

## **Submission to the Inquiry into the Reserve Bank Amendment (Enhanced Independence) Bill 2008**

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*I make this submission in my capacity as a professional economist, and I am willing to have it made publicly available.*

### **Summary of Recommendations**

I recommend that this Bill be either rejected, deferred until after the Subprime Crisis is patently over, or significantly amended, on the grounds that:

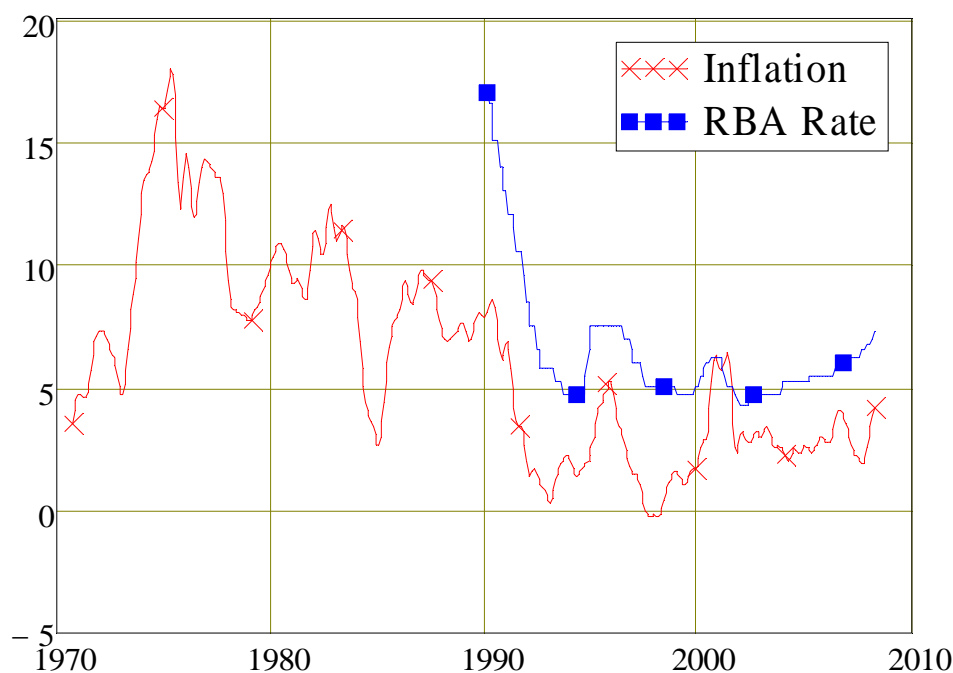
1. The performance of monetary policy to date does not warrant a further extension of the RBA's already substantial independence from political direction;
2. While politicians would not necessarily have done any better in setting monetary policy, they are at least accountable for their decisions;
3. The Bill may have the unintended consequence of locking in a particular approach to monetary policy, at a time when substantial change in policy may be desirable; and
4. The Bill is poorly drafted, with “Gilbert and Sullivan”-esque impacts on RBA independence, rather than any truly substantive change.

### **The Performance Record of Central Bank Independence**

This Act is intended to enhance the already substantial independence of the RBA. The belief that handing monetary policy over to professional economists was good economic policy became widespread around the world in the aftermath to “The Great Inflation” of the 1970s. In Australia, the RBA was given additional independence from political control in the aftermath of the 1980s' boom, when excessively high interest rates were seen as contributing to the severity of the early 1990s' recession. The Government and RBA later codified the policy focus of this independence, in a compact that set a target range for inflation of 2-3 percent over the economic cycle.

Since that time, inflation has never again reached the dramatic levels of the 1970s (see Figure 1). From this point of view, it could be said that “Central Bank Independence” was a success in Australia—and therefore that the further extension of independence intended by this Bill could be warranted.

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*Figure 1: RBA Rates and Inflation*

However, monetary policy in general—and Central Banks in particular—are supposed to do far more than merely contain the rate of inflation. The primary role of monetary policy is to maintain the stability and integrity of the financial system, and on this front there are grounds to regard “Central Bank Independence” as a failure. There have been more financial crises, of increasing severity, in the period after it became the vogue, than at any time since the Great Depression. The list includes the Asian Financial Crisis (1997), the Russian Financial Crisis (1998), the Long Term Capital Management Financial Crisis (1998), the Internet Bubble, the NASDAQ Crash (2000), and now, the Subprime Financial Crisis (2006-ongoing). Numerous commentators, from George Soros down, have described this current financial crisis as the worst in their memory, and arguably the worst since the Great Depression.

Were Central Banks successfully carrying out their mandate, this crisis would not be occurring. We would instead be experiencing financial tranquility, rather than financial fragility and instability.

This is not to say that economic policy makers should be judged by their capacity to contain all the potential vicissitudes of a decentralised market economy—that is far too harsh a standard to set. But Central Banks should at least have seen the crisis coming, and certainly should not have undertaken actions that brought it on.

Instead, they failed on both fronts. I attribute this to the economic philosophy that dominates Central Banks today, which has faith in the self-regulating capabilities of markets in general—and financial markets in particular—and which also believes that monetary policy solely affects inflation,

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so that it should be limited to that objective alone.

Given this philosophy, sound economic management has come to be seen as requiring a reduction in government interference in market processes, and the enhancement of competition, while Central Banks have interpreted their monetary policy responsibility as being limited to controlling the rate of inflation via movements in the short term rate of interest.

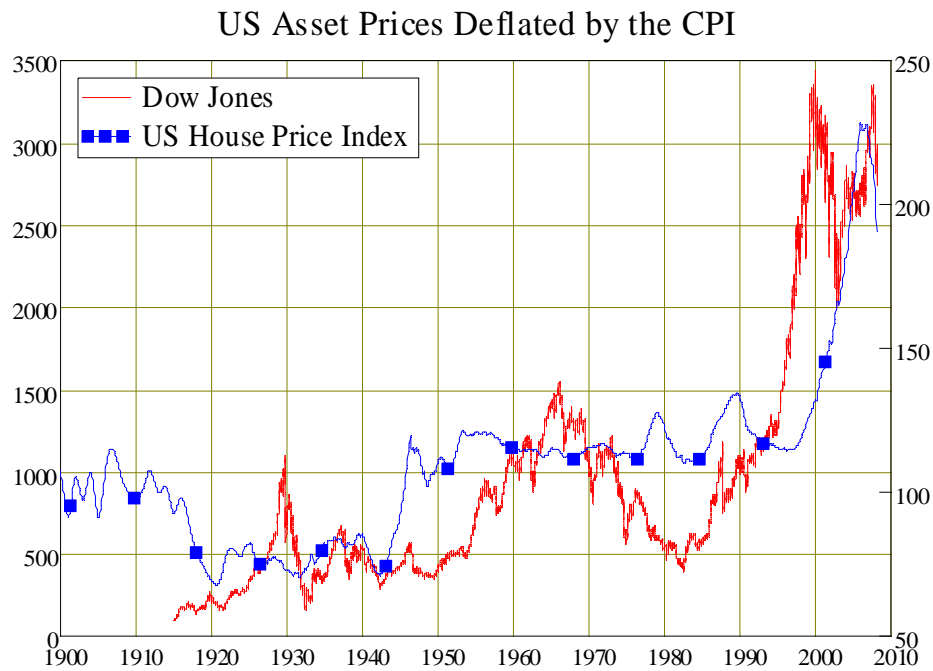
The folly of relying upon financial markets to self-regulate should now be apparent to all. Yet save for critics such as myself, the entire financial system—from regulators, through private commercial and merchant banks, to ratings agencies, fund managers and stock exchanges—approved the development and promotion of the now-notorious Subprime Lending scam, and the associated growth of “Low Doc” loans here in Australia. That a scheme to make money by lending money to people with a history of not repaying debt could be treated as prudent by would-be regulators is a sign that delusion rather than sound judgment dominated the development of monetary policy.

Central Banks—including our own RBA—were complicit in this erosion of monetary standards, with commissions such as allowing the development of the wholesale lending market, and omissions such as ignoring the blowout in mortgage debt levels (relative to household incomes) in the last eighteen years.

There are many indicators now of how this policy position has failed—hindsight, as the saying goes, is 20:20. But more significant are *forward* indicators—data, or rather perspectives on the data, that indicated that trouble was approaching long before it arrived, and could have been seen by those in authority at the time.

The two indicators I emphasise are the CPI-deflated value of asset prices, and the ratio of private debt to GDP. In choosing these, I am guided by what is known as the “Financial Instability Hypothesis”, which (in contrast to the pro-deregulation view that Central Banks in general subscribe to) argues that deregulated finance markets will necessarily develop dangerous levels of debt-financed speculation.

The price ratio indicators show that asset bubbles had obviously commenced in the USA in 1994 (shares) and 1997 (housing), and in Australia in 1996 (housing) and 2003 (shares)—see Figures 2 and 3 respectively. By 1996, the US share bubble had exceeded any level in its recorded history, and housing followed shortly after (in 2000). The scale of the bubble in the USA gives some indication of why some analysts—including myself—do not share the sanguine attitude that the worst of the Subprime crisis is now behind us.



*Figure 2: USA Asset Bubbles were obvious before they burst*

By 1998, Australian house prices exceeded the peak set in 1989, and in late 2000 the bubble clearly accelerated (the impact of the decisions to double the First Home Buyers Grant and halve the rate of capital gains tax in 2004 also stick out like the proverbial sore thumb). Though our bubbles appear less extreme than those in the USA; this is true of shares—even though by 2005 they exceeded the levels of overvaluation that applied in 1987—but not of housing, where our bubble is in fact substantially bigger than the USA's (see Nigel Stapledon's research into long term housing prices in Australia).

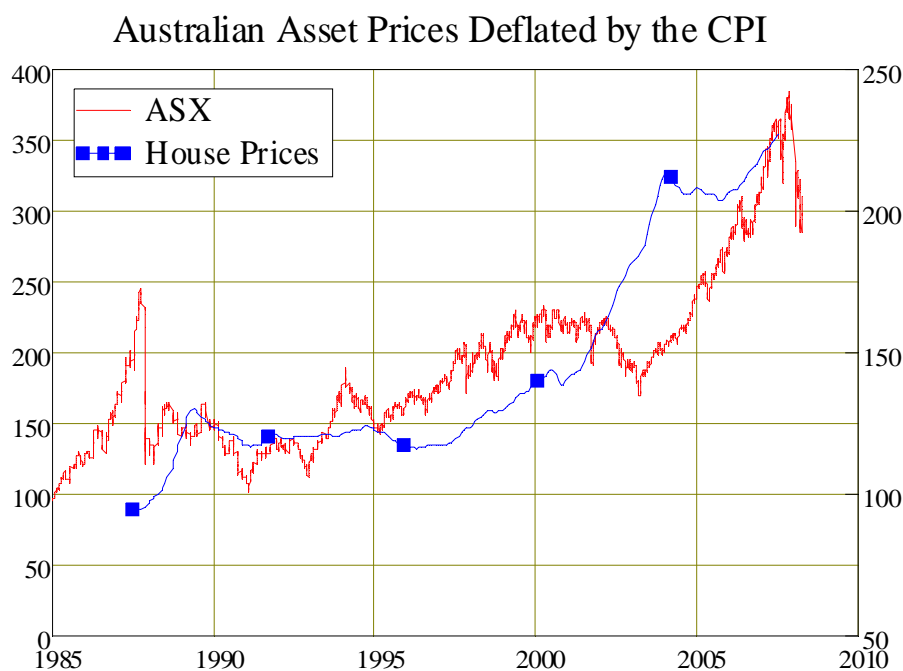


Figure 3: Australia's Asset Bubbles

Central Banks around the world have largely taken the position that asset price bubbles are not their concern, or that they can't do anything to control them in any event. But the link between asset price bubbles and financial crises should be obvious to all now. Ignoring asset bubbles is clearly not good monetary policy. Because they did not consider indicators like the ones shown above, Central Banks, the supposed watchdogs of our financial system, were caught unawares when the current crisis began.

The other indicator that trouble was approaching—and now, the warning that trouble is far from over—is the private debt to GDP ratio. Here again, the record does not justify faith in Central Bank Independence. The debt to GDP ratio has reached a level that far exceeds anything ever seen before in Australia's economic history—including during the booms that preceded the Great Depressions of the 1890s and 1930s (see Figure 4, and the Appendix, where I discuss why this ratio matters).

As I emphasise in my Debtwatch Reports, this explosion in debt relative to income can be dated back to 1964, when a far different regulatory regime applied. This implies that the period of Central Bank Independence was no worse than the previous regime, but conversely, it was no better. Given that debt levels were so much greater, the problem should have been that much more apparent.

### Australian Private Debt to GDP Ratio

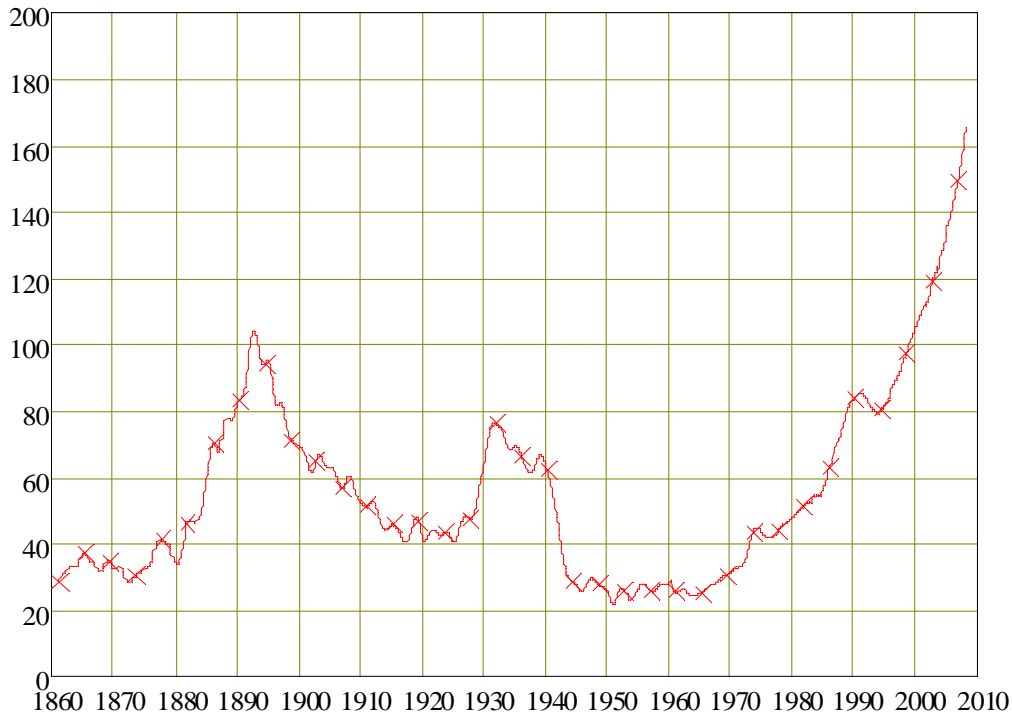


Figure 4: This is the 3<sup>rd</sup> and biggest debt bubble in Australia's economic history

That leaves the apparent control of inflation via movements in the short-term interest rate as the one alleged success of the period of Central Bank Independence. However, I surmise that this will prove as illusory as the 1960s belief that there was a simple trade-off between unemployment and inflation (the so-called Phillips curve).

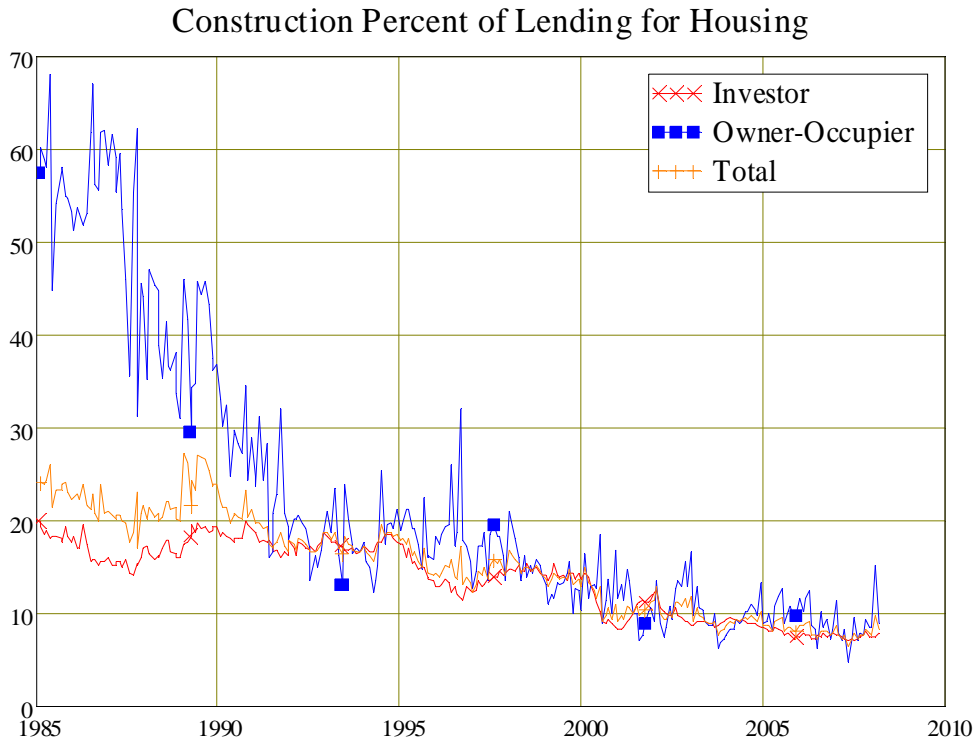
Just as the temporary success of the inflation/unemployment trade-off policy was due to a confluence of factors outside that simple model's purview, the apparent success of Central Banks in controlling inflation during the 1990s may be due more to the contemporaneous rise of China as a low-cost manufacturer than to any "Taylor Rule" inverse relationship between interest rates and the rate of inflation (incidentally, I note recent press comment by Don Harding that it is simplistic to describe the RBA's policy as being driven by a Taylor Rule.<sup>1</sup> While there is some merit to his arguments, on "if it walks like a duck and quacks like a duck" logic, Figure 1 clearly shows Taylor-Rule-motivated behaviour by the RBA).

Inflation is now accelerating, as China has started to export inflation rather than deflation, Global Warming has hit agriculture, and "Peak Oil" (plus Iraq) has driven the price of oil to unprecedented levels. Added to the inflationary pressure from rising rents (See Figure 5: this is a truly perverse outcome of Australia's speculation-driven housing policy, which has resulted in a rental accommodation shortage after a so-called Housing Boom), inflation is likely to rise for the foreseeable

<sup>1</sup> See <http://www.theaustralian.news.com.au/story/0,25197,23644269-7583,00.html>

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future, regardless of the rate of interest the RBA sets. Rate rises are now causing much pain for little gain.



*Figure 5: A borrowing boom, not a housing boom*

On performance alone therefore, I do not believe that the experience of enhanced Central Bank Independence warrants any further extension of independence now, as envisaged by this Bill. The next question is whether monetary policy would have been any better had politicians been in charge of it—as they still are of fiscal policy.

### **Politicians vs “the experts”**

It is hardly being cynical to see the handover of power over monetary policy in the 1990s as a direct result of politicians retreating from the heat of being blamed for the severity of the 1990s downturn. There is also merit in politicians deciding to hand over the management of a difficult task over to the experts.

However, the experts actually have to understand the system they are managing for this devolution of responsibility to be a success. I believe that the evidence already shows that the economists in charge of the world's Central Banks do not actually understand the monetary system. Instead, they understand a *model* of how the economy works, and that model omits factors that are of great significance in the real world—notably, the dynamics of debt and the role of debt-financed speculation in driving asset

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market bubbles. As a result, the greatest debt bubble in world history has occurred right in front of the noses of the experts, and they didn't even notice until debt-inflated asset markets began to burst.

On the record, there is little evidence that politicians would have done any better in preventing the speculative bubbles in Australia, the USA, or the rest of the OECD. However, the great difference between having politicians and independent Central Banks setting monetary policy is that former group is at least accountable for its mistakes via the political process, whereas the latter is not. Given that future economic policy may be dominated by trying to clean up the mess left by this bubble, now is not the time to be making the policy makers even less accountable to the public.

### **Policy Lock-in**

I noted above that non-monetary factors (the switch from China exporting deflation to inflation, Global Warming, and Peak Oil) are now the main drivers of inflation. Had these truly Millennial factors not been present, the Australian and global economies would now be on the verge, not of stagflation, but of deflation. This could still yet occur, if the economic downturn caused by the Subprime Crisis and the ensuing Credit Crunch turns out to be very severe. In that eventuality, the last thing we need is a monetary policy that has a deflationary bias.

A glance at the record of the 1930s in the USA shows why. When the "Great Crash" occurred in October 1929, America's inflation ratio was barely positive, and the debt to GDP ratio was 150 percent. The debt ratio then exploded to 215 percent by 1932, driven not by further borrowing, but by a collapse in both real output and prices. Deflation, with prices falling by as much as ten percent per annum for four years, played a major role in making that Depression the worst in recorded history.



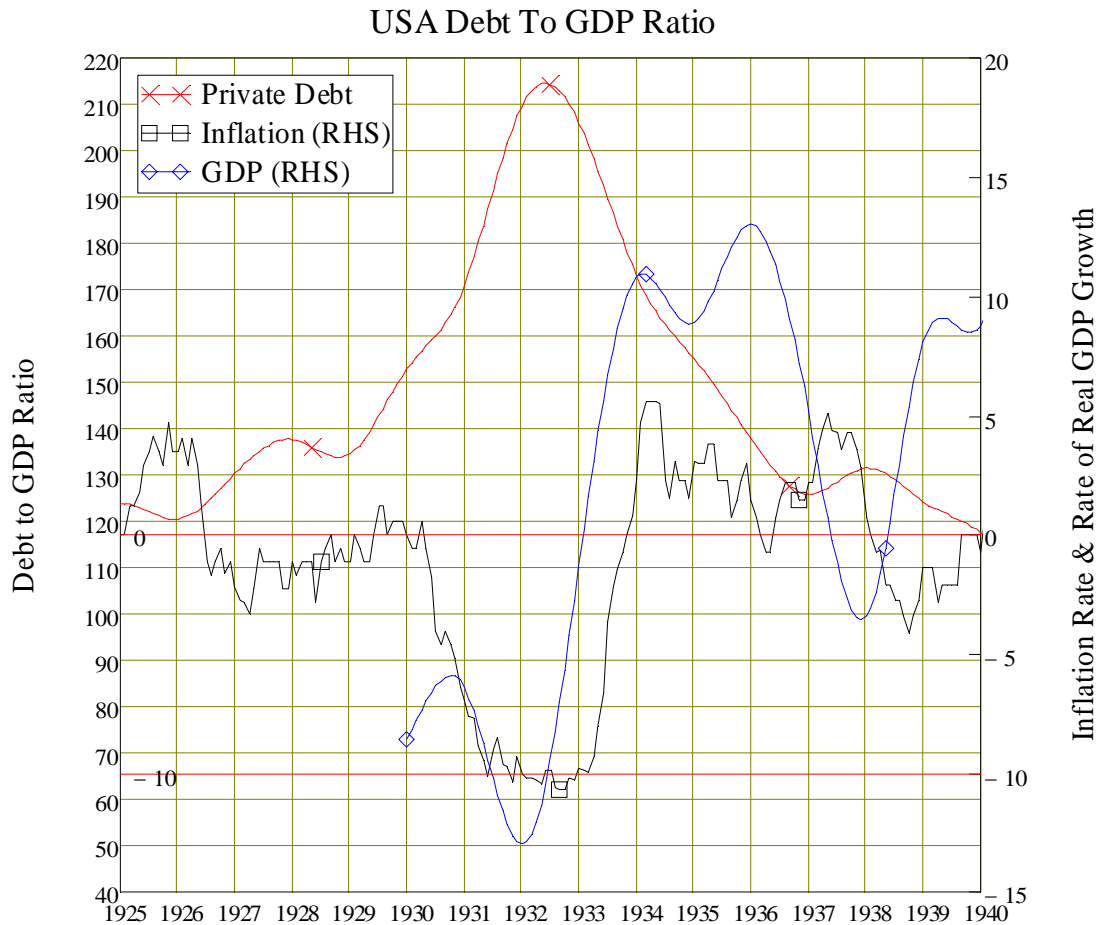


Figure 6: Low inflation is not necessarily a good thing

I am not saying that a Depression will necessarily result from the Subprime Crisis, Credit Crunch and the current unprecedented levels of debt. But if something as severe as, say, Japan's "Lost Decade" does eventuate, we need monetary policy to "turn on a dime" and go from trying to prevent inflation to trying to end deflation—and we need it to be successful.

I very much doubt that an economic culture that has been permanently fixated on limiting inflation, that missed the growth in debt, and that ignored the unsustainable bubble in asset prices financed by debt, will be properly prepared for such a sudden and profound switch in policy. Now is not the time to giving the current incumbents an exalted sense of permanence.

## The RBA and the Mikado

Lastly, this Bill has potentially farcical implications in the event that the removal of either the Governor or Deputy Governor is warranted in the circumstances contemplated by the Bill. The current Act *requires* the Treasurer to terminate those commission(s) if either incumbent:

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- “(a) becomes permanently incapable of performing his or her duties; or
- (b) engages in any paid employment outside the duties of his or her office; or
- (c) becomes bankrupt, applies to take the benefit of any law for the relief of bankrupt or insolvent debtors, compounds with his or her creditors or makes an assignment of his or her salary for their benefit” (Section 25).

I think these are eminently reasonable—and very limited—grounds on which those commissions should be terminated. Yet the Bill changes this from a requirement to an option—“The Governor-General *may* terminate...” (Section 25(1)), *and* adds a procedure that must be followed to achieve this result, including:

- 1 Suspension by the Governor General;
- 2 Within 7 days, the making of a statement to Parliament by the Treasurer;
- 3 Within 15 days of that, a motion supporting termination being passed by both Houses of Parliament; and
- 4 If the motion is not passed, the incumbent being restored to the position.

Imagine that, god forbid, Glenn Stevens and Ric Battellino walked in front of a bus and were put into permanent comas. This procedure would have to be followed to relieve them of their posts, whereas at present, the Treasurer could simply terminate the appointments without fuss—or farce.

The situation could be worse of course, if there were a hung Parliament at the time (anyone for a re-run of Whitlam vs Snedden, but this time over whether to remove a comatose RBA Governor?), or indeed if one of the office-bearers did indeed go bankrupt—or, for argument's sake, start writing paid opinion pieces for *The Daily Telegraph*.

The substantive capacity of the Government to direct the RBA to conduct monetary policy as the Government sees fit is also unaffected by this Bill. Those powers reside in Section 11, and are not amended by this Bill—and nor should they be.

## Conclusion

Since further independence for the RBA is not warranted, and this Bill in any case makes comical rather than substantive changes to its independence, I recommend that the Bill be rejected.

## Appendix: Why the Debt to GDP Ratio Matters

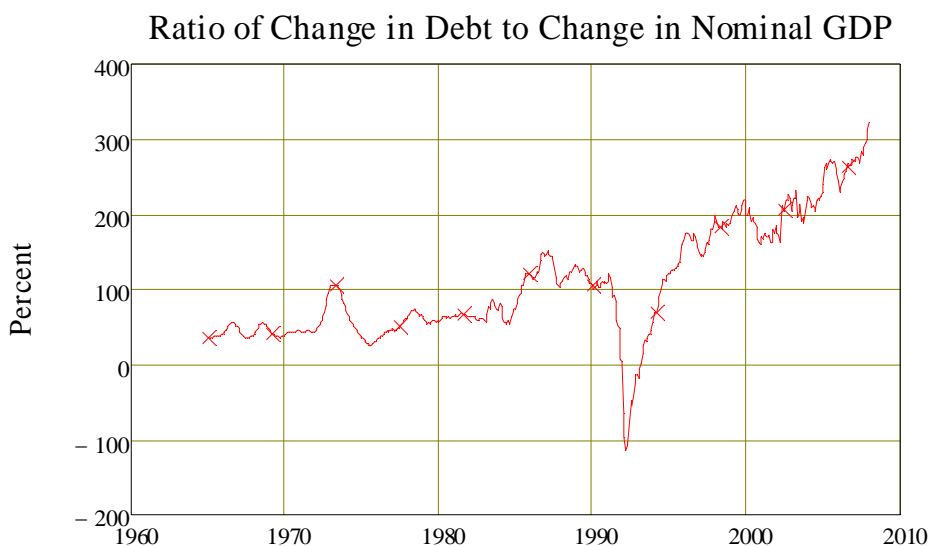
Superficially, comparing the level of debt to the GDP is the comparison of a stock (outstanding debt) to a flow (annual production or income), which immediately makes it appear suspect.

The best way to indicate that it is nonetheless an important ratio is to make an analogy to another stock-flow comparison: the stock of accumulated  $CO_2$  in the atmosphere, compared to the annual capacity of the biosphere to sequester carbon. The bigger this ratio is, the longer it will take the planet's biological processes to reduce an excess of carbon dioxide back to a sustainable level.

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Similarly, the ratio of debt to GDP gives a good indication of how long it would take the economy to reduce this ratio, if economic agents in general decided that they had to reduce their debt levels. The bigger the ratio, the longer it will take economic agents to reduce their level of debt by diverting spending from consumption and investment to debt repayment; and the larger will be the impact on aggregate spending of the reduction in debt. When debt is small relative to GDP, the reduction of debt only has a minor impact upon spending; but when it is large, that impact can be substantial.

This information can be put into more conventional flow-to-flow terms by comparing the rate of change of debt to the rate of change of nominal GDP (see Figure 7). This also indicates how severe a reduction in demand could occur, if the rate of growth of debt turned negative. The annual change in debt is now more three times the size of the annual change in GDP. If, as happened in the early 1990s, the direction of change in debt reverses, then the impact on aggregate spending could be dramatic.



*Figure 7: Change in debt now far exceeds change in output*

Also, just as scientists worry that excessive levels of carbon dioxide could trigger a runaway process of climate change, excessive levels of debt can trigger a runaway economic process that leads to a Depression. This is the ultimate reason why monetary authorities should concern themselves with debt levels, and attempt to control asset price bubbles—though the tools they currently restrict themselves to are manifestly inadequate for that job.

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