Central Bank Independence

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Submission to Senate Inquiry

Treasury Laws Amendment (Reserve Bank Reforms) Bill 2023(Provisions)

Abstract

This submission traces out the development of central banking in Australia and then discusses the proposed granting of total independence to the Reserve Bank of Australia.

Since 1993, the RBA has enjoyed informal independence which was converted to full independence in 1996. However, the Australian Treasurer could overrule the Banks monetary policy direction and stance if he felt it necessary in the interests of the Australian economy and social fabric of society.

The reform proposal to grant full independence to the RBA and its unelected Board of elites is considered not in the best interest of the Australian people. Moreover, history tells us that in the Great depression, the then Commonwealth Bank, supposedly Australia's Central Bank, refused to finance necessary Government counter Depression expenditures. That situation must never happen again; but it could if full independence is granted.

The granting of official independence in 1996, placed the RBA in the position of being responsible for two major arms of Australian macroeconomic policy i.e. Monetary and Exchange Rate Policy Arms. This submission argues that the elected Government must always have final control over all arms of macroeconomic policy. In a democracy, the people must never be deprived of passing judgement on the performance of a governments economic management at the ballot box. Full independence over Two arms of macroeconomic policy therefore becomes an untenable reform. Thus, the proposed Reform Bill must be rejected.

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1 Introduction

In July 2022, an independent review of Australia's central bank was undertaken. Recommendation 1.1 of the reviewing committee was the withdrawal of power of the Australian Treasurer to overrule RBA monetary policy decisions. The full implications of this recommendation have never been publicly debated by Australia's political groups, academics, and respected financial commentators. Whilst that is surprising in the current political climate of character assassination, the fact that academia has not commentated on granting of total independence to Australia's central bank is a major concern.

Central banking has accompanied the development of the semi-planned economy[i]. The role of a central bank has been to advise, regulate, and control an economies' banking system, and the supply and direction of bank credit. Across mature economies, whilst individual central banks have distinctive features, they all possess common features that facilitate control of trading banks, regulate the money supply, influence the volume and conditions of other financial enterprises, arrange financing of foreign transactions, and act as banker to the government[ii].

Prior to Federation, banking in the colonies remained in private hands. However, demands for government control over banking date back "at least to the 1890's"[iii]. Our federal forefathers recognised the need for Government authority over banking and finance. The wording of Section 51 (xiii) of The Australian Constitution confirms the Commonwealth authority over "Banking*, other than State banking; also State banking extending beyond the limits of the State concerned, the incorporation of banks, and the issue of paper money.* Section 51 (xiv) extends Federal Government authority to embrace: "*Insurances, other than State insurance; also State insurance extending beyond the limits of the State concerned*". Clearly, the importance of control over the financial sector was of concern to our founding fathers.

The 2022 Report that recommended total independence of the RBA says more about the prevailing political environment in the twenty first century than about understanding the needs of government to manage the economy, the distribution of income and wealth, and the social fabric of society. No doubt there are legitimate Constitutional questions that surround granting full independence to the RBA, but this short paper will focus upon the political economics that underwrite granting of full independence to our central bank.

1.2 Evolution of Central Banking in Australia

Government involvement in banking had to wait until after Federation. From Federation to 1910, the issue of notes was in the hands of private trading banks and the Queensland Government[iv]. From 1910, note issue became the responsibility of the Commonwealth Treasurer. In 1911, the Fisher Labor Government passed the Commonwealth Bank Act [v] and brought into being The Commonwealth Bank principally to win savings- bank business from State governments, and trading bank business from private sector banks[vi].

The establishment of the Commonwealth Bank came under strong political attack as socialist; but the intentions of the Labor Government were that it should compete actively with the private banks[vii].It was during World War I that the Commonwealth Bank performed an invaluable role in assisting the Commonwealth Government with large scale war finance[viii] .

In 1920, a Note Issue Department was established within the Commonwealth Bank. Consequently, responsibility for Note Issue was transferred from the Government Treasurer to the Bank Board. This gave control of the printing and issue of notes to the Commonwealth Bank[ix].

In 1924, the Commonwealth Government moved to convert the Commonwealth Bank into a central bank controlled by a Board[x]. The Commonwealth Bank Board members were expected to remain above politics and control banking policy[xi]. Private trading banks opened accounts with the Commonwealth Bank which established the Commonwealth Bank as the banker' bank for the settlement of inter-bank indebtedness.

The Great Depression of the 1930's confirmed the importance of central banking in many countries[xii]. In Australia, the Commonwealth Bank assumed control of the fixed exchange rate late in 1931. However, not all was plain sailing during the Great Depression. Over 1929-32, The Bank Board refused to fund proposed Scullin Government fiscal expenditures deemed necessary to stabilise the economy[xiii]. Depression policy was then forced to move to industry protection and depend upon overseas recovery of trading partners[xiv]. This triggered a Royal Commission in 1936.

A Royal Commission was appointed in 1936 to examine the Australian monetary and banking system. The Royal Commission report was delivered in 1937 and identified weaknesses in the existing system. Recommendations of the Royal commission sought to structure a central bank appropriate to the Australian economy of that time. However, World War II broke out before legislation could be enacted. The enactment of the War Power Section 51(vi) provided the Government adequate control over the Australian financial sector for the duration of World War II.

The Commonwealth Bank Act of 1945 provided the Commonwealth Bank with a complete range of central banking powers. The objectives of the post War Australian Central Bank were defined such that it would best contribute to[xv]

1. Stability of the Australian currency
2. The maintenance of full employment in Australia
3. The economic prosperity and welfare of the Australian people

The 1945 Legislation defined the Central Banks relationship with the Australian Government. Legislation ensured that should there emerge a disagreement over policy between the Central Bank and the Government, the Governments opinion would prevail[xvi].

In 1947, the Chifley Government unsuccessfully attempted to nationalise the Australian banking system. The methodology was that the Commonwealth Bank would compulsorily acquire the business of the private banks[xvii]. Nationalisation of the banking system was found Constitutionally invalid by the High Court.

The Menzies government came to office in 1949. Minor changes to banking legislation were made in 1951 and 1953. In 1957, however, major proposals were introduced. Legislation was enacted in 1959 and become operative in January 1960 under which central banking responsibilities of the former Commonwealth Bank were transferred to a new entity The Reserve Bank of Australia. The Commonwealth Banking Corporation was created to absorb the savings, trading and development activities formerly conducted by the Commonwealth Bank. The 1959 Legislation brought the Australian financial system into line with other major mixed economies in which the central bank is the apex of the monetary system controlling other members of the banking system.

Both the 1945 and 1959 legislation were based upon recommendations contained in the 1937 Royal Commission's Report[xviii]. Important measures were that the central bank be empowered to regulate the lending activities of banks. The key power was the right of the central bank to require trading banks to deposit prescribed amounts of cash reserves in frozen central bank accounts. The logic behind compulsory reserves with the central bank is to ensure in a fractional reserve banking system, the willingness of the central authority to underwrite the supply of an unlimited supply of notes that guarantees private bank deposits[xix].

Compulsory deposits with the central bank become important in the creation of bank deposits. Whilst activities of a single bank add little to credit creation, the banking system considered as a whole though becomes a different story. By expanding loans and investments as a multiple of new reserves, trading bank deposits increase. Bank lending then expands by the multiple of new deposits minus the compulsory reserves required. The net increase in new deposits generates growth in the domestic money supply. An important role for a central bank is to regulate the activities of trading banks to ensure bank credit creation does not become a destabilising feature of economic growth[xx].

All this changed under structural reforms of the 1980's and 1990's. Upon deregulation of the financial sector which began in December 1983, the Australian currency was deregulated, and its management became the responsibility of the RBA. By 1985, the flow of foreign capital had destabilised the demand for money function. Consequently, whilst monetary policy remained under the control of the Federal Treasurer, conduct of monetary policy became ad hoc.

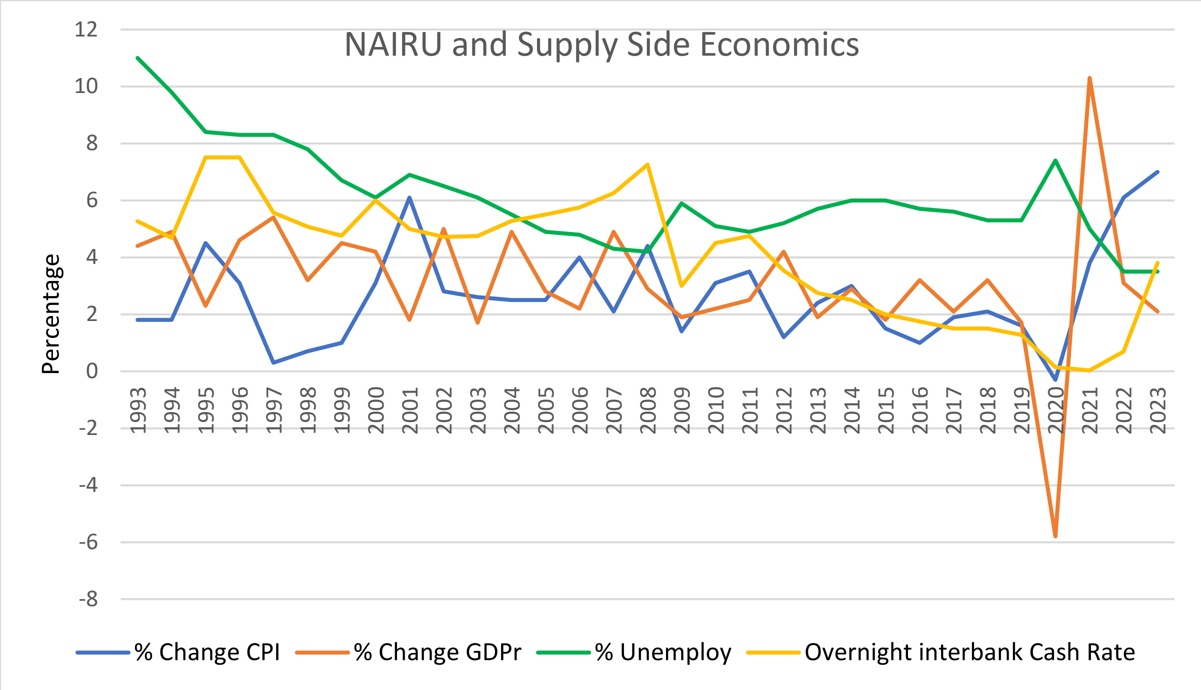
In 1988, it was assumed that the Australian money supply was endogenous determined by bank credit creation. In 1993, monetary policy moved from demand management to supply management to pursue inflation targeting. This required adoption of the cash rate to influence the demand for credit considered necessary to manage inflationary expectations by adjusting the actual rate of unemployment equal to NAIRU. Monetarism became the official economic philosophy underwriting Australian monetary policy.

From 1993 onwards, the RBA became unofficially independent to manage monetary policy pursuing inflation targeting. In 1996, the RBA was granted official independence to manage the important monetary policy arm of macroeconomic policy. However, the Treasurer retained the right to overrule

RBA policy direction under stringent conditions. In the 2020 review of the RBA, it was recommended that the power of the Treasurer be removed to allow the Reserve bank of Australia and its unelected Board full independence in determining monetary policy.

1.3 Conclusions

Chart 1



Compiled from RBA Statistical Tables online, Tables : G1; H1; H5; F1.1

Chart 1 demonstrates empirically, the performance of monetary policy post 1993 when the RBA assumed unofficial independence to conduct monetary policy. Real world evidence does not engender confidence in management of monetary policy particularly since the GFC in 2007. Indeed, it could be argued that empirical evidence suggests monetary policy has been impotent with respect to its Charter and responsibilities to the Australian community and social fabric.

Of major concern though will be effects of granting unfettered independence to the RBA and its unelected Board is that it will be “back to the future” in the history of Australian central banking. The RBA will have unchallengeable control over two major arms of macroeconomic policy: monetary policy, and external policy. That will leave the elected Government control over the one remaining arm of macroeconomic policy: fiscal policy. Meanwhile, the Australian Government responsible to the electorate through the ballot box must ensure economic growth, an equitable distribution of income and wealth, and internal balance with the one remaining arm of macroeconomic policy i.e. fiscal policy.

In terms of the Australian economic system, unfettered central banking will return the Australian economic system to a structure similar to pre 1910 when the Treasurer assumed control of the Note Issue. The next section will try and demonstrate, the type of economic system that might emerged under an unfettered central bank controlling two arms of macroeconomic policy.

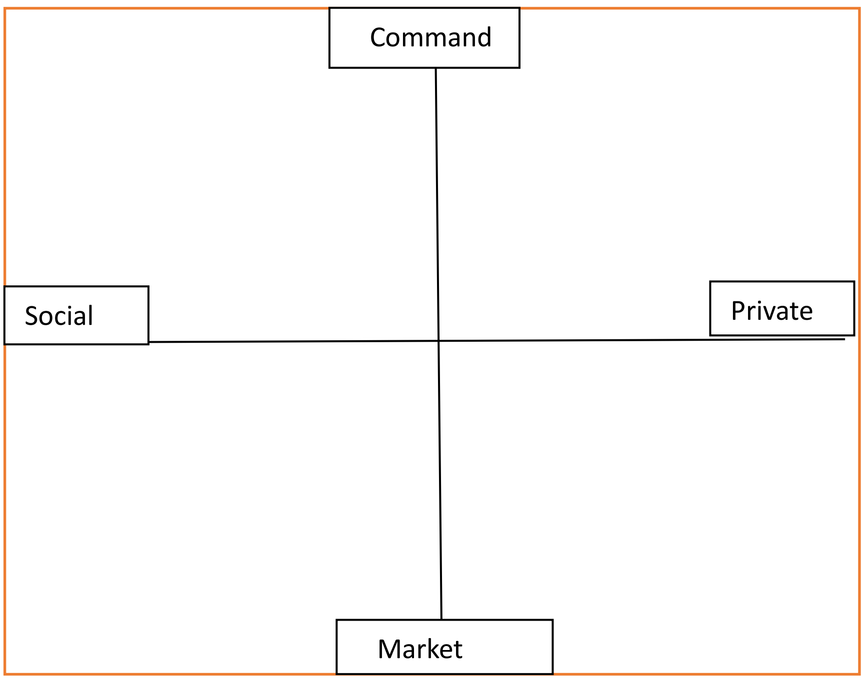
2 Political Economy and Comparative Economics[xxi]

Political economy deals with the interaction between economic mechanisms of society and political and social spheres of social activity. Comparative economics, on the other hand, concerns itself with the different types of economic systems i.e. capitalism, socialism, communism; and corporatism.

An economic system can be viewed as comprising two components or orders of society. Firstly, there is the economic order which embraces decisions relating to the production and distribution of goods and services. Secondly, there is the political order which considers relationships that are concerned with authoritative decision making within an economic system. Both orders of an economic society are interrelated. Consequently, decisions in one order directly affect the other order of the economy.

3 Economic Systems[xxii]

Economic Systems Model[xxiii]



1. The horizontal axis describes the economic order or ownership of the means of production, distribution and exchange.
2. The vertical axis describes the authoritarianism of the political order or decision-making process.

The ownership and control of the means of production determines the type of economic system. There are two authoritarian economic systems situated on the left and on the right of the political spectrum. The one in the fourth quadrant of the model is authoritarian communism. The one in the first quadrant of the model is authoritarian fascism.

The distinguishing feature between the two command economic systems is the ownership and control of the means of production. Under communism, the means of production is owned by the State whilst under fascism the means of production remains under private ownership; but increasing authoritarianism is achieved through extending government regulation and legislation to manage privately owned means of production.

To understand the economic systems model, imagine a pendulum centered at zero; but, at rest at 12.30 o'clock. As it swings leftwards, it traces out increasing public ownership and control of the means of production passing through the economic systems: mixed economy, socialism; and finally, communism in the fourth quadrant.

As the pendulum swings rightwards from 12.30 o'clock, it describes increasing government intervention through regulation and legislation to control privately owned means of production. The pendulum swinging rightwards from 12.30 o'clock passes from the economic systems of: laissez-faire capitalism, corporatism, to liberal fascism, and finally authoritarian fascism approaching 12 o'clock in the first quadrant.

In terms of the Australian economy, the post War Keynesian demand management system would be classified as a mixed economy positioned in the third quadrant. As post 1983 structural reforms were implemented, the pendulum has swung back from the third quadrant through 12.30 o'clock laissez-faire capitalism to secular corporatism.

Corporatist thinking had remerged in mature capitalist countries post World War II. Snavely labels modern corporatism as secular corporatism[xxiv]. Secular corporatism is characterised as functioning within a framework of large business enterprises, powerful labour unions, and a national government which accepts responsibility for the functioning of the economy. In the book *The Hawke Government a Critical*

Retrospective, Tony Moore refers to Bob Hawkes style of governing as "creeping corporatism[xxv]. Barry Jones identifies the National Economic Summit Conference called by Bob Hawke in April 1983 as a corporatist decision making model[xxvi]. The literary evidence confirms that the Hawke Government moved the Australian economic system rightwards from post War mixed capitalism to secular corporatism.

The idea of a move to corporatism in Australia began with an OECD Report of the Australian economy in December 1972[xxvii]. The OECD Report suggested fundamental changes to the Australian economy to ensure sustained economic growth and rising living standards. As government planning had been a major feature of Western European economies, their recommended model for the Australian economy would reflect the prevailing European corporatist economic system which embraced the following structure[xxviii].

- A full employment economy with dislocation emanating from unemployment or balance of payments crises regulated or reduced to a minimum.
- Long-term formalised and institutionalised planning coordinating government expenditures with those of larger private firms plus various controls over wage policy and private consumption
- International monetary, trade, and other types of coordination of the principal capitalist economies
- Institutional integration of a bureaucratic trade union movement into the planning process in exchange for limited but continuous economic gains for the working class - provided all independence of the movement be surrendered except over minor matters.

3 .1 Political Order

Within an economic system, there are two orders or components. The first component is the political order in which political decisions are made. The second order is the economic order in which the economic resources are allocated within the economic system[xxix]

The move to secular corporatism changed the political order within the Australian economic system. The political order brought into the decision-making a new way of governing. For example, whilst the accord was negotiated prior to the election of the Labor Government in 1983, it gave the Australian trade union movement privileged access to the Government decision making process. The National Economic Summit confirmed the move to corporatism by bringing together important national elites at Parliament House to build "*national reconciliation, national recovery and national reconstruction*[xxx] ".

The post 1983 political order was then structured under the new secular corporatist economic system. Invited industry and social elites formed the political order to drive a new direction for an emerging Australian corporatist economic system. Discipline of invited elites would be by threat of exclusion similar to trade unions in the OECD model above. This allows the elected Government to appoint selected elites from industry boards, social movement, and the trade unions to important advisory bodies; and expect cooperation in major policy directions and stance. Important industry appointments such as the Board of the Reserve Bank of Australia would come from unelected elites comprising the political order of the economic system.

From 1993 onwards, appointed elites to the RBA Board and its Governor effectively managed the monetary and external policy arms of Australian macroeconomic policy. If the RBA is granted complete independence as recommended in the 2020 Report, then economic management in Australia regresses back to pre-1920 when the first moves to central banking emerged. History of Depression and two World Wars has taught the Australian political class nothing.

3.2 *The Economic Order*

Following the collapse of the post-World War II reconstruction era "Declining *faith in Keynesian aggregate demand management*"[xxxi] led to a search for a replacement economic philosophy. What emerged in western politics was a movement labelled "The New Right"[xxxii]. Their policy direction pursued two objectives. Firstly, they sought to eliminate waste and inefficiency in the public sector. Secondly, they pursued a belief that free- market solutions are always best. The New Right ignored the reality of economic history that such a belief in free markets is badly mistaken. Whilst markets and profits are vital, "*the pure free market model is deeply flawed*"[xxxiii].

Nevertheless, the New Right emerged formerly as supply side economics over the 1970's as Thatcherism in Britain, and Reaganomics in the USA in the early 1980's. Both versions were strong believers in the logic of free-market economics[xxxiv]. Post election of the Hawke Administration in 1983, Australia adopted Thatcherism and so began the emergence of a "New Right" structural reform agenda of the post-World War II Australian mixed economy. The economic order formed around market deregulation, privatisation, labour market reform. It was a supply side reform of the post War demand side economic order.

"*Supply side economics is a shorthand description for a body of economic policies firmly rooted in the free market tradition of classical economics, Austrian economics, and other schools*".

Bruce Bartlett[xxxv]

Institutional economic modelling became built upon general equilibrium modelling introduced into Australia by Evans in 1971 and extended to major public sector bodies by 1975[xxxvi]. General equilibrium modelling is based upon the economic theories of Leon Walras who produced the first mathematical general equilibrium theory of economics in his *Elements of Pure Economics 1874-77*[xxxvii]*.* Underwriting GE theory is an assumption that "all markets clear" which is a modern restatement of Jean-Baptiste Say's, 1803, *Law of Markets*[xxxviii] i.e. supply creates demand.

The new Neoclassical Synthesis, Modern Keynesian DSGE models are all based upon GE theory and assume all markets clear. Even the New Keynesian monopolistic DSGE model assumes all markets clear over a defined period. Hence the return of classical economics as desired by supply side economic reform of the Australian economy post 1983. Policy modelling of resource allocation in modern Australia will be influenced strongly by a return of classical theory and supply creates demand. The economic order of the modern economic system will be heavily influenced by classical era economic theory formalised in underlying derivatives of the New Neoclassical Synthesis such as DSGE models. The New neoclassical synthesis simply replaced Keynesian theory in the old 1938 Neoclassical Synthesis with Friedman's inflation augmented Phillips Curve

Consequently, the other economic philosophy influencing Australia's post 1983 economic order is Friedmans Modern Quantity Theory of Money. Once the RBA moved to inflation targeting and adoption of NAIRU, Australian monetary policy official adopted Friedmans monetarism. Problems confronting monetary policy based upon Friedman's Modern Quantity theory can be demonstrated by simple mathematics.[xxxix]

Let Ms= Md in equilibrium, Then
Md = f (W, r- 1/r dr/dt, 1/P dP/dt, h) p

W = wealth
R = cash rate
P = price level
H= ratio of human to non-human wealth

In equilibrium

Ms= *f (W*, r- 1/r dr/dt, 1/P dP/dt, h) p

To manage inflationary expectations, the RBA relies upon adjusting the cash rate (r) to bring actual unemployment equal to NAIRU. Once Australia adopted the assumption that the money supply was endogenous back in 1988, then problems arose for applied monetary policy. Under the previous assumption of an exogenous money supply, policy was demand side managed. However, once it was assumed that the money supply was endogenous, setting of the cash rate moved monetary policy to supply side policy influencing the price of credit. Under supply side price of credit policy, the transmission of monetary policy has to work through the banking system to influence industry demand for credit. The outcome of the demand for credit then flows through to the demand for labour to adjust the actual rate of unemployment equal to NAIRU. It is a convoluted and imprecise transmission mechanism.

If other variables are assumed unresponsive to policy change, the wealth variable "W" can be used to discredit the assumption that it is only the demand for labour in disequilibrium. In the Modern Quantity Theory, W is assumed to respond to the Pigou effect[xl]. However, the Pigou effect argues that as prices and wages fall, then the real value of money rises in the same proportion which means that real value of money wealth rises. The real question becomes: what is the role of W under rising nominal prices? An improvised answer can be illustrated by inverting the Pigou effect; but this can become convoluted and confusing.

Another approach offered by Ronald Shone is that the wealth effect "W" can be ascertained only by empirical observation[xli]. Meanwhile, the RBA has an online educational brief[xlii] that explains their view of the monetary policy transmission mechanism. According to the RBA monetary policy is transmitted through two stages:

- Change in interest rates.
- Change in interest rates then affects economic activity and inflation.

Four channels transmit monetary policy to finally influence economic activity and inflation:

- Savings and investment.
- Cash flow.
- Asset prices and wealth.
- The exchange rate.

Given the rising level of homelessness and rising disadvantage in Australia, it is the effect upon asset prices and wealth that interests this discussion of the economic order in the modern Australian secular corporatist economic system. Assume the asset prices and wealth channel approximates the wealth variable (W) in the Modern Quantity Theory. According to the RBA, the asset price and wealth channel delivers three impacts:

1. Influences how much can be borrowed and spent in the economy.
2. Rising asset prices increase equity held in assets and encourages banks to lend which increase domestic credit expansion (DCE) component of the money supply.
3. As asset prices rise, wealth increases which leads to higher consumption and housing investment as householder spend some of their newfound wealth.

Some very slippery assumptions are necessary to validate these underlying wealth impacts transmitted by monetary policy mechanisms. One of which will be rational expectations which underwrites modern micro foundations of macroeconomics.

The economic order of an economic system allocates resources for the economy to deliver economic growth, full employment, an equitable distribution of income and wealth, and through the social fabric, the economic welfare of the community. The assumed channels of the monetary policy transmission mechanism that influences asset prices and wealth channel raise major questions and problems associated with an independent RBA and its unelected Board managing two arms of macroeconomic policy.

4 Conclusions

- From the body of this discussion, to remove the authority of the elected Australian Parliament over two arms of macroeconomic policy is more about ideology than sound economics.
- In a democracy the people elect governments at set times in the belief that if economic management is proving unacceptable, the government can be removed.
- To grant full independence to an unelected Board and Governor of a nation’s central bank over the control of two major arms of macroeconomic policy removes the democratic right of the people to pass judgement upon prevailing economic policy, its direction and delivery.

Furthermore, there will no doubt be constitutional questions that must emerged to challenge the granting of full independence to a nation’s central bank and its authority over two arms of macroeconomic policy. It seems sad that the struggle to establish a central bank has been forgotten. The story identifies how important central banking is in a democratic nation. The refusal of the independent

Commonwealth Bank to finance Government expenditure in a time of great crisis (Great Depression) should never be forgotten. The Government must retain the final say over applied macroeconomic policy arms in the stability of the national social fabric.

The second question to emerge follows naturally and becomes "has supply side ideology reached its used by date?"

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