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Briefing Paper:

RBA Review a Missed Opportunity

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The Commonwealth Treasury has released the report of the three-person panel charged with reviewing the structure, governance, and effectiveness of the Reserve Bank of Australia (RBA). Treasurer Jim Chalmers accepted in principle all 51 of the panel's recommendations, ranging from creating a separate board to make decisions on interest rates, to giving the Bank a simpler dual mandate to pursue both price stability and full employment.

The report represents the most important reconsideration of monetary policy in Australia since the advent of inflation targeting three decades ago. However, Peter Hannam, writing in *The Guardian*, summarised the mood of many analysts when he concluded that "the Reserve Bank overhaul won't fix mistakes of the past." While such assessments are most likely correct, it is important to more deeply consider why.

In fact, the "new look" RBA after this review may even do more harm to the economy than in the past. This is because the independent review panel missed the opportunity to question the deeper myths and assumptions regarding the central bank's infallibility and their ideological bias – which is predominantly anti-labour and pro finance.

The panel did not provide any justification as to why the RBA's 2-3% inflation target should remain unchanged; nor did it convincingly argue why the RBA's 'independence' should be enhanced by removing the government's power to overrule RBA's decisions. Equally, its justification for recommending dropping a commitment to "economic prosperity and welfare of people" from the RBA's mandate, was *ad hoc* at best.

Baseless 2-3% Inflation Target

Much of the problem arises from the underlying commitment to a 2-3% inflation targeting regime. As Don Brash, the then-Governor of the Reserve Bank of New Zealand – the first central bank to adopt a 2% inflation target – later admitted, "The figure was plucked out of the air".

The NZ Finance Minister – during a television interview on April 1, 1988 – made a ‘chance remark’ that he was thinking of genuine price stability, “around 0, or 0 to 1 percent”. Thus, “‘0 to 2 by ’92’ became the mantra, repeated endlessly”. Brash and his colleagues “devoted a huge amount of effort” preaching this new mantra “to everybody who would listen – and some who were reluctant to listen”.

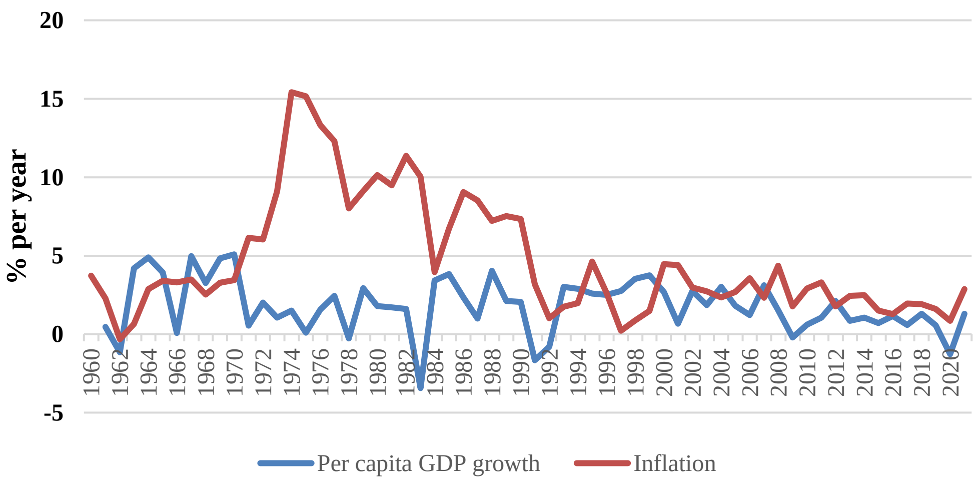
Since the RBNZ’s adoption of a 2% inflation target, leading economists – some of whom have served as senior officials at the major international financial institutions and central banks – studied long time series for many countries. However, none could find any strong evidence to justify a single digit inflation threshold beyond which inflation may negatively impact economic growth. Despite this, most concurred with a single digit inflation target.

For example, Stanley Fischer concluded, “However weak the evidence, one strong conclusion can be drawn: inflation is not good for longer-term growth”. And Robert Barro asserted, “The magnitude of [negative] effects are not that large, but are more than enough to justify a keen interest in price stability”.

An RBA study by Palle Andersen and David Gruen found, “Average inflation is…a fragile explanation of economic growth”. Yet, it concluded, “While the results are not as robust as one would like, the most obvious interpretation of the evidence … is that the negative correlation between inflation and growth arises from a causal relationship”.

It is mind-boggling that a profession that prides itself on empiricism and rigorous methodology could draw such strong conclusions from weak evidence. It is even more shocking when a baseless ‘chance remark’ could become a global economic gospel, as seemingly natural and self-evident as the law of gravity. One can only offer ideological bias as an explanation.

Figure 1: Inflation and Per Capita GDP Growth



Source: World Bank, online data.

Figure 1 shows that Australia's inflation and per capita GDP growth are by and large *positively* correlated, especially when exceptional years are excluded (such the 1970s oil shocks). The correlation between inflation and per capita GDP growth was 0.52 during 1961-1970; 0.24 during 1984-2021. The correlation between inflation and per capita GDP growth declined to 0.15 during the inflation-targeting era.

Table 1 shows that lower inflation since 1992 also meant slower per capita GDP growth, and thus reduced prosperity and welfare. Investment also suffered during the inflation-targeting era, declining from 28.7% to 25.4% of GDP – in sharp contrast to the common claim that price stability would enhance investment decisions by firms, by reducing uncertainty and risk.

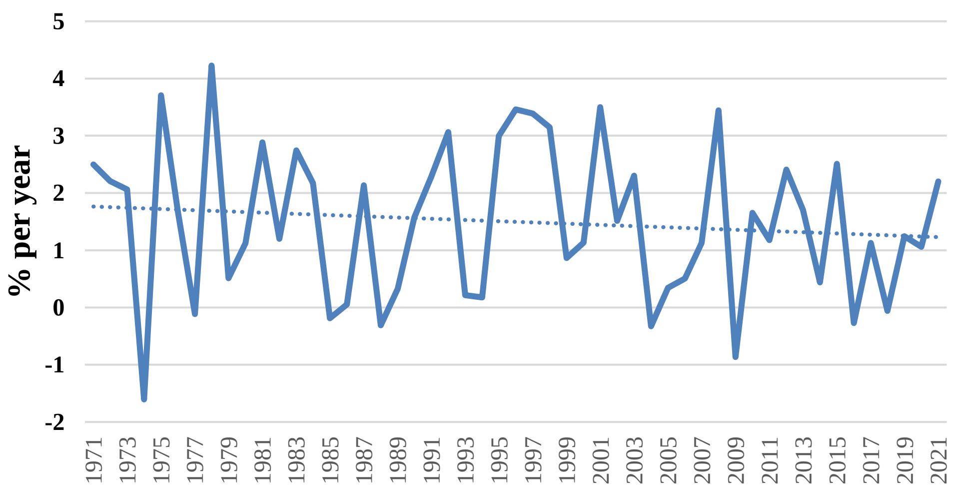
Table 1: Inflation-Targeting Produced Less Growth and Investment in Australia

Average	Pre-inflation targeting 1961-1991	Post-inflation targeting 1992-2021
Inflation rate	6.8%	2.4%
Per capita GDP growth	2.0%	1.6%
Gross capital formation (% of GDP)	28.7%	25.4%

Source: World Bank, online data.

Inflation-targeting (and resulting lower inflation) also failed to reverse Australia's declining productivity growth. This poor productivity performance also disproves other standard neoliberal prescriptions – including labour market deregulation, privatisation, liberalisation, and labour-displacing technological progress, all of which were also supposed to boost productivity performance, but failed (Figure 2).

Figure 2: Productivity Growth Continues to Slow



Source: OECD.

The insistence on a 2-3% inflation target ignores that the world has fundamentally changed. For example, the inflation-unemployment trade-off relationship (i.e., the Phillips curve) has become flatter over the years due to labour market deregulations, off-shoring and other developments since the 1960s. This means trying to dogmatically achieve such a low inflation target would require a much higher unemployment rate, as recognised by the former Fed Chair and current US Treasury Secretary Janet Yellen. In other words, the interest rate must rise more steeply, inflicting serious damage to business finance, household spending and government budgets. In the wake of the 2008-2009 global financial crisis, many economists (including the IMF's then-Chief Economist, Olivier Blanchard) suggested a 4% inflation target would be more appropriate.

In accepting the 2-3% inflation target, the RBA review panel not only ignored this history, but also the results from standard neo-classical macroeconomic models which tend to suggest low welfare loss from inflation. Thus, a recent IMF note observes, "Dislike of inflation … is unfounded and … the main cost of inflation stems from the damage of believing in an *imaginary* harm".

Dogmatic insistence on a fixed numerical inflation target also contradicts Australia's commitment to the IMF's Article of Agreement. The preamble of Article IV says: "Each member shall: (i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances."

Vague Full Employment

The review panel's report mentions 'full employment' 100 times! But does not say what that phrase means. While the inflation target has a numerical figure (2-3%), there is no such certainty for an unemployment target that may be consistent with the concept of full employment. When asked during a press conference, the Treasurer said, "It's a contested concept".

The panel essentially accepts the RBA's current definition and measure of full employment based on the theory of the "non-accelerating inflation rate of unemployment" (NAIRU). In other words, 'full employment' is defined as whatever unemployment rate below which inflation will accelerate.

However, critics have doubted the concept and its usefulness for policymakers concerned with smoothing the business cycle. An article in the RBA Bulletin acknowledged, "Model estimates of the NAIRU are highly uncertain and can change quite a bit as new data become available". There is general consensus that models based on NAIRU are basically wrong. Thus, James Galbraith argued for ditching the NAIRU. And a *Financial Times* op-ed concluded, "The sooner NAIRU is buried and forgotten, the better". A recent Centre for Future Work report by David Richardson provided more historical evidence for the non-existence of this magical rate.

Central Bank 'Independence'

The infallibility of an independent central bank is another myth that has gone mostly unquestioned, and was not seriously evaluated by the review panel. How do central bankers seek and gain this supposed independent credibility, despite dogmatically pursuing an inflation target with neither empirical nor theoretical justification?

After 14 years of pursuing inflation targeting, the former RBNZ Governor Don Brash could "not prove", but nonetheless "believe(d) that the inflation targeting regime did help … at the margin". He confessed it was "less clear that the adoption of an inflation target was in fact successful in reducing the costs of disinflation".

However, former RBA Deputy Governor Guy Debelle concluded confidently, "There was no gain from increased independence [of central banks] in terms of less costly disinflation". Instead, "central bank independence … may increase the costs of achieving low inflation".

Undoubtedly, until the COVID pandemic, inflation slowed down, averaging around 2% over the past three decades in most advanced OECD countries. To what extent can this be attributed to central bank credibility and the inflation targeting monetary policy framework? After all, inflation was already falling for some years before central bank independence was legislated and inflation targeting was formally adopted.

Debelle argued other reforms contributed to lowering inflation, such as labour market deregulation and privatisation. Debelle later observed, "How much [low inflation] can be attributable to central bank independence or the inflation target is difficult to disentangle …[Favourable] assessment mostly relies on assertion, rather than empirical proof". While doubting "nice" outcomes imply causation or correlation, he concluded a "significant disinflationary impulse" was due to China's integration into the world economy.

The historical role of central banks is also moot. Milton Friedman – whom many central bankers still revere – famously blamed the 1930s Great Depression on the US Fed's actions and inactions. With his co-researchers, including Ben Bernanke (who later became the US Fed Chair), Friedman argued that major economic damage in the 1970s was not from oil price shocks per se, but rather due to the "tightening of monetary policy". John Taylor, the author of the "Taylor rule" for monetary policy now worshipped by central banks, ascribed the 2007-2008 financial crisis to the Fed's faulty monetary policy. Guy Debelle noted, "The goal of financial stability has generally been left vague", thus central banks allowed significant financial fragility build up.

No wonder Milton Friedman opposed central bank independence. He argued, "Money is too important to be left to the central bankers". He elaborated his concerns as follows:

"The political objections are perhaps more obvious than the economic ones. Is it really tolerable in a democracy to have so much power concentrated in a body free from any direct political control? … One economic defect of an independent central bank … is that it almost invariably involves dispersal of responsibility… Another defect … is the extent to which policy is … made highly dependent on personalities… A third technical defect is that an independent central bank will almost invariably give undue emphasis to the point of view of bankers… The defects I have outlined constitute a strong technical argument against an independent central bank".

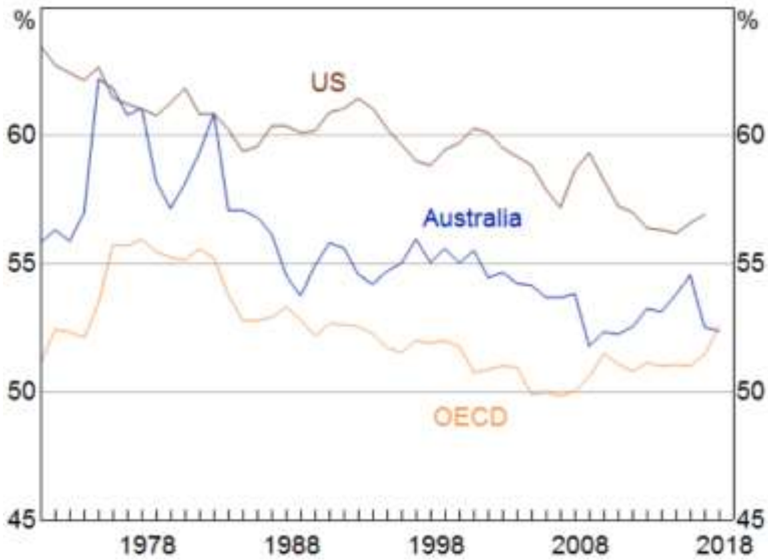
Anti-Labour Bias

The RBA and other central banks defend raising interest rates as necessary "pre-emptive strikes". These supposedly prevent "second-round effects" of workers demanding more wages to cope with rising living costs, triggering "wage-price spirals". However, this paranoia about wage-price spirals ignores the huge changes that have occurred in industrial relations regimes – not to mention the pandemic's lasting effects on workers.

With real wages stagnant for decades, the 'wage-price spiral' threat is grossly exaggerated. Over recent decades, most workers have lost bargaining power through deunionisation, deregulation, outsourcing, globalisation and labour-saving technologies. Hence, labour shares of national income have declined markedly in most industrial countries since the 1980s; and in Australia since the mid-1970s (Figure 3).

Figure 3: Labour's Shrinking Slice of the Pie

Compensation of employees divided by total factor income (%)



Source: Reserve Bank of Australia

Unsurprisingly, RBA research has found no evidence of wage-price spirals in recent decades, and concludes that experience and evidence suggest very little likelihood of "second-round" effects in current circumstances, although some nominal wages are now growing more quickly. The RBA findings are consistent with the research findings of the IMF. Thus, Ross Garnaut observed, "The spectre of a virulent wage-price spiral comes from our memories and not current conditions".

Meanwhile, corporations are taking advantage and jacking up prices to further enhance their profits. The RBA Governor, Phillip Lowe, has acknowledged that recent trends have made it "easier for firms to put their prices up".

Meanwhile, the RBA's ideological anti-inflationary fight with a blunt interest rate tool benefits the big four banks. They are "tipped to rake in record $33 billion" in profits as everyday Aussies battle with rising interest rates.

The Interest Rate: A Blunt Tool

Ideologically blinkered, the RBA and leading central banks regard all inflation as being the result of excess demand, enabled by excess money. Thus, they depend excessively on interest rates as their sole instrument to tame inflation.

However, raising interest rates only addresses the symptoms, not the causes of inflation – which can be many. Raising interest rates too often may not be the right policy tool for several reasons:

- It can kill productive and efficient businesses, along with those less so;
- By slowing the economy, it discourages investment in new technology, skill-upgrading, plant and equipment, adversely affecting the economy's long-term potential;
- It raises debt burdens for governments, businesses and households.

Monetary tightening also constrains fiscal policy. A slower economy implies less tax revenue and more social spending. Higher interest rates also raise living costs, as households' debt-servicing costs rise, especially for mortgages. Living costs also rise as businesses pass on higher interest rates to consumers.

A Need for Policy Innovation

The recent inflationary surge is broadly acknowledged as resulting from supply shortages, mainly related to the new Cold War (with China), the aftereffects of the COVID pandemic, the Ukraine war, and global sanctions. Therefore, policymakers should consider all these varied causes of inflation, and how they interact. Each source of inflation needs appropriate policy tools, not one blunt instrument for all.

Increasing interest rates may slow price increases (however caused) by reducing aggregate demand, but does not address supply constraints – the main cause of post-COVID inflation. Anti-inflationary policy in the current circumstances should therefore pivot from suppressing domestic demand through higher interest rates, to enhancing supply capacity (including by fostering more investment in supply chains, infrastructure, housing, and other 'pinch points' in the economy).

Raising interest rates increases credit costs for all. Instead, financial constraints on desired industries to be promoted (e.g., renewable energy) should be eased. Meanwhile, credit for undesirable, inefficient, speculative and unproductive activities (e.g., real estate and share purchases) should be tightened. Rather than a one-size-fits-all approach to regulating the growth of credit, monetary policy can and should become more discriminating and nuanced.

This requires macroeconomic policies to support economic diversification, by promoting industrial investments and technological innovation. In short, each goal needs customized policy tools.

Social Dialogue, not Class War

Policy fights over inflation have many dimensions, including class. As [Michal Kalecki showed](), inflation is primarily an expression and outcome of class conflict (or conflicting claims) over the distribution of national output and income. Firms set prices as a mark-up over workers' wages and other input costs. The size of the mark-up reflects their structural power. And the mark-up in turn determines the aggregate distribution of income across classes.

Different strategies for managing inflation therefore imply different and conflicting interests in that distributional struggle. The 'social dialogue' approach, implemented under Labor Prime Minister Bob Hawke through the Accords of the 1980s, contrasted with the more confrontational approaches pursued in Margaret Thatcher's UK and Ronald Reagan's USA. In those countries, punishing interest rates inflicted long recessions – and those recessions were in fact part of a deliberate plan to undermine workers' power.

In Australia, in contrast, the [Prices and Incomes Accord]() between the government and unions moderated wage demands in return for 'social wage' improvements – such as Medicare, pension and unemployment benefit improvements, and superannuation. Meanwhile, although business groups were not formally party to the Accord, Hawke brought big businesses into other new initiatives such as the Economic Planning Advisory Council. This consensual approach helped reduce both unemployment and inflation.

Such consultations also enabled difficult reforms – including floating exchange rates and reducing import tariffs. They created the foundation for the developed world's longest uninterrupted economic growth streak – without a recession for nearly three decades, ending in 2020 with the pandemic.

There is no alternative to social dialogue in the face of today's more complex and uncertain economic environment. The current Commonwealth government should facilitate more multi-stakeholder debate and dialogue (as occurred at last year's [Jobs and Skills Summit](), for example) around policy responses to stabilise the economy and safeguard employment.

In other counties, too, more consensual approaches undoubtedly underpinned post-Second World War reconstruction and progress, through the so-called Keynesian 'Golden Age'. Neoliberals claim these policies created rigidities that limited further progress, favouring instead liberalisation and deregulation to achieve more market flexibilities. But that approach produced economic insecurity, stagnating productivity, and crisis. Neoliberal changes also undermined democratic states, and enabled more authoritarian, even ethno-populist regimes. Meanwhile, rising inequalities and more frequent recessions have strained social trust, jeopardising security and progress.

The answer to post-COVID inflation does not lie in still more monetary austerity, insecurity, and hardship. Instead, this is an opportune moment to reinvigorate a more inclusive and consultative approach to macroeconomics. Policymakers should consult all major stakeholders to develop appropriate policies involving fair burden sharing. The real need then is to design alternative policy tools through social dialogue and complementary arrangements to address economic challenges in more equitably cooperative ways.

By accepting as gospel the fundamental tenets of neoliberal monetary policy – namely, the primacy of a singular inflation target, and so-called central bank 'independence' – the RBA review panel missed these more fundamental macroeconomic issues at stake.

Missed Opportunity

Unfortunately, the review panel failed to acknowledge and challenge central banks' ideological biases, and reconsider the fundamental nature of macroeconomic policy-making from a more critical perspective. It remained vague when asking the RBA to consider alternative policy tools other than interest rates. It ignored the broader debates over macroeconomic policy which have been occurring in the wake of the pandemic and its after-effects (such as the ACTU's ambitious vision for a worker-centred macroeconomic policy). Perhaps the only silver lining is the recommendation to broaden the composition of the RBA Board – yet this may have little consequence, given the recommendation to free the RBA completely from government oversight.

In sum, the recommendations of this review are likely to cement an approach to monetary policy that remains very one-sided and ideological, and will undermine future efforts to achieve an inclusive, sustainable, and genuinely fully-employed economy.

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