Review of the Reserve Bank of Australia

Introduction

Narrow Road Capital appreciates the opportunity to make a submission as part of a wider review of the RBA. As a boutique funds management business that invests in Australian credit securities, Narrow Road Capital has direct insight into the negative impacts of errant monetary policy. These include excessive debt levels and malinvestment, which increase financial instability.

This review is timely, with several failures of the RBA becoming apparent this year. These failures originate with the aims set for the RBA as they are too numerous, vague and often conflict with each other. They set the RBA up to fail, as they ask the RBA to achieve outcomes using monetary policy that require coordination with fiscal policy, tax reform, competition/productivity reforms and general economic settings that are all beyond the RBA's control. The RBA and monetary policy is simply being asked to achieve too many often contrary aims.

This foundational issue is compounded by the RBA Board and staff lacking diversity of economic thought. The RBA appears to be fully onboard with Keynesian thinking. Its implementation of MMT-like policies in recent years (in line with other central banks) has been a notable failure with high inflation one obvious and inevitable consequence. Had the RBA considered the evidence based principles of Austrian and monetarist economics it would not have embarked on excessive and largely futile monetary stimulus, which has led to lower economic growth, lower productivity improvements, high levels of debt and zombie borrowers, and increased financial instability.

This paper puts forward several reforms for the RBA with regards to its targets, people and processes. Crucially, these reforms are not a knee-jerk reaction to the RBA's recent failures, they are reforms that were argued for before and at the time the RBA made errors. They are also reforms that align with increasing long term economic growth and productivity, as well as reducing the financial instability risks that come with excessive monetary stimulus.

Narrow Road Capital welcomes the opportunity to assist the committee further. Feedback is welcome and can be sent to info@narrowroadcapital.com.

The RBA's mandate and targets

Whilst the aims set for the RBA are similar to many other central banks, they are too numerous, vague and often conflict with each other. They set the RBA up to fail, as they ask the RBA to achieve outcomes using monetary policy that require coordination with fiscal policy, competition/productivity reforms, tax reform and general economic settings that are all beyond the RBA's control.

The chief failing of the RBA's current aims is that they contain a floor on the inflation target. Whilst this was a helpful guide for a central bank coming out of the high inflation era of 1971-1990, it has proved to be a millstone for the RBA in the recent low inflation era of 2015-2020. This has created a fundamentally wrong view that low inflation is a problem that the RBA should take action to resolve.

Whilst high inflation is a problem that the RBA should take action to resolve, low inflation is not a problem at all. Rather, stable prices (i.e. prices that exhibit only minor increases or decreases on a year to year basis) are historically interlinked with productive and prosperous economies. In the 200 years preceding World War One, inflation in the US was fairly close to zero. People expected that in the long term prices would barely change, and this lack of change was regarded as a good thing. During this period enormous technology improvements occurred, urbanisation took hold and the standard of living greatly improved.

The onset of costly world wars and the removal of the gold standard brought in the modern era of higher inflation levels. The modern embrace of the idea that governments should have ongoing debts provided a reason for governments to want inflation. Whilst the general population doesn't want inflation, governments now view it as a way to reduce the real (after inflation) cost of servicing government debts. Further information on this topic can be found in a pair of 2019 papers that discuss the negative impacts of low interest rates and the errors in recent central bank policy settings.

To correct the RBA's current aims merely requires placing the predominant emphasis on combatting high inflation. This can be as simple as stating that the inflation rate should be kept below 3% over the medium term. This should be complemented by a prohibition on financial repression, which would directly target the aims of long term economic prosperity and financial stability. This can be expressed through a basic formula, smoothed over the medium term:

$$Minimum\ Reserve\ Bank\ Rate = \frac{Inflation\ Rate}{(1 - Top\ Marginal\ Tax\ Rate)}$$

There should also be a prohibition on quantitative easing (QE). QE is a flagrant breach of public trust in government preserving the value of a nation's currency. The decision to implement QE is strong evidence that the independence of a central bank has been corrupted, as QE is often implemented to make excessive government deficits more affordable. By prohibiting QE, profligate governments are forced to deal with the consequences of budget deficits via spending cuts or tax increases, rather than through financial repression.

The RBA's performance against targets

As the aims set for the RBA are fundamentally wrong, criticising the RBA for failing to meet them is somewhat misguided. However, it is reasonable to criticise the RBA for failing to advocate for a correction to its aims, initially privately with government and then ultimately in public. The RBA willingly chose to pursue monetary policy actions which were going to have (and subsequently have been shown to have) predominantly negative long term consequences. Arguments that "we were just following orders" do not wash given the RBA's substantial budget for research and employment of hundreds of economists and adjacent professionals.

It is also fair to criticise the RBA for its communications errors that include;

- Consistently presenting the "house view" as the consensus and only reasonable position, rather than allowing for a wider range of views to be put forward as reasonable and possible
- Misleading the public on the likelihood of interest rates rising over 2022-2024
- Repeatedly stating that low interest rates do not lead to higher house prices, which was subsequently disproved by its own economists
- Repeatedly stating that low interest rates are the result of a glut of savings rather than (i) the RBA setting interest rates at excessively low levels and (ii) the glut of QE from central banks
- Misleading use of statistics, including stating that "households are net borrowers in aggregate"

The RBA should be encouraging a wider discussion of the logic in reaching its policy settings by its own staff and Board members, as is the case for the Federal Reserve. This would allow the public and politicians to see that there is a wide range of possible outcomes and that a wide range of possible responses has been canvassed. The RBA's errors in its communications and sharp reversals in policy have led to public criticisms that "the RBA has lost its credibility" with Australians in general and international investors in particular.

Composition of the RBA's Board and Staff

Based on what is publicly known, the primary deficiency in the RBA's Board and staff is a lack of diversity of economic thought. This comes in two parts;

- The RBA appears to dismiss the principles of Austrian and monetarist economic thought, despite these principles consistently delivering higher levels of economic growth and productivity. Whilst the RBA criticised MMT generally, its excessive monetary stimulus in recent years supported MMT-like government policies.
- The RBA Board is almost exclusively made up of people with professional and personal interests aligned with low interest rates. Those who professionally (Austrian and monetarist economists, market practitioners especially lenders/credit investors) and personally (savers) understand the consequences of low interest rates appear to have no voice.

This lack of diversity and groupthink has resulted in the RBA (and most other central banks in developed nations) implementing policies that have ultimately led to lower economic growth, lower productivity improvements, high levels of debt and zombie borrowers, and greater financial instability.

The lack of non-consensus discussion of Board decisions, by both RBA employees and the Board members themselves, creates a perception that all Board members and RBA staff agree with the decisions made and have a high level of certainty that its actions are appropriate. When economic outcomes are vastly different from the consensus position, as has been the case in the last year, it appears that all Board members and staff are complicit in the RBA's failures.

Just as High Court judges are appointed with a diversity of thought on legal matters, the RBA Board needs to include a greater diversity of economic thought. Board members and staff should be empowered to speak publicly, allowing them to highlight the wider considerations in making decisions and the different views held.

Interactions between monetary policy and macroprudential policy

Undoubtedly, the RBA's excessive monetary stimulus accelerated house price growth and financial asset price growth, as well as supporting the growing number of zombie borrowers. Had the RBA considered the long term prosperity of Australia, it would not have lowered interest rates anywhere near as far as it did and it wouldn't have implemented QE. The reforms already detailed in this paper are sufficient to curtail the RBA's future ability to repeat these mistakes.

The current separation of duties between the RBA and APRA remains appropriate. APRA is rightly criticised for being too timid and slow in implementing macro prudential policies, though noting these were in large part required due to the RBA's excessive monetary stimulus. The actions that APRA should have taken were detailed in this [2021 paper].

Written by Jonathan Rochford for Narrow Road Capital on November 7, 2022.