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Special Article

Monetary Policy Mistakes and Remedies: An Assessment Following the RBA Review

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Abstract

This article responds to the Review of the Reserve Bank of Australia (RBA), which was released on 20 April 2023. We describe the underperformance of the Australian economy over the past decade, and identify the contribution of RBA mistakes. We suggest remedies that would improve prospects for low inflation and unemployment. Returning to general prosperity requires better coordination of monetary, fiscal and macro-prudential policy and of these with other aspects of economic policy-making. We conclude that while the RBA Review makes some valuable suggestions about structure and process at the RBA, it provides little guidance on the content of policy.

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1. Introduction and Summary

The Australian economy has performed badly for most Australians over the past decade. Real output per person has grown at well below the OECD average and real wages fell over a decade for the first time. Over the seven years preceding the pandemic recession, unemployment was stuck at over 5 per cent and underemployment rose strongly, when unemployment fell elsewhere in the developed world. The aftermath of the pandemic brought radically different circumstances. Unemployment fell to 3.5 per cent after fiscal and monetary restraint were abandoned during the pandemic recession. Inflation rose to well above the target of 2–3 per cent that had been followed through the three decades of flexible inflation targeting. Subsequent statements from the monetary authorities suggest a view that unemployment will have to rise substantially for inflation to be brought back to the target range. These statements reveal an expectation that the extraordinary reduction in real wages through the post-pandemic inflation will be sustained.

This was the economic context of the Review of the Reserve Bank of Australia (RBA) initiated by the Treasurer in July 2022, and of the discussion of the Review after its release on 20 April 2023 (de Brouwer, Fry-McKibbibn and Wilkins 2023).

This article discusses the Review's conclusions, and asks whether its recommendations would have led to better outcomes. We will argue that the RBA has not used its key policy

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instrument—the interest rate—so as to achieve the best possible outcome for *both* of its objectives, inflation and employment. The Review's conclusions may improve performance at the margins but on their own cannot raise Australian economic outcomes to acceptably high levels.

A central problem in Australia in recent times is that different areas of policy-making, with influence over different policy instruments, have not worked well together. This article focuses on monetary policy-making. A companion paper (Garnaut and Vines 2024) looks more broadly at coordination of policy across the range of policy-making instruments —what we describe there as the conducting of an economic policy orchestra.

When we describe ways in which cooperation between the RBA and other macro-economic policy-making institutions has not worked well, we note that not all of this has been the RBA's own fault. Furthermore, since the policy-making has lacked a coordinating centre, the RBA has at times been drawn into assumption of roles beyond both its knowledge and its competence.

We begin by sketching the story of economic development in Australia over the past decade. We will then set out some of the reasons why policy has delivered unsatisfactory outcomes. This will allow us to suggest policies that would now lead to improved prospects for inflation and employment and to rising real incomes. We then go on to observe that although mistakes in monetary policy are part of the reason for the underperformance of the Australian economy over the past decade, they are by no means the only reason. Returning to general prosperity will require coordination of policies in many areas. Closer coordination of monetary with fiscal and prudential policy is essential for good performance. But excellent performance requires contributions from and coordination of fiscal and monetary policy with trade, competition, labour, climate and energy policies. We touch only lightly on aspects of coordination away from macro-economic policy-making, since we discuss those issues in Garnaut and Vines (2024).

In a section at the end of the article we ask whether the recommendations of the RBA would be likely to help. It is true that the Review makes some valuable suggestions, which we discuss. But our answer to our overall question is: not much.

2. 2013–2023: A Lost Decade

The RBA Review assessed that the RBA and the economy had performed relatively well over the past three decades. Amongst other things, we had experienced almost three decades of expansion of total economic output without recession.

The long expansion was achieved through a period in which many developed countries experienced two recessions, and our neighbour New Zealand, three. New Zealand is particularly interesting, not only as a neighbour with some similar macro-economic features (a high proportion of commodity exports and deep economic integration into Asia), but because it is the global pioneer, and in some perceptions the exemplar, of the inflation-targeting monetary policy regime.

2.1 Three Periods

We can see the reality of underperformance in the half dozen years before the pandemic recession within an unprecedentedly lengthy economic expansion more clearly if we recognise highly differentiated performance across three periods during Australia's many years of unbroken growth.

The first decade, to about 2001, saw strong expansion of economic activity and per capita output and incomes driven by productivity growth at the top of the developed world—Australia's Productivity Boom.

The second period, roughly 2002–12, was underpinned by high terms of trade and investment in mining as the Australian economy underwent profound restructuring to meet the requirements of a rapidly growing Chinese economy—Australia's China Resources Boom. Unlike all other developed countries except Korea, Australia did not experience a recession during the

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global financial crisis (GFC), and our country had lower unemployment in the years immediately following. This was a considerable achievement. But these superior outcomes did not continue for long after the immediate recovery from the GFC.

The third period, 2013–19, saw unprecedentedly low growth in productivity and output per person. Growth in total output was maintained despite stagnating output per person only because there were exceptionally large increases in the labour force from immigration—Australia's Dog Days (see Garnaut 2013, 2021).

Through this third period, several other influences exacerbated the downward pressure on ordinary Australians' living standards that was coming from low productivity growth. There was an increase in the profit share in national income, and a fall in the wage share. And Australians did not share the reduction in unemployment experienced in the United States and many developed countries. In 2013, unemployment was several percentage points higher in the United States than Australia's five point something. By the eve of the arrival of the COVID-19 pandemic, seven years later, unemployment in Australia remained at five point something, while underemployment had increased markedly. By contrast, the percentage of the labour force which was unemployed in the United States had fallen to well below that in Australia, to about 3.5 per cent.

The three-and-a-half years since the beginning of the pandemic have had their own dynamic that is weaving its way into what threatens to become a new Dog Days story.

2.2 Global Developments

The disruption of international trade and more generally of global supply chains caused by the pandemic greatly reduced productivity. The disruption of supply chains has only gradually unwound. But as economies have emerged from lockdowns, demand for goods and services has grown rapidly. In the developed economies, accumulated liquid financial balances have been liberated to support consumption expenditure. A combination of low productivity and high demand has driven a strong inflationary impulse through the United States and Europe and from there to the rest of the world. This inflation was pushed to new highs by disruption of global markets as a result of the Russian invasion of Ukraine and the international response to the ongoing conflict there.

Monetary policy has been tightened everywhere and fiscal policy has also been tightened in many countries. By mid-2023, this had brought recession to some developed countries including to our neighbour New Zealand, and recession is now threatened in others. Throughout the developed world, higher prices were driven by scarcity and by market opportunity, with profits representing an unusually high proportion of inflated prices and incomes (IMF Research Department 2022; Blanchard and Bernanke 2023). Sharply higher prices for energy, food and chemical manufactures following the Russian invasion of Ukraine were returning to pre-invasion levels by mid-2023. The restoration of supply chains and easing demand growth were together giving rise to decelerating inflation for traded goods and services generally. But inflation remains well above target levels in large parts of the developed world.

Distinctive policies in the world's two largest economies, the United States and China, have exerted powerful influences on the global economic performance in the aftermath of the pandemic.

In the United States, the Trump administration conducted strongly expansionary fiscal and protectionist trade policies from 2017 until the COVID-19 pandemic (Corden and Garnaut 2017). Interest rates began to rise moderately from this time—from levels for nominal cash rates and real long bond rates that were near zero—leaving overall demand growing strongly. Continuing strong domestic demand and more restrictive immigration and trade policies led to a continuing reduction in unemployment to around 3.5 per cent. This was widely seen as being close to full employment—the point beyond which an increase in demand for labour would lead to

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increases in wages at a rate that threatens to cause an acceleration of the rate of inflation above its target level (see Blanchard and Bernanke 2023).

The United States, like the world as a whole, fell into the pandemic recession with the lockdowns during the first half of 2020. Massive increases in government spending and deficits and monetary expansion through sub-zero cash rates and quantitative easing placed a floor under aggregate demand and unemployment. They also led to an extraordinary increase in private cash balances and liquid financial assets, building a powerful latent expansionary impulse awaiting the return of more normal economic conditions. The COVID-19 disruptions compounded the negative impact of America's turn towards protectionism on productivity growth both at home and in trading partners. The Biden administration added to fiscal expansion from early 2021 as an anti-recessionary initiative, and again with the ironically named Inflation Reduction Act from October 2022. The Federal Budget deficit is expected to remain at about 6 per cent of GDP in FY 2023 despite unemployment being historically low and widely thought to be close to full employment. Strong demand, supply-side shortages and the disruption of trade quickly lifted inflation to over four times the official target of 2 per cent (again see Blanchard and Bernanke 2023). Inflation was transmitted abroad by the strong dollar that was induced by fiscal expansion and monetary tightening. But despite extraordinary fiscal expansion at a time of historically low unemployment, US inflation has been decelerating rapidly through 2023. Some commentators have begun to refer to 'immaculate disinflation'—disinflation without an apparent cause.

China is by far the world's largest producer of manufactured goods, and contributes parts of the goods supply chain almost everywhere. It is overwhelmingly Australia's largest trading partner. Within China the COVID-19 lockdowns were maintained until close to the end of 2022, extending supply chain disruption and reductions in productivity across the world. Continued disruption of supply chains through the first year of post-pandemic expansion in the rest of the world magnified the global inflationary impact of increased demand. China's own anti-recessionary policies were more restrained than those in the United States and the rest of the developed world so that the end of lockdowns and easing of supply chain disruptions from early 2023 brought disinflation. Producer prices were falling through 2023 and there was discussion of the possibility of general deflation in the absence of new, expansionary fiscal and monetary policies.

The United States and China have both contributed a great deal to pressure for lower inflation in global goods markets through 2023.

The dislocation of global energy, chemical manufactures and food markets by the Russian invasion of Ukraine in early 2022 came as global post-COVID-19 inflation was at a high point. Over the year-and-a-half since the invasion, much of the old volumes of Russian and Ukraine exports have found their ways onto global markets, returning prices for these goods to close to their pre-invasion levels. Together with easing supply chain conditions generally and global monetary tightening, this has been bringing inflation down through the developed world in 2023. But not as fast as some have hoped, and as some have thought necessary in order to remove the risk of raising inflationary expectations.

2.3 Pandemic and Subsequent Developments in Australia

In Australia, the pandemic recession marked the end of 28 years of continuous growth in total output. Federal and state governments provided unprecedented levels of income support, and extended the provision of health and other services to households and subsidies to businesses. The federal and several state government budget deficits as a share of the economy were far in excess of anything previously known outside the two world wars. Policy interest rates (cash rates) were reduced to their lowest-ever levels, at 0.1 per

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cent. Australia for the first time adopted a policy of quantitative easing (QE) like that which had been introduced in most developed countries in response to the GFC, and was introduced in all developed countries during the pandemic recession.

The RBA monetised the huge federal and state deficits through QE. It took the unprecedented step of setting a target for interest rates on multi-year bonds, and expressed its expectation that it would keep both cash and medium-term interest rates at record low levels for several years.

Suddenly, the historically high rates of immigration which had occurred during the Dog Days period were replaced by net emigration which caused a marked decline in labour supply. In combination with massive expansion of demand, this reduced unemployment below 5 per cent by late 2021 and to 3.5 per cent in June 2022. This was lower than for half a century, and down to the levels achieved in the United States immediately before and after the pandemic. It has continued at that level through to the latest data available, for June 2023. There has been no evidence of any upward pressure on real wages in the market place that would have signalled that the non-accelerating inflation rate of unemployment (NAIRU) had been reached (Borland 2023).

In mid-2023, record high terms of trade, low unemployment and firm fiscal policy have generated the first budget surplus since before the GFC for the financial year 2022–23. Together with high inflation, this is reducing public debt as a proportion of the economy far more rapidly than had been anticipated in any official or private forecasts. This is a welcome strength of Australia's current economic circumstances, which expands the range of policy options available to governments.

The United States and Australian macroeconomic situations are similar in some ways and starkly different in others. Both countries have low unemployment by the standards of the past half century—3.5 per cent in Australia and 3.6 per cent in the United States in June 2023. Demand for labour is being driven by contrasting combinations of fiscal and monetary policy. The US federal budget deficit is the highest ever in peacetime at a time of reasonably low unemployment. Australia is running a rare budget surplus. Both countries are running the tightest monetary policies since the GFC: cash rates 5.25–5.5 percent in the United States and 4.1 per cent in Australia. Total demand relative to labour supply is stronger in the United States: real wages have been rising in the United States and falling in Australia. The different combinations of fiscal and monetary expansion in the two countries mean that Australia is in a stronger position to manage the effects of future economic shocks on intergenerational equity, and they have also contributed to Australia's relatively strong competitiveness in trade-exposed industries. The larger US economy and its issue of the world's international currency insulate it at least for a while from the consequences of policies that would be imprudent in Australia.

2.3.1 What Happens Next?

The RBA says that any tendency for nominal wages to rise to offset the effects of inflation will require further increases in interest rates. If the RBA's declared approach is the only policy response, we can anticipate continuing low economic growth, perhaps recession despite the high immigration, and much higher unemployment alongside entrenchment of the recent declines in real wages.

Australia can do much better than this. We think that policies that lead to a post-pandemic Dog Days would be a mistake.

3. The First Way in Which Things Have Gone Wrong for the RBA: Running an Excessively Tight Monetary Policy

Perhaps the most contentious macro-economic policy question of this century so far is how far the RBA needs to raise interest rates in order to bring inflation back within the 2–3 per cent target range within a reasonable time. We believe that the approach by the RBA to this question has been misguided and that the

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thinking underlying its mistakes goes back some time.

The picture that we painted in Section 2 of the economy as it came out of the pandemic was of disrupted supply, high demand, high prices for traded goods and high inflation. During 2021, 'year to' inflation rose to nearly 8 per cent[1] and by June 2022 Australia's unemployment rate had fallen to 3.5 per cent.[2] The 'year to' inflation rate was still above 7 per cent at the end of 2022.

3.1 The RBA's Mistakes About the NAIRU

The RBA leadership had been asserting for many years prior to the pandemic that the NAIRU was over 5 per cent. The 2019 Freebairn Lecture at The University of Melbourne was given by an Assistant Governor of the RBA, Luci Ellis[3] (Ellis 2019). Ellis noted that the NAIRU had fallen steadily through the 2000s and was still falling at the time at which she was giving her lecture. She noted that the RBA's own econometric models said that the NAIRU had by this time already fallen to 4.5 per cent. She went on to introduce a number of qualifications that we think are important, in particular that these models did not either account for changes in rates of underemployment or allow for a weakening of workers' bargaining power. She cautioned that the NAIRU cannot be observed directly, noting that 'you can guess that you are below it if wage growth is accelerating'. Deputy Governor of the RBA, Michelle Bullock, explained eloquently in June 2023 the benefits of full employment. But she did not spend time on Ellis' qualifications and stated that unemployment at 4.5 per cent would achieve that desirable condition (Bullock 2023).

The latter number informs an RBA view that for inflation not to accelerate, unemployment needs to be 4.5 per cent or above. For inflation actually to be brought down, the rate of unemployment needs to be above 4.5 per cent to discipline the wage-fixing process. How much above depends, according to this argument, on the steepness of the Phillips curve.[4]

In fact, unemployment has stayed at more or less the same level—3.5 per cent—for more than a year, and yet inflation has declined. In the June quarter of 2022 the consumer price index (CPI) increased by 1.8 per cent. At the end of July this year—a year later—we learned that in the June quarter of this year the CPI rose by only 0.8 per cent (ABS 2022, 2023). It is thus not at all clear that the arguments put forward by the RBA leadership are correct.

One of us, Ross Garnaut, surmised, in his book *Reset: Restoring Australia after the Pandemic Recession* published in February 2021 and based on lectures given in June and July 2020 (Garnaut 2021), that the NAIRU may already have fallen as low as 3.5 per cent and this view seems to have been vindicated. There are many reasons for this. The first is that, even in current circumstances, there is virtually no industrial action. This appears to be because, in Australia at present, such a very low proportion of the workforce belongs to a union and we are in a period in which there has been weaker enforcement of labour regulations and laws and a further reduction in the regulation of wages. Second, real wage growth is being held down by technological change, including the effects of the internet, of more sophisticated and powerful computing and now of artificial intelligence. Third, the very rapid increase in immigration has also helped to hold real wages down.[5] Fourth, a long period without large increases in unemployment from recession disqualifies fewer people from employability on grounds of inadequate previous work experience. Finally, higher underemployment changes the relationship between conventionally defined full employment and pressures for higher wages in the labour market. Jeff Borland's careful analysis of actual labour market conditions, focusing on the last of these features, has pointed to the likelihood that the NAIRU may now be as low as 3.5 per cent (Borland 2022, 2023).

But even if we accept that the NAIRU is now no higher than 3.5 per cent, we need to ask another question in the inflationary conditions of 2023. Does unemployment

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need to be increased *above* the NAIRU in order to bring inflation down, and in particular to prevent the development of a wage price spiral? Concerns about the possible emergence of such a spiral have been significant globally (IMF Research Department 2022), as well as in Australia.

Some US evidence may shed light on how to think about this question for Australia. In their widely noticed econometric analysis of recent inflation in the United States, Olivier Blanchard and Ben Bernanke demonstrate two important things (Blanchard and Bernanke 2023). First, they show convincingly that the shocks to inflation in the United States were transitory rather than permanent, that is, they were mainly 'external' shocks that disrupted both demand and supply of all of goods, services and labour, rather than shocks 'internal' to the labour market. Second, US inflation expectations—both through the COVID-19 pandemic and subsequently—remained partly anchored at a low level. Although the very great increase in inflation in 2021 and 2022 appears to have given rise to a sudden upward move in shorter-term inflation expectations, it does not appear to have dislodged longer-term inflation expectations, which have remained very close to the 2 per cent inflation target. In a thought-provoking study, Tomas Michl and Bob Rowthorn argue that, in such circumstances, merely keeping unemployment at the NAIRU, so as to prevent inflation from coming under pressure to accelerate, may well be enough to bring inflation down quite quickly, simply because people expect it to come down (Michl and Rowthorn 2023).

We think that similar circumstances are likely to be relevant in Australia. In Australia's case, the appropriate policy for bringing inflation back down towards its target is not one of seeking to create more unemployment, as argued by Governor Lowe and Governor-elect Bullock, so as to exert discipline on the wage-bargaining process. Instead, what matters is that policy ensures that inflation expectations are not dislodged and that these expectations remain at least partly anchored on the inflation target. The necessary containment of inflationary expectations, as well as of inflation itself, is being greatly assisted by the fall during 2023 of the prices for many traded goods that had lifted sharply through the post-pandemic expansion and the Russian invasion of Ukraine.

If anti-inflationary policy is to be conducted in this way, then communications will play a critical role. The RBA will need to make it absolutely clear that it is determined to ensure that the target level for the rate of inflation will not be allowed to slip, even if the return to target takes a number of years. They will do this more credibly if public statements on monetary policy are calibrated accurately against observable economic realities. Such an approach to policy is likely to assist not only in the task of establishing full employment with moderate inflation. It may well also help to hold the NAIRU at a low level, and perhaps even contribute to its continuing fall. This will be a quite different approach to anti-inflation policy from the one being pursued at present.

A gradual approach to returning to the target range of inflation will be essential if unnecessary increases in unemployment are to be avoided. This is because there are strong economic reasons to expect higher-than-average increases in nominal wages for some time. The very rapid inflation over the past two years has led to the largest-ever contraction in real wages. Whilst the CPI increased by 12.35 per cent over the two years to March 2023, the official wage price index indicates that average wages rose by only 6.2 per cent—a fall by 5.8 per cent in average real wages (ABS 2022, 2023). Official forecasts anticipate continued substantial reductions in real wages after March 2023, at least until the end of 2023. But when the economy settles down after this inflationary episode we can expect the level of real wages to return to near its level before the pandemic because there has been no change in structural relationships in the economy that would point to a reduction of 6 per cent and more in the equilibrium real wage.[6] The low rate of productivity growth means that it may not end up at a level much higher than this, but there is no reason to

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expect an absolute decline. For such an outcome wages must grow faster than prices for a period of time. This will be a period in which the increases in traded goods prices that initiated the general inflation will be lower than they had been earlier, and this moderation will be placing downward pressure on the general price indexes. But the natural tendency for money wages to catch up with past inflation means that the inflation rate is likely to come down less rapidly than it would otherwise have done. The calls by Governor Lowe for wage increases to remain below price increases do not seem to recognise the importance of this re-adjustment process.

In a careful study, Isaac Gross and Andrew Leigh, using the RBA's MARTIN model, find that the interest rate was kept too high during the period from 2016 to 2019, so that during that time inflation fell below the RBA's target band (Gross and Leigh 2022). The authors did this by comparing actual monetary policy decisions to a counterfactual in which the interest rate was set according to an optimal simple rule. They suggest that optimal monetary policy in that period would have required a substantially lower interest rate and would have led to significantly better employment outcomes. 'The failure to implement optimal monetary policy cost the equivalent of approximately 270,000 people being out of work for a year' (Gross and Leigh 2022, p. 281). Gross and Leigh confine their analysis to 2016–19, but the phenomenon of unnecessary unemployment was also present at least over the several immediately preceding years.

Gross and Leigh obtained their conclusions by using the RBA's MARTIN model, with its embedded assumptions about the NAIRU, which we believe are probably inappropriate, for reasons which we have already discussed. Bishop and Greenland (2021) note that there is too little data and the data change too much over time for us to be confident about results that are obtained from regressions using historical national time series, as the models do. They themselves draw upon larger numbers of observations using regional data and estimate a lower NAIRU. We think they were right at that time and would be right by a wider margin now. As a consequence, the excess unemployment caused by the RBA during the period from 2016 to 2019 would have been larger than the figure quoted above.

3.2 The RBA's Mistakes about the Setting of the Interest Rate

We make two points.

First, it was a mistake to set interest rate targets other than the cash rates that had hitherto been the focus of policy. Rates for multi-year bonds are necessarily set in deep global markets. Unlike cash rates, they are not within the control of the RBA. It is not surprising that market developments overwhelmed the RBA targets in less than a year, and the policy was cancelled. It was also a mistake to announce an expectation that cash rates would remain at 0.1 per cent until 2024. The future is inherently unpredictable. A central bank loses credibility when it announces an expectation that is soon rendered obsolete by changes in economic circumstances.

Second, the RBA also appears to have the wrong view that the 'natural' or 'neutral' interest rate—that interest rate which is neither expansionary nor contractionary and is consistent with full employment and steady low inflation—is substantially positive. This view is leading them to a belief that there will be no cost in taking nominal interest rates back to levels that would be substantially above the inflation rate, once that inflation rate is back within its target range. In these circumstances, the RBA seems to think that it is simply restoring a normal real cash rate that would have to be re-established sooner or later. The reality is very different: the neutral real cash rate may not be significantly positive for as far ahead as we can see. Of course this has massive implications for whether the interest rate is being set at the right level at present.

The RBA view ignores the fact that real long-term interest rates, set in capital markets, have been falling steadily for several decades, with an acceleration following the GFC (Blanchard 2023, p. 29). Real interest rates

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for low-risk debt are much lower than they have been over at least 700 years excepting only the inflation with suppressed interest rates during the 20th century's two world wars (Blanchard 2023, p. 32). This reflects underlying tendencies in supply and demand for capital: tendencies to lower investment shares in expenditure and higher savings shares in income. The strengthening of these tendencies since the GFC has led to discussion of ‘secular stagnation’ by Summers (2020) and others. The maintenance of full employment and economic growth at an optimal rate requires real interest rates on low-risk debt of zero or below—and even with zero real interest rates may require large public deficits. Even the immense US, Japanese and other budget deficits of the post-pandemic period have not lifted the neutral real interest rate in developed countries to somewhere above zero.

The IMF speaks of interest rates staying ‘lower for longer’[7]. Olivier Blanchard's (2023) widely noticed book *Fiscal Policy under Low Interest Rates* structures discussion of optimal fiscal policy around expectations that the neutral real interest rate in developed countries will stay near or below zero. This structure is built on the assessment that long-term interest rates will remain low for a long time. We agree with Blanchard.

We are discussing a world phenomenon. But these global developments will have a profound influence on long-term interest rates in Australia, with its deep integration into global capital markets.

Our view that the natural real interest rate is near zero, and likely to remain there, is not contradicted by the very rapid rise in nominal interest rates which has occurred on the recent past. The inflationary pressures which we describe above have required policy-makers to raise interest rates very quickly—although until recently they have remained well below contemporary inflation rates. The forces determining long-term real interest rates, which we briefly described a few paragraphs ago, are very different from those determining interest rates in the recent past which have been determined by the current inflationary pressures.[8]

There is no discussion in the RBA Review of the RBA's perception of the ‘neutral’ interest rate—the real cash rate at which savings and investment are in balance with full employment and moderate inflation. That rate is well below RBA calculations in recent years. This misconception has distorted RBA perceptions. There is an intriguing statement in the Review's Executive Summary that there is ‘uncertainty’ about future neutral interest rates in a world of growing inequality and demographic change. There is no acknowledgement that these and other factors have led to the certainty of a lower neutral rate.

4. The Second Way in Which Things Have Gone Wrong for the RBA: A Failure to Adequately Cooperate

In our view, the RBA's biggest error was in running tighter monetary policy than the rest of the world in the seven years before the pandemic, at a time when the Australian economy was not in a strong-enough position. Inflation by all relevant measures was on average below the target range over this period. This relatively firm monetary policy caused the Australian dollar exchange rate to be high. The high exchange rate had a large impact on trade-exposed industries other than resources early in the period. Unemployment stayed well above the lowest level consistent with low inflation during this whole period. A failure of coordination of monetary with prudential (APRA) and fiscal (Treasury) policy contributed to the mistakes.

During the period from 2013 to 2019, there was some public discussion from time to time of the RBA being inhibited in lowering interest rates, not because it thought that unemployment was below the NAIRU but because it was concerned about the systemic risks associated with high levels of borrowing for housing and the associated housing asset boom. Gross and Leigh pick up this point in relation to their discussion of the period between 2016 and 2019: ‘the RBA was concerned about financial stability and accordingly set interest rates higher than inflation and unemployment alone would warrant’

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(Gross and Leigh 2022, p. 281). They are very critical of such a policy stance. They say that, on this point, the literature is remarkably clear cut. 'A strategy of using monetary policy to constrain asset price growth, dubbed leaning against the wind, has been found generally to fail any reasonable cost benefit test' (Gross and Leigh 2022, p. 283).

Gross and Leigh do not discuss the even greater waste of resources in the earlier period from 2013 to 2016. The period following on from the end of the China Resources Boom in 2012 saw a large fall in the terms of trade and mining investment. This was also a period in which there was sustained fiscal consolidation of 1 per cent per annum over six years—a massive withdrawal of aggregate demand by fiscal policy—at the very time when external demand for exports had fallen significantly. A number of people, including Stephen Grenville in his submission to the RBA Review, have criticised this fiscal consolidation. During this period, the RBA recognised that aggregate demand in the economy was too weak to generate satisfactory levels of economic activity and the Governor at various times urged the federal government to loosen its fiscal stance.

Others have argued that this fiscal contraction was appropriate and necessary, given the way in which public sector debt had been massively increased in the response to the GFC, and given the exposure of the Australian economy to significant international shocks. But whatever one's view about the fiscal position, this was a time when aggregate demand was contracting very significantly. Lower policy interest rates would have directly facilitated demand expansion and led to higher incomes and investment in the trade-exposed sector via a lower exchange rate.

Apparently there were significant discussions about this issue within the RBA throughout the period from 2013 to 2019. According to one view, the lower interest rates which would have been economically appropriate would have led to a damaging increase in asset prices, which APRA would have been powerless to prevent. A second view was that APRA should have been trusted to fulfil its prudential task. The first view appears to have had more influence.

Greater cooperation between the Treasury, Reserve Bank and APRA would have produced a much better outcome.

5. Would the Recommendations of the RBA Review Have Actually Helped?

Our answer to this question is: not very much. The review makes recommendations on structure and process. Some of the institutional reforms recommended by the Review have merit. But it is not obvious to us how they would have led to superior economic outcomes, except in one important respect which we identify below.

Overall we are comfortable with the Review's restatement of monetary policy objectives to give equal and exclusive weight to full employment and price stability. Actually, the equal weighting of currency stability and full employment is already in the law under which the RBA operates, which was legislated by the Menzies government in 1959. The exchange of letters between Governors and Treasurers since 1996 has been interpreted as and may have led in practice to inflation being given priority over employment. The Review's approach simply restores respect for the established law.

However, the Review barely touches the performance of the economy. It shows that inflation and unemployment have been lower on average over the past three decades of flexible inflation targeting than in the two preceding decades. True enough. But there is no comparison with the two decades that preceded the past five, when performance was far superior. And it treats the last three decades as a single period by averaging them, and so hides the distinctive underperformance of Australia after 2013. In particular, the Review does not assess underperformance on unemployment compared with the United States and some other developed countries over the past decade.

In fact, the Review says much too little about the failings in monetary policy-making

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which we have discussed in some detail in this paper. The Review also says too little about the coordination of monetary policy and fiscal policy. And it says almost nothing about the interaction of monetary policy with other areas of policy-making. In particular, given the mistakes we described earlier, we think it a weakness of the Review that it did not make recommendations for the re-integration of prudential and monetary policy—the return to the RBA of the prudential function, from whence it was taken two decades ago.

We now turn to the discussions in the RBA Review of institutional culture and its recommendations about structure and decision-making processes. We have three points to make.

5.1 Independence

We think that there are advantages in independence, and believe that these have been fully realised over these past decades. Nevertheless the existing legislation gives government the power to over-rule RBA decisions, providing—however—that the government follows a set of carefully specified procedures. The Review recommends ending this power. In our view that would be a mistake.

The relevant current provision of the legislation governing the RBA had its origin in the Commonwealth Bank's resistance to Treasurer Theodore and the Scullin government's (as it turns out, well-judged) expansionary policies, supported by currency devaluation. It is now widely accepted that the costs and distress of the Great Depression in Australia would have been substantially less if the Theodore/Scullin policies had not been blocked by the Chairman of the Commonwealth Bank, Sir Robert Gibson. Lessons were carried from that experience through Chifley's participation in the Royal Commission on Banking in the 1930s, and then by Coombs' advice to the Menzies government on the wording in the current law.

The law allows for the government to override the RBA on a policy matter, but requires it to provide an explanation to the Parliament. That power has never been used, although we note former Treasurer Keating's recent statement that he once threatened its use (Hutchens 2023). Since the Governorship of Bernie Fraser during the Keating Prime Ministership 1991–1996, there has been an understanding that the RBA would act independently, and that it would seek to hold inflation at an average of 2–3 per cent over time. This understanding has taken the form of a written agreement since the exchange of letters between Governor Ian Macfarlane and Treasurer Peter Costello in 1996. Of course, no such agreement between two parts of executive government can override the law.

In our view, the current arrangements have the relationship where it should be. In normal circumstances, the government leaves the RBA to do its job independently. However, if the democratically elected government forms the view that the RBA is wrong, and wrong to an extent that warrants taking the political risk of explaining to Parliament and therefore the community why it thinks the RBA's action is wrong, it would be anti-democratic for the government to be blocked from acting in what it judges to be the national interest. In this context, we note that the strong commitment to the idea that governments should never have any role in monetary policy were brought into the policy discussion of the democratic world by the Austro-Hungarian economists with their roots in a pre-democratic political economy.

5.2 Separating 'Governance' from 'Monetary Policy'

We see no harm and possibly some good in the separation of the 'governance' responsibilities of the RBA from the monetary policy committee (MPC). If there is such a governing board, it should be clearly superior to the monetary policy board (MPB).

What would the governance board actually do? At the Bank of England, the Court has prestige but does not do much. It oversees compliance with the law and management of conflicts of interest, looks after the Mint, organises surveillance of the gold reserves,

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and provides supervision over Bank pensions and terms of employment. All this might become possible in the case of the RBA governing Board. A Canadian expert, David Dodge, has said to us that having such a Board in the Bank of Canada has been valuable.

5.3 A Monetary Policy Committee

We see merits in the shifting of responsibility for monetary policy from a Board of generalists to a Board with greater specialist expertise in monetary analysis and policy. The authors of the Review argue that this would lead to a better understanding by the Board of the options for policy, to better discussions at Board level, and better actual decisions about policy. We agree that their proposals might lead to such an outcome, if amended in the way we suggest below. Doing this might help the RBA to avoid making the kinds of mistakes which we have described in this paper.

We think it a good thing that the Review recommends that the Secretary of the Treasury remains a member of the Board, in their personal capacity. But we see a large problem in finding in our small country six external economists with the necessary specialist expertise and practical experience—especially if they are to be rotated periodically in the way of well-managed boards. Care would have to be taken about conflicts of interest between Board members with continuing access to RBA staff, expertise and data, and their part-time commercial employment. That leaves economists employed by universities and specialist research institutions, and people with the appropriate expertise who are prepared to avoid conflicting commercial employment (perhaps parents temporarily out of the full-time labour force, people retired from public or private sector employment or employed in non-commercial private roles). The relevant qualifications must include wisdom on the operation of the real economy. Knowledge and experience are necessary in order to participate helpfully in discussions of monetary policy. And confident judgement may be required when the real-world economy is generating outcomes that diverge from the output of econometric models.

It may be realistic to find two suitable academic and two other appropriately qualified people with no current commercial roles as Board members on a continuing basis. We doubt that more people than that of the required quality would be available on a continuing basis. If there were four RBA appointees, plus the Governor as Chair, a dynamic with four external appointees could work well, so long as the externals had access to the data and knowledge of RBA employees, and staff support to carry out their own investigations, and so long as a political culture of open discussion was established anew. This is the setup in relation to the MPC in the United Kingdom. If only three appropriately qualified external members were available, the number of RBA full-time employees could be reduced to three, plus the Governor as Chair. The proposal made in the Review for six external members of the Board, and only the Governor and their Deputy from within the RBA, seems wildly unbalanced, since it would deprive the discussions of the detailed knowledge that senior internal officials can bring.

We are sure that one day a week is too short a period of time for the external members of the MPB who are meant to be expert in the details of the models and the data to devote to the task. There was no explicit statement about this in relation to the MPC in the United Kingdom when it was established, but the amount which the members of the MPC are paid, and the expectations of what they are to do, means that it is thought of as a three-day-a-week position. Not full-time but much more than a day a week. It has been said to us that very few of the existing six external members of the RBA Board would be prepared to devote three days a week to membership of a MPB. But maybe that says something about the kind of person that needs to be found to serve on the Board.

The Review suggests that external Board members should be required periodically to make their own public statements about

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monetary policy. If this recommendation is adopted in practice, care will need to be taken that public discussion of economic policy is not dominated by reporting of divergences of view within the Monetary Committee, at a large cost to coherence in policy-making and communications on policy, and to the exclusion of debate over issues that are fundamentally important to the Australian standard of living.

6. Improved Development and Co-ordination of Policy

It is clear that the large mistakes of the RBA that have contributed to economic underperformance will need to be corrected by improvements in economic analysis and discussion. The RBA Review makes useful suggestions as to how this might be done, with its proposal for greater research capacity on the macro-economy, greater external interaction with stronger economic research institutions outside the RBA, and joint use of the output of this research by both the Treasury and the RBA. Such developments would help to improve thinking about policy, and also help lead to better coordination between fiscal and monetary policy and to better cooperation across a number of areas of policy-making.

A central requirement will be the strengthening of the professional capacity of Treasury and other policy departments, after a decade of cuts in recruitment and staffing numbers and outsourcing of policy analysis and advice to private consulting groups. The denuding of professional capacity was much less important in the RBA than within the economic policy-making departments of state; the RBA was able to protect its access to professional resources, while other areas of policy-making were vulnerable to decisions on arbitrary reductions in numbers of officials across the board.

However, the biggest changes required if Australia is to achieve sustainably full employment with rising incomes for a growing population are in the wider economic policy discussion. An RBA fit for the future will help. But it will not avoid the need for clearer coordination of policy-making across a range of policy-making institutions to do with all of: trade policy, competition policy, labour market policy, and policies to do with climate and energy. We will turn to discuss these coordination issues in our companion paper to be published in the *Economic Record*.

Beyond this there is a need for clearer public discussion of the fundamental policy choices facing Australia. In particular, it is necessary for a strengthening of the national democratic culture, to allow leaders committed to the Australian national interest to pursue that interest with wide comprehension of what is at stake across the community. In this wider context, improving the performance of the RBA is a necessary condition for success, but far from the only condition.

Endnotes

1. See <https://www.rba.gov.au/chart-pack/aus-inflation.html>.

2. See <https://www.rba.gov.au/chart-pack/factors-prod-labour-mkt.html>.

3. Luci Ellis was at the time the RBA's Assistant Governor, Economic, responsible for the Bank's Economic Analysis and Economic Research Departments, the chief economic advisor to the Governor and the Board.

4. That is to say, on how much an increase in unemployment will actually cause wage demands to be reduced.

5. It is of course possible that the increases in the regulation of wages currently being contemplated, and a lifting of the Jobseeker allowance, will raise NAIRU.

6. There is a large literature on this question in labour economics, known as the wage-curve versus the wage-Phillips-curve discussion, which was largely triggered by the UK–US economist Danny Blanchflower. Blanchflower and Oswald (1995) argue that workers will attempt to restore their real wage, in the manner which we describe in our text. In an alternative approach, it is assumed that workers only attempt *temporarily* to defend themselves from a fall in their real wage and that the level of the real wage can be successfully pushed down by a sufficiently lengthy period of unemployment. The evidence for the United States is muddy, but closer to the wage-Phillips-curve case. By contrast for Australia we

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think that the situation is likely to be closer to that captured by the wage-curve version of the story. How the two cases might be distinguished in econometric work was clearly explained in 1997 in a paper by Thomas Whelan (1997).

7. See IMF (2023).

8. Some observers are resistant to this argument, claiming that interest rates depend fundamentally on monetary policy and on the risk premia set in financial markets. That is, of course, true in the short run, in the way that we have discussed, especially at times of supply constraints and demand surges, and at times of crisis when the risk premia imposed by financial markets may well be large. But as we have discussed, when crisis is over, and inflation is back under control, then it is the supply of savings and the demand for investment that will matter for the determination of interest rates. This is fundamentally because monetary policy-makers will need to set interest rates which ensure that these two things are in balance so as to ensure full employment without inflation, and—of course—because pandemic-related risk premia will have largely adjusted in those circumstances.

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