global financial crisis.

There seem to be valid reasons for the RBA to hold a broader range of assets than is the case at the moment.

Recommendation: The limited categories of assets held by the RBA needs to be rethought so that the RBA's financial management might reflect broader social and economic policies.

[20] Future Fund (2022) *Portfolio update at 30 June 2022*, 31 August, at file:///C:/Users/davidr/Downloads/Portfolio%20update%20to%2030%20June%202022.pdf accessed 30 September. The figure quoted includes the FF itself as well as other funds managed by the FF.

RBA's economic thinking

One of the legislated functions of the RBA is to contribute to the stability of the currency, which we would interpret liberally as referring to the stability of the financial system as a whole. That is especially the case given that currency, if taken to mean physical cash, is less common today as a store of value and a means of payment.

In theory the role of the finance sector is to channel funds efficiently from savers to borrowers and the smaller the finance sector has the more efficiently it is doing its job. Indeed, in *A licence to print money* we made the point that high banking profitability increases the 'wedge' between borrowing and lending rates and so imparts a serious imperfection into the allocation of resources over time.[21] The financial system has grown well beyond borrowing and lending. Over recent decades we have seen massive growth in all sorts of financial engineering and the development of derivatives and other products that were unimaginable 40 years ago. When we then looked at the data, the assets of authorised deposit-taking institutions at the end of June 2013 were 210 per cent of GDP that year and for the financial sector as a whole assets were 356 per cent of GDP. By comparison the off-balance sheet business of the banks was a massive 1521 per cent of GDP. These figures are worth bearing in mind in the context of the too-big-to-fail argument. Indeed, these figures may be more dramatic in recent periods.

It became apparent in the aftermath of the global financial crisis that most people who bought the complex products (eg CDOs) did not know what they were really buying and those that did had off-loaded them or packaged them up and sold them to subsequent buyers who would have had much less information about the nature of the loans. The asymmetric knowledge of the buyers and sellers has meant there is a massive incentive to mislead buyers and disguise toxic assets as top-rated securities—which is exactly what led up to the global financial crisis in the first place. Where there is asymmetric knowledge there is an incentive to exploit it on the part of the party with the greater knowledge.[22] That is why some of the bankers and economists have blamed the global financial crisis on a failure in the regulatory regime. The bankers' complaint has been wittingly paraphrased as saying 'It's your fault: you let us do it!'[23] Certainly the Stiglitz UN Committee has been scathing and essentially blames free market ideology. It is worth quoting in full:

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[21] In principle a narrowing of the gap between borrowing and lending rates makes possible new lending that enables new borrowing for productive uses to the benefit of both savers and investors.

[22] Admittedly banks are sometimes on the other side of the asymmetry when, for example, someone seeks a loan for a project they may know all about but the banks have no way to assess its commercial potential.

[23] Stewart cited in Morgan J and Sheehan B (2014) Information economics as mainstream economics and the limits of reform: what does the Stiglitz Report and its aftermath tell us? *Real-world economics review*, Issue no 66, pp. 95-108.

> …Both policies and economic theories played a role. Flawed policies helped create the crisis and helped accelerate the contagion of the crisis from the country of its origin around the world.
>
> 3. But underlying many of these mistakes, in both the public and private sectors, were the economic philosophies that have prevailed for the past quarter century (sometimes referred to as neoliberalism or market fundamentalism). These flawed theories distorted decisions in both the private and public sector, leading to the policies that contributed so much to the crisis and to the notion, for instance, that markets are self-correcting and that regulation is accordingly unnecessary. These theories also contributed to flawed policies on the part of Central Banks.
>
> 4. Flawed institutions and institutional arrangements at both the national and international level also contributed to the crisis. Deficiencies in international institutions, their governance, and the economic philosophies and models on which they relied contributed to their failure to prevent the crisis from erupting, to detect the problems which gave rise to the crisis and issue adequate early warning, and to deal adequately with the crisis once it could no longer be ignored. Indeed, some of the policies that they pushed played a role both in the creation of the crisis and its rapid spread around the world. All of this facilitated the export of toxic products, flawed regulatory philosophies, and deficient institutional practices from countries claiming to be exemplars for others to follow.[24]

Another observer has noted:

> Since the 1990s the Bank of England and Fed in particular have made use of a Taylor rule framework approach that is, in turn, rooted in a Conventional Theoretical Macro Model (CTMM). The Taylor rule focuses on the manipulation of short term interest rates to maintain stable inflation and economic growth. The Taylor rule framework and the CTMM are problematic in a number of specific and general ways…. Specifically, the combined approach pays little or no attention to broad money, is based in rational expectations and has, in its Bank of England guise, used an extrapolation procedure that has a strong presumption of long term stability.[25]

All the evidence suggests that the RBA shares this uncritical and optimistic view of the working of the modern economy. The RBA does use its informal business contact arrangements to try to get a feeling for business conditions away from Martin Place. There

[24] Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System (2009) *Report*, NY: United Nations, 21 September at http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf accessed 22 January 2014.

[25] Morgan J (2009) "The limits of central bank policy: economic crisis and the challenge of effective solutions", *Cambridge Journal of Economics*, vol 33, 581–608.

seems to be a case for other initiatives to improve the RBA's understanding of the real world.

EQUILIBRIUM AND THE NAIRU

Statements by the RBA either explicitly or implicitly point to them possessing a model of the economy which is constantly heading towards equilibrium in the financial and labour markets in particular and in the economic system as a whole. In such a model shocks can happen but if anything does happen to disturb the equilibrium then forces are set up to restore the equilibrium.

In such a hypothetical model monetary policy is sometimes needed to nudge the economy back towards the equilibrium and, rarer still, fiscal policy may be needed.

The real world continuously violates the model. The RBA's own experience with the conduct of monetary policy must indicate there is something wrong with the model. It is the RBA's own activities that determine the cash rate and there is nothing that suggests some movement towards an alternative equilibrium. Similarly the RBA (and Treasury/Finance) continue to over-estimate future wage movements based on the non-accelerating inflation rate of unemployment (NAIRU) equilibrium model of the labour market.

The NAIRU might be defined as that rate of unemployment at which inflation has no tendency to increase or to decline. For the OECD the NAIRU was defined as "that rate of unemployment which is consistent with stable inflation".[26] According to the theory, if unemployment is lower than the NAIRU, then inflation will accelerate continuously (until unemployment is increased), while if unemployment is greater than the NAIRU, inflation will decelerate. As we will see below, the NAIRU is taken to reflect some sort of real equilibrium in the labour market, and hence it is regarded as an optimal rate of unemployment suggesting in some sense that it is 'better' than any other rate of unemployment.

To appreciate the importance of the issue in Australia, note that the lost production associated with 5 per cent unemployment is of the order of $100 billion per year.[27] *The Economist* tries to explain the concept of the natural rate, and its weaknesses.[28] *The Economist* mentions that even for supporters, volatility in estimates of the natural rate limits its usefulness for policy. Moreover, it points out that 'recent experience has led some to doubt the very existence of the natural rate of unemployment'.

[26] Turner D et al (2001) "Estimating the structural rate of unemployment for the OECD countries", *OECD Economic Studies*, No 33, p 179.

[27] This assumes that a hypothetical zero unemployment would be associated with a 5 per cent increase in Gross Domestic Product (GDP). That figure would be higher if we took into account the waste associated with underemployment and hidden unemployment, as we discuss below.

[28] Economist (2017) 'Economics brief: The natural rate of unemployment', *Economist*, 26 April.

Yet the RBA persists and is often wrong as a result.

"Hysteresis" literally means "the dependence of the state of a system on its history" and refers to the observation that keeping unemployment below (above) the NAIRU actually seemed to reduce (increase) the estimated NAIRU. Hysteresis thereby represents an important qualification if not a critique of the NAIRU. It seems that if we started the post-war era with unemployment at less than 1 per cent but now have a much higher 'natural' rate, we should be able to get back to the lower rates by reversing those increases in structural unemployment: through labour market and education/training programs on the one hand, and better income maintenance on the other hand. Higher aggregate demand would also be a critical factor.

When unemployment is high it is unacceptable to suggest the NAIRU has increased as a result of hysteresis. Such induced increases in structural unemployment are not an inevitable, indeed 'natural' outcome. This seems a particularly perverse conclusion of NAIRU thinking—and should be repudiated in the strongest of terms. Whether or not we accept the natural rate of unemployment, the mechanisms attributed to hysteresis may still be at work and would have important consequences. As Dobrescu, Paicu and Jacob suggest, 'high persistent unemployment might have surprisingly deep consequences, because it leads to an increase in the NAIRU, whereas low unemployment has a beneficial effect, in that it leads to a reduction in the NAIRU'.[29]

This effectively refutes the Friedman idea, or the common interpretation of Friedman, that nothing can be done to influence the natural rate of unemployment. Holding the rate below the natural rate lowers the natural rate itself and so refutes Friedman's argument against policy activism. It also casts doubt on the meaning, and even the existence, of this 'natural' rate in the first place. In short, hysteresis raises the question of whether we should even maintain a concept of a NAIRU that shifts with the state of the economy. The theory of hysteresis has been tacked onto the NAIRU to try and keep the latter concept alive. However, it could be regarded alternatively as indicating the failure of the NAIRU—a failure that throws serious doubt about any policy based on a supposedly optimal and invariant rate of unemployment.

Stiglitz, who is sympathetic to the NAIRU concept, nevertheless concedes that half the mainstream economics profession is hostile to the concept.[30] Just as the rest of the world is becoming more suspicious of the very idea of a natural rate of unemployment, it remains official policy in Australia and has become an influential tool in economic modelling and

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[29] Dobrescu M, Paicu C and Iacob S (2011) "The natural rate of unemployment and its implications for economic policy", Theoretical and Applied Economics, vol XVIII, no 2, p 192.

[30] Stiglitz says many economists are hostile to the NAIRU specifically (not the natural rate), but as we have seen the two concepts are synonymous. See Stiglitz JE (1997) 'Reflections on the natural rate hypothesis', *Journal of Economic Perspective*s, vol 11, no 1, pp 3–10

policy making. However, that official policy is theoretically unfounded, empirically ambivalent, and practically dangerous.

In our view, Joan Robinson was spot on years ago when she described the economy as "lurching" from one rest point to another.[31] The rest points are not unique and there is no necessary movement to any unique point except as might be implied by general macroeconomic consistency. Movements in the macroeconomy are explicable with Keynesian approaches and bottoms up models based on microeconomic theory are inappropriate as well as dangerous and misleading.

On top of the above in the real world we observe financial instability. As Shiela Dow put it:

> Minsky's … financial instability hypothesis rather showed financial instability to be systemic, with stability actually creating the conditions for instability. Stability creates overconfidence in risk assessment (in spite of uncertainty), encouraging increasingly leveraged borrowing fuelling rising asset prices. The fragility so created means that any small reversal in expectations which prompts asset sales sets off a reversal of the whole process.[32]

This is the sort of instability that cannot be modelled. Keynes once said that it is not very useful for economists to point out that once the storm passes conditions will be calm again. The storms also need to be studied.

While on the subject of the NAIRU recall that the NAIRU is supposed to be the unemployment rate at which inflation is stable. The logic of the NAIRU model is that inflation could be stable at any rate of inflation which takes us back to the inflation targeting discussion. So in principle inflation could be targeted at any arbitrary number. What we do not have is any justification of the present target (2 to 3 per cent). It used to be thought that some low level of inflation was a sort of lubricant for the economy. Real prices and relative prices that needed to fall might not need anyone to actually cut nominal magnitudes if underlying inflation is positive. But we do not know the relevance of that argument in the present economic circumstances nor do we know that the present target might be optimal.

Recommendation: The RBA needs to adopt a non-dogmatic and more pragmatic attitude towards the operation of the economy. Episodes of instability need to be intensely studied to draw out lessons for future instability events.

[31] She says "the system will lurch from one short-period position to another". See Robinson J (1959) "Accumulation and the production function", *Economic Journal*, Vol 69 no 275, pp 433-42.

[32] See Dow S (2020) "Money, finance and the role of the state", in Dunn B (ed) *A research agenda for critical political economy*, Cheltenham: Edward Elgar, pp47-60.

THE NAIRU IS ALL OVER THE PLACE

A property of a "correct" or "realistic" view of the economy seems to be that people habituate to recent circumstances, Joan Robinson's "rest points", as is evident in the reaction to recent moves to increase short term interest rates.

The danger with the RBA model is indicated by recent experience with the NAIRU concept. By using a model in which the economy is assumed to be close to equilibrium, a period of rest at high levels of unemployment was taken to indicate that the actual unemployment must be close to the unobservable NAIRU. Hence the NAIRU was estimated to be 8 per cent in the 1990s.[33] Economic policy based on that concept is likely to have been particularly cruel to the unemployed, especially in the 1990s and in subsequent periods as well.

We might add that inflation is seen as an external impact on people's lives and it seems the RBA is producing a benefit in lowering inflation (if indeed it does). However, the consequential unemployment used to fight inflation[34] is not seen as due to the RBA so much as reflecting problems in the individual who experiences unemployment. Moreover, the NAIRU thesis is used to salve the conscience of those in the RBA.

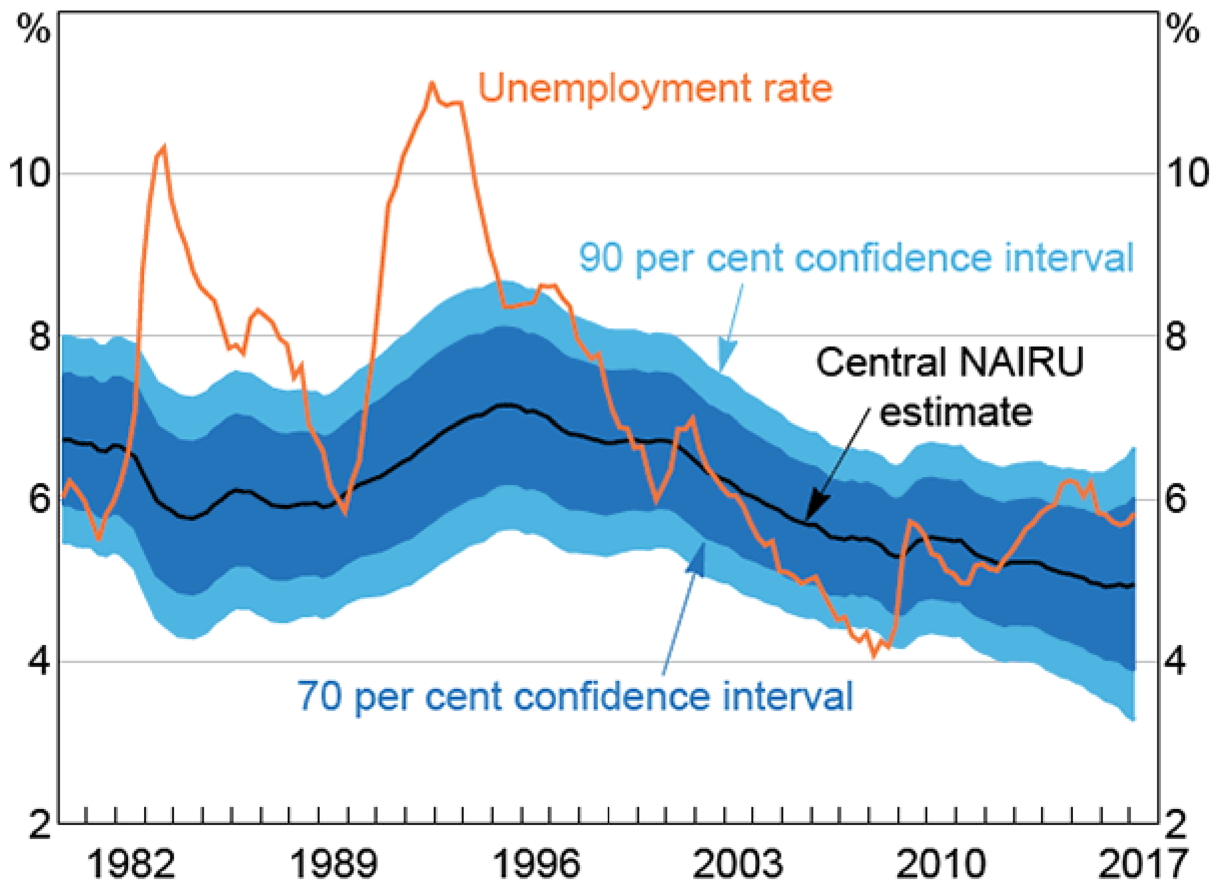
In evidence to the House of Representatives Economics Committee in February 2022 the RBA said the estimate of the NAIRU was in the range "low fours to high threes".[35] This is of course a substantial change from the earlier estimates as is illustrated in the graph taken from a 2017 RBA publication.

Figure 2: RBA estimates of NAIRU.

[33] Richardson D (2019) *Tolerate Unemployment, but Blame the Unemployed: The Contradictions of NAIRU Policy-Making in Australia*, Centre for Future Work (Australia Institute).

[34] Or at least an outcome of the policies used to fight inflation.

[35] Ellis L (2022) "Transcript of evidence to House of Representatives Economics Committee", *House of Representatives Committee Hansard*, 11 February at https://parlinfo.aph.gov.au/parlInfo/download/committees/commrep/25631/toc_pdf/Economics%20Committee_2022_02_11_Official.pdf;fileType=application%2Fpdf#search=%22committees/commrep/25631/0000%22 .



Source: https://www.rba.gov.au/publications/bulletin/2017/jun/2.html

From Figure 2 it is clear that the NAIRU wanders around and tends to follow the lagged unemployment rate. This is not how the NAIRU is supposed to behave. The NAIRU is supposed to be something that does not change, it should be independent of the actual unemployment rate. Figure 2 should have seen the end of the notion of an invariant NAIRU.

As a final point on the NAIRU we want to point out that the obsession with the NAIRU means concentrating on the labour market as the source of any inflationary tendencies. Over time we have seen the price level increase relative to wages with a consequent increase in the profit share of national income. Against that background, demand increases in the last few yeas have allowed producers and other suppliers to increase their profit margins and so contribute to inflation.

We take this up a little more below.

Recommendation: The RBA needs to study exactly how markups and corporate power have changed over the most recent business cycle to contribute to a better understanding of the

recent inflation dynamics. The RBA needs to avoid using hypothetical constructs such as the NAIRU.

NEUTRAL INTEREST RATE

Along with the NAIRU there is the concept of the "neutral rate of interest" and "neutral" seems to be synonymous with "equilibrium", "natural" and so on. Hence Deputy Governor, Michele Bullock, is reported to have said ''We've got to get it up to some sort of concept of what we call the neutral interest rate. We don't know where that particularly is, but we know it's a fair bit higher than where we currently are.''[36] Philip Lowe adds that "The concept of the neutral real interest rate is a useful one – it is the real interest rate that is neither stimulatory nor contractionary."[37] Our experience with the NAIRU is a warning. Any estimates of a "neutral interest rate" are likely to be very volatile and dependent on the business cycle. It was not long ago that commentators were suggesting the clearing rate of interest was negative.

The neutral rate of interest is rooted in some notion of a price (an interest rate) that equalises the demand and supply of funds at the full employment rate. This is sometimes referred to as the loanable funds theory. But the RBA itself knows the theory is wrong. In Australia the RBA itself determines interest rates and, since the pandemic, it witnessed the increase in demand for funds on the part of the government yet the RBA lowered interest rates. The massive increase in the demand for funds came from the government's deficit spending at the same time as interest rates were being lowered. There is also a strong theoretical critique of the loanable funds theory which Joan Robinson has referred to as pre-Keynesian theory after Keynes.[38] This is not the place to dissect the loanable funds theory in detail but to note that the supply and demand for funds is supposed to shadow savings and investment.[39] We now know that it is not interest rates but income that equilibrates savings and investment.

The consequence of loanable funds bthinking is that monetary policy should aim for the neutral rate in times of stability. Interest rates below that would be seen as inflationary. Morgan adds that "interest rate policy … should not in itself be used as an additional source

[36] Reported in Mizen R "Rates have to go 'fair bit higher', RBA deputy says", *Australian Financial Review*, 20 July.

[37] Lowe P (2022) "Inflation, Productivity and the Future of Money" *Address to the Australian Strategic Business Forum 2022*, Melbourne, 20 July.

[38] Robinson J (1964) "Pre-Keynesian theory after Keynes", *Australian Economic Papers*.

[39] To investment should be added government deficits and net imports in a full account. A critique of the loanable funds model can be found in Richardson D (2015) "What does "too much government debt" mean in a stock-flow consistent model?" *Real-world economics review*, No 73, pp 2-15.

of economic growth"[40] That is an interesting comment. Interest rates are used for short-term stabilisation purposes only. But governments often use concessional interest rate mechanisms to advance particular industries. Capital standards in Australia are tweaked to favour housing while concessional finance is available through the Clean Energy Finance Corporation.

Generally, the RBA eschews such things but during the pandemic it committed to hold state government debt in order to keep government borrowing rates low and the market liquid. There is no reason why the RBA might not target particular sectors with low interest rates. Not that long ago the RBA used to engage in exhorting private banks to lend more to such and such a sector and less to others. Effectively it was engaging in some sort of industry/social policy. Below we consider some of the options this opens up.

Recommendation: The RBA should avoid any tendency to think in terms of invariant neutral rates of interest or provide a theoretical and empirical basis for its current thinking.

[40] Morgan J (2009) "The limits of central bank policy: economic crisis and the challenge of effective solutions", *Cambridge Journal of Economics*, vol 33, p 585.

Expectations as explanatory variables

Recently the RBA has said it has been aggressively raising interest rates so that higher inflation expectations do not get a hold in Australia.[41] This view suggests that those expectations are an important determinant of inflation and, also, that people are in a position to act on them. This is another case of the RBA relying on hypothetical variables—variables that cannot be measured but are relied upon as explanatory factors that can cause inflation.

Expectations figure heavily in the neoclassical theory of inflation put by Friedman and Phelps in their critiques of the use of the Phillip Curve as a means of analysing inflation. Inflation expectations are supposed to influence labour market behaviour in particular. Hence if inflation expectations are different to how inflation actually works out then workers will have been fooled into working more or less than they would have had they known better. Workers who are tricked into thinking the real wage is higher than it really is may find they are working longer than they would have wanted had their expectations been more accurate.

The idea that workers' expectations rule seems to be equivalent to the tail wagging the dog. The above description of the way things work is naïve and unrealistic. It does not matter much what workers think inflation might be if they are not in a good position to bargain for higher wages. Government workers in NSW and the Commonwealth have been subject to wage caps and there is very little they have been able to do about it. The bosses may or may not have well founded inflation expectations but they will not offer workers higher wages if they do not have to. Likewise price setters will price according to what the market will bear and in light of their own costs irrespective of how they see other prices panning out.

Recommendation: Discussions about expectations need to include evidence that inflation can be satisfactorily measured and it should be demonstrated that they influence the behaviour of major players in the economy.

[41] For example, RBA (2021) *Statement on Monetary Policy*, November.

Operation of monetary policy

Economists once talked about monetary policy as chiefly using interest rates to influence business decisions to invest. Today discussions about monetary policy tend to concentrate on how changes in the interest rate can have a large impact on the household spending and household balance sheets. The mechanism is that variable interest mortgages require higher payments when interest rates increase and that leaves less left over for spending on other goods and services.

We have come a long way from thinking that the price level is proportional to the volume of money and that changes in the latter smoothly and harmlessly reduce the former. Our understanding these days is that monetary policy works by forcing those with little disposable income to ration their spending out of their income after-tax and after-mortgage payments. This means monetary policy is not a neutral instrument. It works by punishing lower and middle income groups with large debt. Of course, we acknowledge that higher interest rates may also have the opposite effect on so-called self-funded retirees.

We think the damage done by monetary policy is a good argument for keeping it in reserve and using other tools to manage the macroeconomy. It is indicative that high house prices and high debt levels are good for monetary policy because they mean households are forced to make significant changes to their spending in response to higher interest rates.

Recommendation: Monetary policy based on interest rate movements is a crude and harmful mechanism that needs to be used very sparingly. It should be treated as weak as a stimulus and cruel as an austerity tool. Interest rate increases need to be accompanied with an impact statement and an assessment of how the costs to affected individuals is weighed against any benefits from lower inflation.

Alternative approaches to fighting inflation

It is traditionally thought that the appropriate response to inflation is aggregate demand management generally and monetary policy specifically. As suggested elsewhere in this submission, monetary policy is not necessarily better at targeting inflation. To that we might add that other mechanisms may be just as good at controlling prices.

There have been proposals to collect more tax revenue from the fossil fuel miners and use that to subsidise motorists. That is a pragmatic approach that would reduce inflation in Australia. Likewise, government policies such as increasing the subsidy for child care, and cutting drug prices were implemented in the revised 2022-23 budget and should reduce prices for those items.[42] In principle there can also be a contribution by addressing competition and other issues in various retail markets. We have drawn attention to the monopoly profits in the electricity market as another prominent cost of living issue.[43]

During WW2 the US used price controls effectively and again in the wage price freeze under President Nixon. While Australia and other countries also used war-time price controls the US administration under JK Galbraith seems much better known. Many countries use rent controls and other mechanisms in specific markets. Suggestions that similar controls be reintroduced seem very heavy handed to many economists (Australian economists seemed less worried about caps on wages for some reason.[44]) However, the alterative of fighting inflation with unemployment imposes heavy costs on those who lose their jobs. Controls offer an easy way out compared with unemployment such as Australia experienced in the early 1990s.

PROTECTION AGAINST INFLATION

In addition to measures to reduce inflation, attention also needs to be given to improving the protection against inflation afforded to different income groups. Inflation does not have to be fought so much if it's harmful impacts can be addressed. For example, people on government payments, pensions and benefits, receive half-yearly indexation of their

[42] See Chalmers J (2022) *Budget Speech 2022-23* at https://ministers.treasury.gov.au/ministers/jim-chalmers-2022/speeches/budget-speech-2022-23.

[43] See Richardson D (2013) "Electricity and privatisation: What happened to those promises?" *Technical Brief No 22*, April.

[44] Paradoxically the RBA put one of the few objections to governments repressing wage growth in the lead up to the pandemic. Sluggish wages growth contributed to sluggish consumption expenditure and was seen as a drag on the economy.

payments. However, these groups can experience fairly lengthy delays between spikes in prices and compensation through indexation. A move towards quarterly indexation of pensions and benefits would assist in providing more timely compensation for price increases.

At the moment minimum wages are adjusted for inflation and other factors just once a year. Those could be subject to more frequent indexation.

Quarterly indexation was introduced in the 1970s to moderate the wage price spiral which, at that time seemed to resemble the conflicting claims theory of inflation. As it happened, unions at the time found they needed compensation for previous price increases but also needed insurance against future price increases. Quarterly wage indexation provided the latter and so produced a reduction in inflation. There is no reason why quarterly wage indexation should not apply to all wages. In the absence of inflation, a wage bargain would mean a specified real wage. There is no reason why a wage bargain in nominal prices should be able to reduce the real wage, yet that is exactly what is happening and would be easily fixed with quarterly wage indexation.

The RBA might be expected to have most of the expertise in so far as inflation is concerned and might therefore be expected to be in the perfect position to advise on methods to address the impact of inflation on particular income groups.

It was mentioned above that low and middle income earners with debt are badly affected by interest rate increases, especially those with large mortgages. To mitigate the impact on indebted households the RBA should review the housing finance market and the role of the standard variable mortgage. The US, Denmark and France have fixed-rate long term housing loans while in Canada the rates are fixed for 5 years. We think there should be fixed interest loans in Australia reflecting the conditions prevailing at the time people finance housing.

A bank giving fixed rate housing loans may need to fund them with matching fixed rate liabilities. If the RBA loaned money with a 25-year maturity to home lenders it would match the maturity of the standard home loan. That could be done through a special RBA deposit with the home lender. There would be no risk to the home lender If those loans involved fixed interest rates and, in addition, the RBA deposits could be liquidated in the event that the retail customer paid off the loan.[45]

This is one possible model which would insulate debtors from the impacts of monetary policy. However, new home loans would reflect any interest rate changes and so would affect total spending in the economy beginning in the housing market.

[45] If that resulted in excess liquidity in the financial markets there are standard methods of mopping up surplus liquidity in the system.

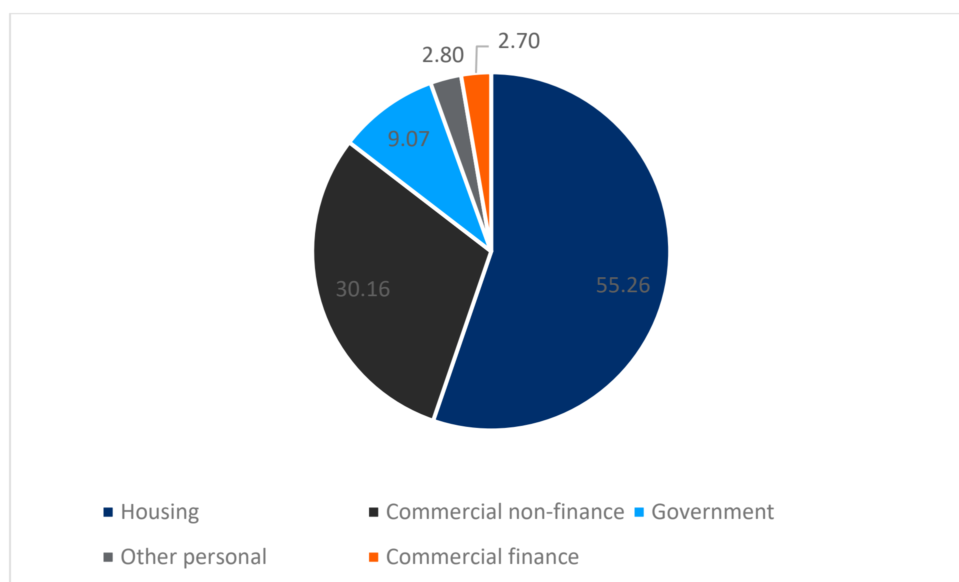
To the extent that everyone is protected against inflation it is much less important that inflation be fought at all!

Recommendation: The RBA initiate a research agenda that considers alternative methods of fighting inflation and the optimal approach to compensating various income groups for the effects of inflation. Where applicable, the RBA should advocate that all contractual forms of income should be subject to frequent indexation. Reforms in the home loan market are needed to insulate outstanding household debt from upward movements in interest rates.

Bank lending by sector

The Australian banking system has increasingly become focussed on individuals and housing. At June 1975 15 per cent of the assets of Australian banks was in housing loans.[46] By June 2022 that figure increased to 55 per cent.[47] Apart from that we have very little information. Commercial lending is split into just two categories, financial and non-financial, and, in addition, we have non-housing personal lending and lending to government. The shares for June 2022 are given in the pie chart at Figure 3.

Figure 3: Bank lending by sector, share of total



Source: RBA Statistics

Figure 3 shows the heavy bias in banking towards housing at 55 per cent compared with commercial lending for the non-finance sector at 30 per cent. By contrast, national accounts data shows that private dwelling investment is 5.3 per cent of GDP while other private investment, that is business investment, is 12.3 per cent of GDP. These figures give the strong impression that bank lending is biased against business investment.[48]

Among other things large volumes of bank lending for housing may be implicated in the high housing prices that make it difficult for new home buyers to enter the market. Banks may

[46] RBA (1998) *Australian Economic Statistics 1949-1950 to 1996-1997, Occasional Paper No. 8* at https://www.rba.gov.au/statistics/frequency/occ-paper-8.html

[47] RBA Statistics at https://www.rba.gov.au/statistics/tables/ Table D5.

[48] We acknowledge that home loans are dominated by second hand purchases which contaminates the results here.

also be encouraging high levels of consumer debt with implications for the stability of the financial system when many households are heavily leveraged.

We do not want to go into a fuller discussion but suggest this needs further study, especially in light of business complaints that bank finance is difficult to obtain. Meanwhile the big banks are increasingly specialising in housing loans from which they derive enormous profits. In that context it may be desirable to encourage banks to increase their lending for business purposes. There needs to be a full assessment of the charge that bank capital requirements encourage housing at the expense of lending to business. Likewise concerns that the banks are more concerned with what they are lending against rather than what they are lending for. Security as represented by housing assets may also contribute to the bias against business.

Too big to fail?

We often hear complaints that modern financial institutions are too big to fail because the consequences would be too severe. Government effectively underwrites the risks involved in financial systems. However underwriting risk creates the moral hazard problem: if banks are insured against downside risk they will most likely want to take more risks. But there is another concern. Banks are trying to change their culture with CEOs and board chairs and members expressing strong concern that these cultural problems are cleaned up. There are a number of researchers now concerned that big companies are too big to monitor and ask whether a group of around a dozen people in 12 monthly meetings can monitor a bank such as the Commonwealth Bank with 45,000 workers.[49] Directors typically face substantial problems in monitoring, which can stem from basic issues like firm size, firm complexity, outside job demands, complexity of those job demands, dissimilarity of those job demands, size of the board, frequency of board meetings, diversity of the board, norms of deference of the board, and power of the existing CEO.[50] One group of researchers have put it:

> most academic research, popular press accounts, and even U.S. legislation all echo the sentiment and deeply held belief that boards should be able to actively monitor and control management. ... Given the research reviewed in this article, we are pessimistic about the possibility of boards being able to effectively monitor managers on an ongoing basis in many circumstances. ... Given the size and complexity of many modern firms, we believe some firms may effectively be 'too big to monitor', and that successful monitoring by boards may be highly unlikely in many large public firms. It might be time to concede that our conception of boards as all-encompassing monitors is doubtful ... Consequently, we believe that future research and theorizing needs to focus on boards as advice-giving bodies, or bodies that get involved in punctuated events, and look to other corporate governance mechanisms to secure monitoring.[51]

If there is so little accountability in one direction and control in the other we have to regard the internal workings of the big company as somewhat anarchistic. Boards may not be 'really equipped to catch or stop misbehavior'. What often seems like directors shirking their responsibilities may instead just reflect the impossibility of really managing big companies. That of course raises very fundamental questions about the proper role of one

[49] https://www.commbank.com.au/about-us/careers.html

[50] Taylor T (2016) 'Corporate boards: Stop expecting the impossible?' Conversable Economist Blog at http://conversableeconomist.blogspot.com.au/2016/06/corporate-boards-stop-expecting.html

[51] Steven Bovie, Michael K. Bednar, Ruth V. Aguilera, and Joel L. Andrus (2016) 'Are Boards Designed to Fail? The Implausibility of Effective Board Monitoring', Academy of Management Annals, vol. 10, no. 1, pp. 319–407

of the cornerstones of our economy – the modern corporation. With particular regard to the financial corporation the former chair of the Federal Reserve System, Paul Volker, has made the point that none of the boards of the firms using financial innovations are likely to understand them and that imposes huge problems for financial governance.[52] In that regard it is also worth mentioning that there is already cause for concern with rogue traders using sophisticated instruments and we recall the problems imposed by staff members who brought down Barings Bank and caused grief for the National Australia Bank. We can be sure all the board members do not understand all the financial products their companies deal with. There has been a proposal that new financial products should require authorisation by the regulators before they can be sold.[53] They would be treated much like new pharmaceuticals and have to show that they are useful as well as safe for both the buyers and for the stability of the financial system as a whole.

There also seems to be a case for breaking up our giant banks into smaller entities that would be easier to manage and regulate. Such entities might then be more responsive to the needs of particular communities. There should also be prohibitions on banks buying smaller banks. If competition is every going to work it is the smaller banks that are likely to provide effective competition but that means big banks will want to buy them in order to remove the competitive threat.

Recommendation: Government investigate governance issues generally and report on whether some companies are indeed too big to govern and whether there is an appropriate size for finance companies in particular.

Recommendation: New financial products should be treated like new pharmaceutical products and require authorisation before being marketed.

Recommendation: The role of breaking up large banks be further examined and there should be a prohibition on mergers among the big four as well as takeovers of smaller banks.

[52] Notermans T (2013) 'Reforming finance: A literature review', Financialisation, economy, society and sustainable development, No 8 working paper series.

[53] Cited in Notermans T (2013) 'Reforming finance: A literature review', Financialisation, economy, society and sustainable development, No 8 working paper series, p 7.

Interaction of monetary policy with fiscal and macroprudential policy

We should preface this section by pointing out that given the earlier arguments we doubt that a clear distinction is possible between monetary and fiscal policy. Fiscal policy involves issuing money-like liabilities to fund spending. By contrast monetary policy involves setting/managing the price, terms and conditions on which credit is made available.

In recent years fiscal policy has been relegated to major crises while monetary policy has become the de facto regulator of the economy in between crises.

It used to be thought that monetary policy is better than fiscal policy because it is quicker to implement and change course than fiscal policy. Perhaps Friedman's helicopter money image assisted with that perception. Friedman was trying to show how increases in the money supply would induce spending and inflation and he used the hypothetical example of the central bank throwing money out of helicopters. The imagery seemed persuasive in suggesting monetary policy could be quick and effective. However, we should re-examine this.

In Australia, stimulus programs have often included giving money to people who receive government income support and/or taxpayers. To make those payments the government draws in its account with the RBA. This ultimately involves payments from the RBA that fund an unrequited payment to pensioners and other stimulus recipients. But such an operation is treated as fiscal policy. And, in that case, the RBA would be making payments to individuals following payments from the government.

The exact details need no detain us, but if the government instructs the central bank to distribute helicopter money the central bank will want something in exchange and the operation would be classified as a fiscal policy. The central bank would not simply issue liabilities without increasing its assets. Helicopter money would have to be financed by government in which case it is fiscal policy. In principle it would be no different to the one off cash payments to pensioners and other recipients of income support. What Friedman has done is unwittingly shown how responsive fiscal policy can be if it needs to.

Macroprudential policy raises other issues. A feature of modern financial systems is their periodic tendency to instability. This was explained well by Hyman Minsky and Sheila Dow put it well:

> Minsky's … financial instability hypothesis rather showed financial instability to be systemic, with stability actually creating the conditions for instability. Stability creates overconfidence in risk assessment (in spite of uncertainty), encouraging increasingly

> leveraged borrowing fuelling rising asset prices. The fragility so created means that any small reversal in expectations which prompts asset sales sets off a reversal of the whole process[54]

This process requires constant vigilance on the part of the RBA and APRA. These institutions have the ability to work closely with the finance sector and should be in a position to make much more accurate assessments than outside observers. However, some of the statistics from the financial markets raise alarm bells.

RBA statistics show that in the six months to April 2022, average daily foreign exchange turnover was $212 billion.[55] Credit items on the current account of the balance of payments were $638 billion over the 4 quarters to March 2022.[56] These are closely matched by debit items and there are some financial and capital transactions. And so the underlying foreign transactions are perhaps around $4 billion a day. This means that the daily foreign exchange turnover is some 50 times larger than the underlying transactions would suggest. On top of that gross foreign liabilities in Australia are $4,428 billion or some 5.3 times the net foreign liabilities of $834 billion. When underlying markets are associated with even larger layers of financial engineering there is always the potential to go wrong.

The foreign exchange market is not alone. The value of derivatives, forward contracts, options and warrants, have been many multiples of the underlying securities. On top of that are the housing debts.

Recommendation: The RBA should note that the present calm is likely to breed the next bout of instability and should be stress testing all of the derivative and other markets that have been associated with instability in the past.

[54] Dow S (2020) "Money, finance and the role of the state", in Dunn B (ed) *A research agenda for critical political economy*, Cheltenham: Edward Elgar, pp47-60.

[55] https://www.rba.gov.au/statistics/tables/

[56] ABS (2022) *Balance of Payments and International Investment Position, Australia, March 2022*, 31 May.

Social and environmental stability

Mark Carney, the Governor of the Bank of England, has complained that the "development of … new sustainable finance is not moving fast enough for the world to reach net zero."[57] He talked about bringing climate risks into mainstream finance decision making and that "climate disclosure must become comprehensive; climate risk management must be transformed, and sustainable investing must go mainstream." He outlined plans to stress test the financial system against different climate scenarios and advocated sustainable investment to support the transition "from brown to green".

When we search the RBA website, "climate change" turns up 331 results. In the first result the Head of Domestic Markets, Jonathan Kearns, points to the risk attached to climate change. He notes the insurance sector has acted most quickly to address the challenge while the banks have been laggards.[58] While the comments of Kearns and others is welcome, they represent an approach to climate change that emphasises the risks of damage that need to be taken into account. A cynic might also point out that dinner and lunch time addresses to business groups only go so far in addressing the need to incorporate climate change into mainstream business thinking and action.

There is less evidence of the RBA emphasising the upside for the community in the transition from brown to green as the UK Governor of the Bank of England put it. Even if we just concentrate on inflation, climate change plays havoc with prices as is evident with the prices for fresh vegetables during recent flood events. There have also been the occasional but important impacts on meat prices as a result of droughts in the recent past.

We earlier mentioned the provision of finance to green industries. Along with that there is a need to put stronger policy instruments behind corporate investment decision-making and investment finance.

Recommendation: The RBA and APRA monitor and report on climate change issues in the financial system and should develop stricter climate change guidance with the possibility of sanctions if compliance proves problematic.

Recommendation: The RBA should research the price and inflation impacts of climate change.

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[57] Carney M (2019) *Remarks given during the UN Secretary General's Climate Action Summit 2019* at https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/remarks-given-during-the-un-secretary-generals-climate-actions-summit-2019-mark-carney.pdf?la=en&hash=C0D3A9F2C86647B04D88E7C0DC23264639D03BE2

[58] Kearns J (2022) "Climate change risk in the financial system" *Credit Law Conference 'Managing Financial Services Risks in an Age of Uncertainty'*, Sydney, 24 August 2

The payments system

The payments system is a critical part of the Australian infrastructure and it is critical that it includes world best practice and operates as efficiently as possible with minimal cost and inconvenience to the users. We at the Australia Institute have argued that the Australian payments system could be separated from the loan and other functions of the banks. The payments system is a utility and returning it to the public sector would address the way it is presently abused by the big banks in Australia to make significant economic rents.

Over recent decades the payments system has witnessed a good deal of technical innovation but private banking providers have introduced innovations that benefit customers in a way that seeks to strengthen the control of the bank/s. The RBA will recall the big fight with the banks over credit cards in which the banks managed to get people to use credit cards as a transactions card. Consumers were presented with rewards for using the card which the banks funded with large fees imposed on merchants. Apple has linked with the ANZ to introduce phone banking to the exclusion of other banks. In these and other ways the banks attempt to pervert the payments system infrastructure into a source of competitive advantage in a struggle between oligopolies.

While all this was happening the phenomenon of cryptocurrency appeared. At first it was little more than a curiosity but soon had central banks around the world wondering if they should be part of it by offering stable bitcoins.[59] Cryptocurrencies seem to be unnecessarily complicated using verification processes that preserve anonymity even to the sponsoring/issuing party.[60] They perhaps evolved out of the need for secrecy on the part of traders in illegal goods and services. If central banks go down the crypto road they need to ask if they should allow for such anonymity or just offer the type of security offered by the regular banking system.

Banking with the central bank

Just when we were wondering what to do with banks in the wake of the Royal Commission the *Economist* was arguing that people should be able to bank directly with central banks, in Australia's case the RBA. No reason at all why you could not have your weekly/fortnightly income paid directly into an account with the RBA. This would give choice back to bank customers who would like to bank with a government-owned bank. Many Australians may prefer to deal with a government owned organisation just as others may prefer a member-

[59] For an Australian discussion see Richards T (2021) "The Future of Payments: Cryptocurrencies, Stablecoins or Central Bank Digital Currencies?" *Address to the Australian Corporate Treasury Association Online*, 18 November.

[60] They are also very energy intensive.

owned organisation. If there are no government-owned organisations, then arguably the government is denying consumers their right to choose among different types of organisation. That is especially important when the security of people's savings and their credit information is an issue.

Australia has tried to address banking monopolies/oligopolies using competition policy at least since the 1840s and has not yet been successful—the payments system is a utility and returning it to the public sector would address the way it is presently abused by the big banks in Australia.

The economist sees other advantages

> One answer is that individual accounts could help them [central banks] with their monetary-policy mission. At present, they manage interest rates across the economy indirectly, by adjusting the rates banks earn on their reserves. But these are passed on only imperfectly to consumers. At the moment, banks in America can earn a short-run, risk-free interest rate of about 1.75% (those in Europe and Japan earn less). Current accounts at private banks, meanwhile, pay approximately nothing. In a world of individual central-bank accounts, in contrast, the rate paid on individual deposits would become a potent policy tool. Rate changes would have a direct, transparent effect on depositors. And were central-bank digital money to account for a big share of transactions, swings in such spending could become a useful real-time source of data for policymakers.[61]

The introduction of these accounts could represent a first step away from deposit-financing of bank lending: a reform favoured by some economists and regulators. Among others, John Kay has argued for structural separation of the payments system and bank lending.[62]

It is worth noting that Commonwealth Bank collects and publishes internal credit & debit spending data in a timely manner. Such data could be massively enhanced with a retail operation.

In 2011 the Australia Institute presented a submission to the *Senate Economics Committee inquiry; 'Competition within the Australian banking sector'*. Among other things it argued that a consequence of the global financial crisis was that the smaller banks are now even less competitive against the big banks. The former Governor of the Bank of England, Mervyn King, had said 'Of all the many ways of organising banking, the worst is the one we

[61] The Economist (2018) "Central banks should consider offering accounts to everyone", *The Economist*, 26 May

[62] J Kay (2009) 'Narrow Banking: The reform of banking regulation' Centre for the Study of Financial Innovation.

have today' and moreover 'ever since the Industrial Revolution we have not cracked the problem of how to ensure a more stable banking system'.[63]

Following King the paper examined another possible form of competition but based on structural separation of the banking business. We note that Australian banks are prohibited under the Banking Act from applying depositors' funds for purposes other than strictly traditional forms of bank lending. Banks are certainly not allowed to apply depositors' funds to, for example, purchases in the share market. That prohibition had been lifted in the US and elsewhere and the global financial crisis was one of the consequences. Following the global financial crisis, governments in other countries have been trying to return to a separation of traditional and investment banking.

The Australian model allows banks to monopolise the mobilisation of funds through the payments system and then to dominate the lending market. Banks, through their access to the clearing system, have monopolised the payments system which gives them an abundant source of cheap money and places them in an ideal position to monopolise the nation's lending behaviour. Governor King's concern was more about the regulatory problems inherent in banking and the propensity for banks to use other people's money to invest in risky undertakings. For him the issue was that the 'damaging externalities created by excessive maturity transformation and risk-taking must be internalised'.

King did raise the possibility of divorcing the payment system from the rest of the financial sector:

> if banks undertake risky activities then it is highly dangerous to allow such "gambling" to take place on the same balance sheet as is used to support the payments system, and other crucial parts of the financial infrastructure.[64]

Structural separation would have benefits for the stability of the financial system, however, it should also address the problems of a small group of banks monopolising the payments system. In Australia we have witnessed the banks exploiting the payments system in a number of ways. For example earlier on they effectively ensured that electronic payments could only be made through credit cards which they promoted through loyalty programs financed by hefty fees on merchants. The Reserve Bank effectively tackled that issue making credit card fees more efficient and encouraging debit cards. More recently the banks have responded with the 'tap-and-pay' system which is certainly popular and convenient for transactions under $100 but can only be accessed with a credit card.

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[63] Quoted in Richardson D and Dennis R (2010) Submission to the Senate Economics Committee inquiry 'Competition within the Australian banking sector' at https://australiainstitute.org.au/wp-content/uploads/2020/12/Banking-submission-Nov10_8.pdf

[64] Quoted in Richardson D and Dennis R (2010) Submission to the Senate Economics Committee inquiry 'Competition within the Australian banking sector'.

It should be noted that in its essence, a crypto currency is just an electronic entry in the host's computer. Most ordinary banking is just that. Crypto coins are issued and then bought and sold in a secondary market. They are effectively no-one's liability and, as such, they are similar in practice to cash. The RBA is under no obligation to exchange its notes for anything else of any value. Bank notes have a physical presence but banks themselves hold cash in the form of electronic accounts with the RBA. In that sense there would be no difference if banks held crypto coins issued by the RBA. However, as mentioned earlier, ordinary retail customers cannot bank with the RBA but that would change if the RBA issued crypto coins more widely. It would have to provide some sort of registry service and means for their exchange with third parties. In that way they would be almost indistinguishable from setting up an ordinary banking service. We think the RBA should offer retail accounts.

In practice the RBA could use the Post Office as agent and could well create a distinct entity much like the Kiwi Bank in New Zealand.

Recommendation: The RBA operate a retail facility and promote its retail services.

RBA too close to the banking and finance sector?

We began this paper with the views of Adam Smith who said a small group of bankers with corrosive moral sentiments could ruin the entire economy. There is a long discussion in the Wealth of Nations showing that competition among bankers reduces the soundness of the banking system as a whole.[65] Australia's banking lobby group admitted that competition was harmful in Australia. The banks have tried to suggest that there is a trade-off between the stability of the banking system and the degree of competition in the industry. A former chief executive of the Australian Bankers Association warned that attempts to promote competition in banking "need[ed] to be careful that the balance is not tipped too far towards unsafe competition.[66] The former Governor of the Bank of England, Mervyn King, has said 'Of all the many ways of organising banking, the worst is the one we have today' and moreover 'ever since the Industrial Revolution we have not cracked the problem of how to ensure a more stable banking system'.[67]

The *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* in Australia showed that problems in the finance sector were endemic. It was not a case of a few bad apples. The impression was that Australia's finance system could have been the focus of Zingales' critique when he said 'I fear that in the financial sector fraud has become a feature and not a bug'.

> From Libor fixing to exchange rate manipulation, from gold price rigging to outright fraud in subprime mortgages, not a day passes without a news of a fresh financial scandal.[68]

Zingales, in his Presidential Address to the American Finance Association, makes it clear that 'If the most profitable line of business is to dupe investors with complex financial products, competitive pressure will induce financial firms to innovate along that dimension'.[69] Zingales makes the point that economists and especially finance economists are prone to the 'belief in our profession…that all that we observe is efficient'[70] but without any evidence to justify that belief. By contrast Zingales argues that 'market forces cannot bring [the finance sector]

[65] Smith A (1778) An Inquiry into the Nature and Causes of the Wealth of Nations online at https://www.gutenberg.org/files/3300/3300-h/3300-h.htm.

[66] Munchenberg, S (2011). 'Balancing bank stability and competition', The Australian, 17 January

[67] M King (2010) 'Banking: From Bagehot to Basel, and back again', The Second Bagehot lecture, Buttonwood Gathering New York, 25 October, p. 18, available at https://www.bis.org/review/r101028a.pdf

[68] Zingales L (2015) 'Does finance benefit society?' 2015 American Finance Association Presidential Address.

[69] Ibid.

[70] Ibid, p 9.

in check'.[71] Zingales discusses a number of specific problems with the finance sector as a whole beginning with 'duping unsophisticated investors' and other dishonest and immoral conduct. Zingales is sobering if not disheartening. It suggests that an approach that leaves things for the market to decide simply cannot work. The incentives are lined up in a way that virtually guarantees fraud is a feature of finance.

The Stiglitz UN Committee was also scathing as we saw above and put the view that left to its own the finance sector plays out much as Adam Smith feared it would.

In the light of this discussion it is disappointing in Australia to note that the RBA often seems to discuss banking and finance with a certain naivete as if everything were above board and there is nothing to be worried about. For example, in response to suggestions that the banks are very profitable the RBA made a submission to a Senate Committee saying that the major banks profits "are similar to those of other major companies in Australia" and published a graph showing returns on equity were similar to those of the top 20 listed companies.[72] In oral evidence the Australia Institute were able to point out that comparisons with the top 20 listed companies is to compare the banks with the top monopolies, duopolies and oligopolies in Australia as well as various mining companies that have a monopoly on their particular mineral deposits.[73] The RBA's tolerance of high bank profits is a departure from the observations of a former governor of the bank, Ian Macfarlane, who responded to questions about bank profitability by saying

> I, like you, have often wondered why banks are so profitable—and they certainly have been extremely profitable in Australia… They always were very profitable, let's face it. They were very profitable in the regulated phase, and some of us thought that those profit rates would go down in the deregulated phase, as competition heated up. So you can understand why people are very interested in profits and very surprised that profits or rates of return on equity have remained so high.
>
> Any business, whether it is a bank or any other business, if it is aiming for extremely high rates of return on equity—if it is aiming for 18 or 20 per cent in an environment of two per cent inflation—it seems to me there are an awful lot of very useful things that could be done which are profitable, but they are not quite that profitable.

[71] Ibid p 4.

[72] RBA (2010) *Senate economics references committee inquiry into competition within the Australian banking sector*, 30 November at https://www.rba.gov.au/publications/submissions/financial-sector/inquiry-competition-within-australian-banking-sector-2010/pdf/inquiry-competition-within-australian-banking-sector-2010.pdf

[73] Denniss R and Richardson D (2010) "Transcript of evidence", Hansard, Senate Economics References Committee Inquiry: Reference: Competition within the Australian banking sector, 15 December at https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Completed_inquiries/2010-13/bankingcomp2010/hearings/index

> If they are literally doing what they are aiming to do they are failing to invest in a lot of things which are reasonably profitable and socially very useful.[74]

This statement should be taken as a powerful critique of the Australian big banks that are able to sustain very high profitability. The RBA should be concerned about this and doing something about it rather than defending the status quo. Indeed, in other ways the RBA may be seen as abetting the very high bank profitability as we suggest below. The RBA should have been more proactive in resisting the takeovers of smaller banks such as St George and BankWest.

There is a further concern that former senior management in the RBA end up in senior roles in the finance industry. Other senior public servants with roles that should include regulating finance, nevertheless, end up with senior roles in managing the private operators in the finance sector. The movements from senior management in the public sector to the banking sector should be raising alarm bells. In this regard note that Ken Henry was head of the Treasury when it worked on a new bank competition policy and soon after joined the board of the National Australia Bank.[75] Moreover, the appointment of Ken Henry to the board of the Australian Stock Exchange gave the appearance of a conflict of interest at a time when Treasury was undertaking a review of Australia's financial market licensing regime and following the earlier failed takeover of the ASX. Ken Henry ran the Treasury when the Foreign Investment Review Board was considering the proposal by Singapore Exchange Limited to take over ASX Limited. The FIRB advised the Treasurer, Wayne Swan, to reject the bid which he did in April 2011[76] - the first time since 2001 that a Treasurer has rejected a bid on national interest grounds. None of this is to suggest any actual wrongdoing, but there are conflicts of interest involved in these circumstances.

We have singled out Ken Henry for attention, but he is far from alone. When the Commonwealth Bank was being investigated by AUSTRAC for ignoring apparent money laundering we learned that, in the midst of the AUSTRAC investigations, the Commonwealth Bank hired key AUSTRAC staff involved in the investigation. Indeed, one observer is reported to have said that ‘the revolving door with ASIC and the banks has facilitated regulatory capture’.[77] “Regulatory capture” is a very serious condition for Australia to find itself a part of.

We would draw the Committee’s attention to the conclusions of a project funded by the European Union which says ‘weaknesses of prudential regulation may result from regulatory

[74] Macfarlane I (1999) “Transcript of evidence”, Hansard, Standing Committee on Economics, Finance and Public Administration: Reserve Bank of Australia annual report 1997-98: Discussion 17 June.

[75] Kehoe J and Tingle L (2014) “Henry rejects conflict claims”, *Australian Financial Review*, October 7

[76] Swan W (2011) “Foreign investment decision”, Media Release, 8 April at https://ministers.treasury.gov.au/ministers/wayne-swan-2007/media-releases/foreign-investment-decision-5

[77] Ferguson A (2017) ‘How CBA recruited AUSTRAC executives’. *The Australian Financial Review*, 6 August.

capture and regulatory arbitrage; from the incentive structure of the supervisors'.[78] If there is mobility between senior levels of government and big businesses and there is a promise of a board or other position for senior bureaucrats then we have a serious potential problem with conflicted interests.

Recommendation: The Committee takes note of the critique of Professor Zingales and others and note their observations on the ubiquity of fraud in a finance market unless it is heavily regulated. With such strong incentives to 'misbehave' it is recommended that sanctions be as strong as possible, including hefty fines and gaol terms combined with rigorous enforcement.

Recommendation: The flow of senior staff between the RBA, other regulators and the finance sector should be prohibited for at least 10 years.

[78] Notermans T (2013) 'Reforming finance: A literature review', Working Paper Series, no 8, Financialisation, economy, society and sustainable development, p. 45.

Governance and independence

The present objectives of the RBA are to contribute to "the stability of the currency, full employment, and the economic prosperity and welfare of the Australian people". To that we should add environmental sustainability in an inclusive and egalitarian society. Adding those items addresses targets whose urgency has become more evident since the RBA legislation of 1959. However, these changes would also reflect the fact that actions of the RBA do matter in the case of these issues. The environment is clearly affected by RBA actions and the actions of the financial sector that it regulates and monitors.

Recommendation: The aims of the RBA as expressed in the legislation should be amended to include environmental sustainability and an inclusive and egalitarian society with perhaps other inclusions that better define the objectives that should be pursued by the RBA in a modern Australia.

INDEPENDENCE

This is perhaps one of the most important issues facing the RBA. There are ever present dangers when elites are selected to exercise power over critical processes in the functioning of the Australian economy and society. We have seen above that there is no settled view on what the functions of the RBA might be. Indeed, the need for a review itself is to deliberate on how the RBA might best function. In this context the RBA has been able to entertain views that wages represent the major threat to the persistence of inflation. We have seen in other parts of this submission that the RBA's view of the world seems dominated by a neoliberal or market-knows-best approach which is inevitably reinforced by a board dominated by business interests. There can be little confidence in an RBA with a board dominated by business.

There is an influential argument that central banks should be politically independent of governments. The RBA is not completely independent as is evident in the instructions by previous Treasurers to target 2 to 3 per cent inflation. In the event of a dispute with the government the Act makes it clear that the government has final say and can direct the RBA to implement government policy. Hence it could be argued that the RBA is less than completely independent but if there were an independence scale it would be closer to independent end than the not independent end of the scale.

Thomas Palley has argued

> The case for central bank independence is built on an intellectual two-step. Step one argues there is a problem of inflation prone government. Step two argues independence is the solution to that problem. This paper challenges that case and

> shows it is based on false politics and economics. The paper argues central bank independence is a product of neoliberal economics and aims to institutionalize neoliberal interests. As regards economics, independence rests on a controversial construction of macroeconomics and also fails according to its own microeconomic logic. That failure applies to both goal independence and operational independence. It is a myth to think a government can set goals for the central bank and then leave it to the bank to impartially and neutrally operationalize those goals. Democratic countries may still decide to implement central bank independence, but that decision is a political one with non-neutral economic and political consequences. It is a grave misrepresentation to claim independence solves a fundamental public interest economic problem, and economists make themselves accomplices by claiming it does.[79]

Essentially the view is that markets know best and government (and central bank) intervention is necessarily suboptimal. Government failure is taken to be worse than market failure. Hence the logical extension; central bank decision-making should be out of the hands of government. Of course, that just means replacing the bias and prejudice of one group of people with another group. Palley argues that so-called independence advances industrial and financial capital at the expense of other interests. In this regard we might note that the present board of the RBA does not include any representatives of labour or the welfare sector. Apart from the bureaucrats that are automatically included, the rest of the board has strong business links, and one board member is also on the board of right wing thinktank, the Centre for Independent Studies (Mr Mark Barnaba). This is a biased board and the bias has been sold as a virtue in the past.

Following the election of the Rudd Government the heads of Treasury and the RBA wrote to the incoming Treasurer, Wayne Swan, outlining the criteria they suggested for drawing up a short list of candidates for RBA board membership from which the Treasurer might choose.[80] Trade unionists were effectively excluded with guidelines removing “any perception of political considerations in the appointment process” and would reinforce “the current practice of board members seeing themselves as representing the broad national interest, rather than narrower sectional interests”.[81] Other selection criteria included the:

- “need to have a high degree of personal integrity, political independence, as well as extensive leadership and governance experience”.

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[79] Palley T (2019) “Central Bank independence: A rigged debate based on false politics and economics”, Investigación económica, Vol 78, no 310 at https://www.scielo.org.mx/scielo.php?pid=S0185-16672019000400067&script=sci_arttext&tlng=en

[80] Dwyer M (2011) “Mates don’t rate at RBA”, *Australian Financial Review*, 6 January. This report is based on documents discovered after application under Freedom of Information (FOI) legislation.

[81] Dwyer M (2011) “Mates don’t rate at RBA”, *Australian Financial Review*, 6 January.

- “would typically include having leadership experience in a large and influential organisation, or demonstrated intellectual leadership,” and
- need to have a “sufficient grasp of economic and financial matters to contribute meaningfully to the board’s monetary policy deliberations”.

They may just as well have said captains of industry without any labour or left-wing sympathies. We need not point out that capital and labour have fundamentally different values and see economic policy quite differently. We need only mention the importance of employment policy for the labour movement and, for capital, low inflation combined with a docile workforce.

It is difficult not to agree with Thomas Palley when he says central bank independence “is about control of monetary policy”.[82] Years ago Michael Kalecki outlined how this would work over the course of the business cycle. As he said:

> the *maintenance* of full employment would cause social and political changes which would give a new impetus to the opposition of the business leaders… the 'sack' would cease to play its role as a 'disciplinary measure’. The social position of the boss would be undermined, and the self-assurance and class-consciousness of the working class would grow. Strikes for wage increases and improvements in conditions of work would create political tension. It is true that profits would be higher under a regime of full employment … But 'discipline in the factories' and 'political stability' are more appreciated than profits by business leaders. Their class instinct tells them that lasting full employment is unsound from their point of view, and that unemployment is an integral part of the 'normal' capitalist system.[83]

One of the tangible outcomes in Australia has been the obsession with the NAIRU as outlined above. Arguably the NAIRU has replaced the full employment objective as far the RBA is concerned. Resistance to full employment policies also comes about because if employment is independent of business decision-making, then business loses a valuable tool. Threats about ‘business confidence’ are a powerful tool business uses to achieve its ends in a supportive government policy. In Australia we often see references to the state of business confidence and such things as ‘sovereign risk’, the idea governments might scare off business if it changes policy on the environment, access to resources and so on. Mike Keating refers to the ‘powerful and articulate’ Business Council of Australia (BCA) whose ‘reform agenda is stuck in the past with its demands for lower wages and taxes’.[84]

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[82] Palley T (2019) “Central Bank independence: A rigged debate based on false politics and economics”, Investigación económica, Vol 78, no 310.

[83] Kalecki M (1943) ‘Political aspects of full employment’, *Political Quarterly*.

[84] Keating M (2018) ‘The future agenda for economic reform’, *John Menadue – Pearls and Irritations*, 29 November

References in the public sphere to the oscillations of 'business confidence' or 'investor expectations' are actually indicators of the constant blackmailing of governments by business groups, and remind bureaucrats of the permanent danger of a 'Kaleckian reaction' – that is, an investment strike of capital owners.[85] Hence central bank independence can be thought as a quasi-outsourcing of interest rate policy and monetary policy generally to an unelected, unaccountable RBA dominated by business interests.

One of the consequences of the RBA board dominated by business interests is the tendency to exaggerate the potential role of any future wage increases in stoking inflation. We have given a lot of evidence to the effect that such a scenario is wrong. But the RBA keeps over-estimating future wage growth and relying on informal business consultations that suggest wage pressures are much stronger than in the statistics.[86] Business CEOs have an obvious instinctive bias for low wage growth.

Palley points out that "central bank independence partakes of liberal paternalism, which is a cousin to authoritarianism. Paternalists claim democracy is unreliable and they know better. Independence puts an important piece of democratic decision making (the central bank) in trust, under technocratic hands." Certainly it has to be granted that central bank independence is undemocratic. That raises questions such as whether or not a more representative RBA board have accepted such high levels of unemployment in recent years and accepted assurances that the "natural" rate of unemployment was very high. Likewise when a choice is presented between higher inflation or higher unemployment, would a more representative board have accepted the implied choices of recent years.

The choice to target inflation rather than unemployment was made easier by the monetarist emergence in the late 1960s. One has the impression that as the Keynesian revolution was undermined from the late 1960s by the monetarism associated with Milton Friedman in particular. One also has the impression that central banks were some of the most enthusiastic adopters of monetarism. Monetarism asserted that monetary phenomenon and real economic activity were independent and central banks could concentrate on inflation and real economic activity would look after itself. Hence, not only could followers advocate independence but the idea that targeting inflation did not harm economic activity insulated the central bankers from blame for harmful economic fall outs. Yet in the US for example, it has been convincingly argued that most post war recessions were the outcome of zealous campaigns to fight inflation. Dornbusch has written: "None of the US expansions in the past 40 years died in bed of old age; every one was murdered by the Federal

[85] Rugitsky FM (2013) 'Degree of monopoly and class struggle: Political aspects of Kalecki's pricing and distribution theory', *Review of Keynesian Economics*, Vol 1(4), pp 447-64.

[86] For example, RBA (2022) *Statement by Philip Lowe, Governor: Monetary Policy Decision, Media Release No 2022-33*, 4 October.

Reserve".[87] Likewise in Australia the 1991 recession seemed to be the direct outcome of the higher interest rates leading up to that recession.[88]

When Friedman and his followers spread the fiction that controlling the money supply would control inflation there was intellectual support for the idea that inflation fighting could be conducted independently of the rest of the economy. But now we know that from the beginning central banks were not controlling the money supply but were manipulating interest rates.[89] Now it is more clearly understood that central banks influence the economy via interest rates and their impact on aggregate demand. But given interest rates impact the opportunity cost of investing and the cash flows of borrowers and renters, we can no longer accept the fictional view that monetary policy is independent of the rest of the economic system. In rejecting that view, the idea that central banks should be independent should also be dispensed with.

We could put this more strongly. We share a heritage of governance through a Westminster system that gradually narrowed the domain of arbitrary rule by elites and brought more and more of the economic and social system under democratic control. So-called independence of central banks is really a return to rule by elites. Decisions of the RBA result in changes in employment/unemployment, the distribution of income and wealth, changes in economic activity, the incidence of poverty and much else. As such it is intolerable that the RBA sits outside democratic processes and is unaccountable.

Democratising the RBA means there needs to be a much more representative board. A more democratic board is going to ask questions about how the RBA might contribute to other social, economic and environmental concerns.

The present board composition presents as if it were deliberately designed to concentrate decision making in one sectional interest: big business. This is ironic given the Treasury/RBA attempt to rid the board of sectional interests. If one were to deliberately design the RBA board with a view to ignoring the handbrake effect on the Australian economy of oligopolistic and increasingly concentrated industry in Australia, then you would put big business in charge. If you were to design a system to blame workers and unions for our ills, then you would put business in charge.

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[87] Dornbusch R (1997) "How real is US prosperity?" *World Economic Laboratory Columns*, December. For the great recession of 2008, or what we call the "global financial crisis" in Australia, Stiglitz blames the Fed albeit for different reasons, such as the neglect of obvious warning signs. See Stiglitz JE (2009) "Interpreting the causes of the great recession of 2008", *Lecture to have been delivered at BIS Conference*, Basel, June, 2009.

[88] Official cash rates were 16.5 to 17 per cent just prior to the 1991 recession. Over much of 1989 and 1990 the standard variable home lending rate was 17 per cent. See RBA Statistical Ttables at https://www.rba.gov.au/statistics/tables/

[89] Interest rates may have been regarded as the instrumental variable used to control the money supply.

The logic of the above is that the RBA needs to be returned to the realm of political transparency and accountability. There are many alternative models that might be pursued but the broad outline might be that the RBA retain administrative responsibility for monetary policy implementation and an advisory role on policy itself. The Board should be representative of the community it serves. The actual policy would be the responsibility of the government of the day which would, of course, be accountable to the people of Australia. The government of the day would not and should not be able to distance itself from monetary policy on the grounds the RBA is independent of government.

Recommendation: The RBA board be reconstituted to better reflect the community and its role changed to advice and the administration of monetary policy.

RBA signals oligopoly pricing

Australia has tried to address banking monopolies/oligopolies using competition policy at least since the 1840s and has not yet been successful. Governments have championed alternatives to the big private banks such as the original publicly owned Commonwealth Bank, then building societies and credit unions were supposed to provide competition against the big banks. Then there was the promised competition from foreign banks but most recently we seem to have given up and the big profit-hungry banks are accepted.

Earlier we put the view that the RBA has been something of an apologist for huge profits on the part of the big banks. There is the further argument that the RBA is in complicit in the behaviour of the big banks. The RBA will have noticed that each time it has increased the cash rate it is quickly followed by copycat increases on the part of the banks. It is standard economic theory to suggest that oligopoly markets are characterised by high prices and profits. One of the strategies to maintain high profits is to refrain from price competition that, in ordinary markets, should act to keep prices low, to the point where producers are just covering costs and making reasonable returns on capital. But when costs change or new opportunities arise, there has to be some mechanism so that all members of the oligopoly increase their prices in tandem.

It is a common observation that, following RBA announcements, banks' interest rates increase before there is even a hint of increased banking costs. The impression is that RBA announcements become a signal for how the banking oligopoly might reprice their lending products. The RBA is acting as the price leader for the big bank oligopoly. This presents a huge dilemma for the RBA. Clearly there is value in announcing the RBA's target cash rate. Prior to the present system introduced in 1990, market commentators had to guess the RBA target by looking at market transactions. On the other hand, the RBA then had more flexibility and was able to change target rates at times other than 2:30 pm on the first Tuesday of each month.

Perhaps it is no coincidence that in 1989 the profits of the big four banks were 1.0 per cent of GDP but since then rose fairly quickly to be consistently around 2 per cent of GDP or more in more recent times.[90] By 1999 they reached 1.8 per cent of GDP and in 2006, 2.3 per cent of GDP. In 2017 we calculated that pre-tax profits for *all* the banks was 3.4 per cent of

[90] Richardson D (2012) "The rise and rise of the big banks Concentration of ownership", *Australia Institute Technical Brief No. 15*

Australia's national income.[91] Upheavals since then, including the Haines royal commission and the pandemic, have moderated bank profits somewhat.

The present arrangement no doubt suits the RBA in one way. The RBA needs a mechanism to spread its interest rate changes out to the general economy. When the RBA announces changes to the official interest rates, that only affects the short-term money market and bank deposit rates. These are very small and isolated parts of the general economy. The costs of doing business on the part of the banks is minimally affected but there is tacit agreement among all parties that bank lending rates are free to increase in line with official rates.

This raises an interesting question. The RBA wants rapid increases in interest rates throughout the economy and the oligopolists provide them. If monetary policy objectives dictate an increase in interest payments on outstanding and new debt in the economy at large, is there a way of achieving the same thing without boosting the profits of the big banks? If that cannot be achieved is there a way of recovering those profits from the banking sector? There have been arguments in the past for a super profits tax on banks or a type of economic rent tax. The danger of course is that such taxes would be passed on to consumers unless there were an additional mechanism to ensure additional taxes are not passed on. Perhaps the additional profits could be required to be passed on to domestic depositors. Since the whole idea is to hurt borrowers there is probably limited scope to compensate borrowers but that is an argument to use interest rate increases sparingly as mentioned earlier.

The Major Bank Levy was introduced to address excessive bank profits but it would appear to raise only a fraction of the major banks' after-tax profit. In 2021-22 that tax raised $1,454 million[92] while figures from the Australian Prudential Regulation Authority (APRA) show the big banks made after-tax profit of $29,843 million.[93]

Recommendation: Banks are able to increase their profits by following the RBA's lead during interest rate increases. This needs further study with the aim of returning to the community any profits made following official interest rate increases. That might best be done through increases in the Major Bank Levy.

[91] Richardson D (2017) Consumer protection in the banking, insurance and financial sector: Submission to the Senate Economic References Committee at https://australiainstitute.org.au/wp-content/uploads/2020/12/Consumer-protection-in-the-banking-insurance-and-financial-sector.pdf

[92] Australian Government (2022) "Budget strategy and outlook: Budget paper No 1", *Budget October 2022-23*.

[93] APRA (2022) *Statistics: Quarterly authorised deposit-taking institution performance, June 2022.*

Non-bank financial institutions

Since the 1970s with the Campbell Report and other inquiries we have witnessed a deregulation that has enhanced the competitive position of the banks. That may not have been the intention of the governments involved in pro-competition and deregulation policies but it was the outcome none-the-less. Part of the process involved management in building societies and mutuals who sought the trappings of private ownership. We think there is a strong case for encouraging alternatives to the banks but the incentive structure and the regulatory environment pointed in the other direction.

Mutuals and co-operatives

An important issue here is support for mutual and cooperative financial institutions. We have argued elsewhere that a defining feature of co-operatives is their democratic nature. They are owned and controlled by their members, and they apply co-operative principles and values in their day-to-day activities. They provide a genuine opportunity for people to do their banking without being ripped off.

Recommendation: The RBA should promote alternatives to the shareholder-owned financial institutions.

Government owned and/or controlled entities.

Australia used to have a number of development banks including the Rural Credits Department of the RBA, the Commonwealth Development Bank and the Primary Industry Bank of Australia. These development banks tended to serve peripheral areas not well served by regular banks. There were also various state-based organisations. Each of these were direct interventions designed to ensure access to finance. We do not want to claim these are necessarily the best tools to use in order to direct lending, but they point to how the finance system, including the RBA, did it in the past and how RBA involvement today should not be thought of as some radical departure.

The Primary Industry Bank of Australia (PIBA) is an interesting one. It was a joint venture between the Commonwealth Government, the major trading banks, and some state banks. Some of its funds were provided by the government for concessional on-lending to be distributed to the rural sector. Critics of hidden industry assistance make the point that explicit subsidies are better than mechanisms such as tax expenditures or giving advantages through regulation. The PIBA was a vehicle for delivering subsidised finance.

Now that the financial system is dominated by banks targeting home loans and funds managers targeting large corporates there is a case for revisiting this area. The Productivity Commission (PC) insists that finance is competitive and if any sector is not well served it is due to the particular risk or other characteristics. But assertions from the PC are not evidence.

An important issue here is that the rate at which society discounts the future is likely to be vastly different depending on issues being considered. For example, a high interest rate means that future benefits are being heavily discounted by those who use interest rates in their decision-making. That may be appropriate for commerce and commercial-like activities. However, when considering environmental proposals, a high interest rate means heavily discounting the weight given to the values of future generations with larger populations. This is inappropriate and needs to be addressed with lower discount rates (maybe even zero) for public projects and delivering lower actual interest rates for commercial projects with environmental implications.

That naturally raises the question of whether the RBA should make concessional finance available on environmental grounds for projects that meet the relevant criteria. A relevant model would be the old Rural Credits Department of the RBA.

Recommendation: The RBA establish facilities to fund eligible projects, perhaps through existing financial institutions.

Foreign issues

A good deal of the RBA's work involves international dealings with other central banks and in discussions on sustainable finance and a host of other international issues as well as the institutional arrangements for foreign exchange settlement. There is also the day-to-day management of international clearing arrangements etc.

The RBA says

> The Bank also operates in the foreign exchange market to meet the foreign exchange needs of its clients (the largest of which is the Australian Government) and to assist with liquidity management in domestic markets. It holds and manages Australia's foreign currency reserves, and has the capacity to intervene in the foreign exchange market to address any apparent dysfunction in that market or significant misalignment in the value of the currency, consistent with the objectives of monetary policy[94]

Interventions in the market used to referred to euphemistically as "testing and smoothing" operations. However, there is a case for more strategic intervention and management of the currency especially given the resources instability that Australia often experiences.

RESOURCES INSTABILITY

One of the complications for economic management in Australia is the frequent upheavals emanating from the resources sector. At the present time Australia is going through a resources boom fuelled by Russia's invasion of Ukraine coming on top of a general upswing in commodity prices.

We were concerned during the period prior to the global financial crisis when the RBA was using monetary policy to recess the non-mining parts of the Australian economy. In part that worked by forcing the Australian dollar to appreciate and so reduce the competitiveness of the non-resource tradeable sectors.

The RBA Act includes the aim of stability of the currency as mentioned above. Currency stability is often taken as a reference to the value of the Australian dollar vid-a-vis other currencies. However, currency stability does not seem to have been at all a concern of the RBA. For example, the Australian dollar was allowed to appreciate to much higher levels during the worst of the resources boom. That is likely to have played a large part in the

[94] RBA (2021) *2021 Annual Report* p. 6

dramatic reduction in the share of manufacturing in the Australian economy. Manufacturing fell from 9.5 per cent of GDP in 1999-00 to 5.6 per cent in 2020-21.[95]

Monetary policy statements of the time referred to the need to encourage resources to move from the rest of the economy to the mining sector which meant some contractionary policy for the economy at large, higher exchange and interest rates. This seemed curious at the time. The mining industry has never been a large employer and any labour flows were not going to be terribly significant. Most mining investment was going to involve a lot of imported machinery and local construction. The construction industry was traditionally used to fluctuating fortunes. The RBA should have offset the adverse impact of the mining boom on the $A and hence the rest of the Australian economy.

Norway is an example of a country that manages to avoid the domestic disruption that would otherwise be generated by large resource receipts. It does that reinvesting its inbound receipts in foreign markets so that the monetary inflow from resources is matched by a monetary outflow on capital account. The latter would involve the acquisition of foreign assets which is consistent with other recommendations that the RBA hold more than just government securities.

In more recent years we have experienced commodity prices at or higher than during the resources boom leading up to the global financial crisis. Despite that the Australian dollar has been on a downward trend as distinct from the strong upward trend in evidence during the earlier boom.

Recommendation: The mining industry is subject to booms and busts but the RBA should not allow that to harm the rest of the economy as happened in the resources boom especially in the lead up to the global financial crisis.

Recommendation: The RBA needs to establish a mechanism to manage unusual monetary inflows over the balance of payments by an equivalent purchase of foreign assets. Assets accumulated in this fund could be managed by the Future Fund or some dedicated fund held by the RBA.

DEFLATIONARY BIAS IN THE INTERNATIONAL SYSTEM.

The global financial system is biased towards the rich advanced countries and it imparts a deflationary bias to the system. The world composition of reserves is strongly biased towards a small number of rich countries. The data shows world reserves are held 60 per

[95] Figures refer to value added as a share of GDP, both in chain volume measures. ABS (2020) *Australian National Accounts: National Income, Expenditure and Product, March 2022*, 1 June.

cent in US dollars, 20 per cent in Euros and so on.[96] Australia's currency composition is much the same with the actual allocation shown in Table 2.

Table 2: Currency composition of Australia's foreign reserves (% of total)

US$	Euro	Yen	Canadian dollar	Chinese renminbi	Pound sterling	S Korea won
55	20	5	5	5	5	5

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Source: RBA, *2021 Annual Report*.

Apart from the US and UK, all other currencies are issued by economies running a current account surplus on their balance of payments. The US in particular does not run a surplus on the current account but obtains a huge advantage in issuing the currency that others wish to use for international transactions and which other countries wish to hold as their main foreign currency holding.

The deflation bias is a product of a system in which all of the adjustment is forced on the deficit countries. They are forced to react by reducing imports and boosting exports, neither of which is of any benefit to the rest of the world. Keynes pointed out that there would be an automatic financing mechanism if all countries held their surpluses in assets denominated in the currencies of the deficit countries. Instead, countries want to hold their reserves in hard currency assets or US dollars.[97] In addition, for every deficit country there is a surplus country. The sum of all deficits is equal to the sum of all surpluses. That means in principle the system could function as well if all the burden of adjustment were put on the surplus countries. Alternatively, there could be arrangements whereby adjustments are forced on both surplus and deficit countries.

When the RBA discusses international monetary arrangements, it tends to focus on mundane issues such as managing payments within the existing financial architecture. There is very little that questions that financial architecture itself and how it might be improved for the benefit of the global population. It is as if the RBA has never turned its attention to international issues associated with demand management, global poverty, the environment and a host of other social and economic issues at the global level. All of these are impacted by how the international monetary system works.

If countries like Australia do not consider these issues then the default is leaving it to the "Washington consensus" that revolves around the US Treasury, the IMF and World Bank. The Washington consensus involves neoliberal thinking and responding to many crises with deflationary policies. Countries with balance of payments problems in particular are told to

[96] https://data.imf.org/?sk=E6A5F467-C14B-4AA8-9F6D-5A09EC4E62A4

[97] For this and other aspects of Keynes's position see Richardson D (1985) "On proposals for a clearing union", *Journal of Post Keynesian Economics*, Vol. 8, No. 1, Autumn, pp 14-27.

reduce welfare programs and subsidies to the poor, creating incentives for the rich while selling public assets, often at fire sale prices.

We note too that present arrangements have encouraged alternative mechanisms such as some of the Chinese initiatives. It is possibly a healthy thing that there are budding alternatives to the Washington consensus. However, Australia is likely to prefer modifying the Washington consensus rather than watching new developments associated with Chinese finance.

Recommendation: Australia become more active in addressing international monetary arrangements and how they contribute or should contribute to improvements in the global economy. The RBA should regularly report on international developments and how monetary arrangements might best serve international objectives.

RBA statistics on banking seem deficient.

There is no one place where we can examine how bank liabilities are structured over foreign borrowings, interest free deposits, term deposits, hybrid securities, and so on. In other respects, the RBA statistics are outsourced and only give a short run of data. Historical copies of the outsourced data are not available.

This is not the place to make a full review of the RBA statistics but our impression is that the coverage is not as good as used to be the case. Some of the problem may be the creation of APRA and the split in functions.

Recommendation: The RBA, in conjunction with APRA as necessary, review and report on its statistical coverage and address gaps and other deficiencies.

Terms of reference

https://rbareview.gov.au/about

The Review of the Reserve Bank of Australia (RBA) is designed to ensure that Australia's monetary policy arrangements and the operations of the Bank continue to support strong macroeconomic outcomes for Australia in a complex and continuously evolving landscape.

1. The Review will assess Australia's monetary policy arrangements:

1.1. The RBA's objectives, as outlined in the *Reserve Bank Act (1959)* and in the *Statement on the Conduct of Monetary Policy*, including the continued appropriateness of the inflation targeting framework.

1.2. The interaction of monetary policy with fiscal and macroprudential policy, including during crises and when monetary policy space is limited.

1.2.1. This will include Australia's macroprudential governance arrangements, but exclude APRA's statutory role or functions.

2. It will also assess the following aspects of the RBA:

2.1. Its performance in meeting its objectives, including its choice of policy tools, policy implementation, policy communication, and how trade-offs between different objectives have been managed.

2.2. Its governance (including Board structure, experiences and expertise, composition and the appointments process) and accountability arrangements.

2.3. Its culture, management and recruitment processes.

3. The Review will exclude the RBA's payments, financial infrastructure, banking, and banknotes functions.

4. The Review will consult extensively with domestic and global experts and members of the public.

5. The Review will take account of analysis conducted in prior reviews of other central banks, including the US Federal Reserve, the Bank of Canada, the Reserve Bank of New Zealand and the European Central Bank.

6. The Review may invite and publish submissions and seek information from any persons or bodies.

7. A final report, with a set of clear recommendations to Government, is to be provided to the Treasurer no later than March 2023.