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978-0-521-83990-7 - Australia's Money Mandarins: The Reserve Bank and the Politics of Money
Stephen Bell

Excerpt

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Introduction

Central banks must be among the least well understood institutions in the entire world.

Alan Blinder, former Deputy Chair, US Federal Reserve¹

Central banking is a strange profession little understood by the members of the public.

H. C. 'Nugget' Coombs, former RBA Governor²

Central banks stand at a fascinating interface between the economy and politics. These days their primary role is to conduct monetary policy, typically by regulating the supply or price of money in the economy. Central banks also have responsibility for the stability of the financial system, act as a lender of last resort in financial calamities, act as a banker to other banks and to governments, and perform a range of other functions in banking and financial systems. In recent decades, in a world of burgeoning financial markets, major assaults on inflation, and a proliferation of financial calamities, central banks have risen to unprecedented prominence. They also face unprecedented challenges.

Central banks became critical institutions in modern capitalism in the latter part of the twentieth century. Standing at the centre of an inflation-prone, traumatised monetary system and at the interface between nation states and newly deregulated and increasingly powerful financial markets, central banks broke out of their cloistered existence and became powerful, aggressive inflation-fighting machines. So pivotal did they become in the fight against inflation that governments worldwide handed them substantial control over monetary policy – these days, the most important weapon of short-term macroeconomic policy. The fight against inflation was a hard-won victory. The early 1980s and early 1990s saw major policy-induced recessions with huge collateral damage in various countries, including Australia, as high unemployment was used to battle inflation. Central banks emerged victorious from this struggle. By the mid-1990s, they had gained new credibility in the financial markets and an unprecedented public profile.

Yet severe challenges confront central banks. In a world simultaneously confronting surging debt and asset prices, it is not clear what role central banks should play, or even if monetary policy – the instrument of choice in the late twentieth century – will retain its former clout.

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This book describes how the Reserve Bank of Australia (RBA) has operated in this testing context. It explains the politics of central banking in Australia, the Bank's changing relationship with the federal government and how and why it emerged from relative obscurity to become one of the most powerful policy institutions in the country.

In the early 1990s the Bank asserted its policy independence from the government, even though the powerful Treasurer (and later Prime Minister), Paul Keating, opposed central bank independence. Why did the RBA adopt a more aggressive stance towards fighting inflation during the early 1990s recession, a strategy which Keating had explicitly rejected in a public showdown with the Bank in 1990? And why did the government come to sanction central bank independence and pass control over monetary policy to the RBA, a strategy at odds with claims by Keating when he said he would not 'abrogate responsibility for the stance of monetary policy from the elected government to unelected and unrepresentative public officials in the name of fighting inflation first'?³

In recent decades, monetary policy has primarily involved manipulating short-term interest rates in attempts to control aggregate or CPI inflation. Policy deliberations within the RBA now command attention – especially in the financial markets and the press – because the RBA's interest rate policies directly impact on the fortunes of individuals, businesses, and those within the markets. Interest rates are a blunt instrument. As Australia found out, especially in the early 1990s recession, high interest rates can flatten an entire economy. The steep increase in debt levels in recent years has also exposed more Australians to the potentially punitive impact of interest rate rises.

Things were not always like this, as chapter 1 explains. Only in the last few decades has a relatively powerful and independent RBA emerged. This happened in the context of several factors: the turn towards neo-liberal orthodoxy in economic policy; global financial deregulation and the associated rise (or return) of powerful financial markets; the inflationary capitalism of the 1970s and 1980s, and the attendant policy shift away from the policy of full employment to one focused on low inflation. With the increasingly passive use of fiscal policy, monetary policy has become the 'swing instrument' in dealing with inflation and attempting to guide the macroeconomy.

These changes have restructured power relations within the state and placed central banks in the macroeconomic policy cockpit; a distinct departure from the earlier centrality of fiscal authorities under the post-war (Keynesian), full employment policy paradigm. This book argues that central banks have become so important, particularly in the face of demands by financial markets for policy 'discipline' and 'credibility' on inflation, that their 'independence' from govern-

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ment is now a key indicator of policy 'soundness'. This reflects concerns that monetary policy is now too important to be left to the vagaries of partisan politics or government 'meddling'. It also underscores the new policy authority of central banks and the firm grip they now have on the instruments of monetary policy.

These changes have constituted a world-wide trend as a wide range of economies confronted the common challenge of high inflation in the 1970s and 1980s. The changes reflect the shared experiences of institutional innovation in central banking and in monetary policy. The changes are a response to the impacts of domestic and global financial deregulation since the 1970s and the rise of financial markets as a powerful anti-inflationary constituency.

Much of this book is about the exercise of power in the monetary policy arena. The main protagonists are financial markets, governments and central banks, although wider business interests and an increasingly debt-exposed community are also important. There has been a shift in power towards financial markets and central banks. Ultimately, governments still hold the whip hand, because they set the regulatory and statutory rules for financial markets and central banking. Nevertheless, the processes of domestic and global financial deregulation have created powerful financial market forces that regularly constrain the choices of governments and central banks. Although central banks have become more powerful domestically, their power in relation to financial markets is more limited.

This book is also about the institutional dynamics of the RBA. The RBA has experienced an institutional revolution, but the key changes have been informal rather than statutory. What has mattered most have been *elite* interaction and accommodation behind the scenes. Indeed, decisions and operations in the upper reaches of the Bank and at the level of the Reserve Bank Board still occur in secret, and it is part of the purpose of this book to peer into this closed world.

We will also see how the RBA has operated to achieve two important institutional imperatives: the search for market credibility, and the search for wider institutional legitimacy. The former is the judgement of the markets and other economic players on the Bank's performance (especially on the inflation front but also increasingly on financial stability). The latter is the justification for an *independent* central bank (essentially a technocracy) in a democratic setting. Much of the work of the Bank and most of the institutional innovations, especially in the 1990s, have aimed at these two imperatives.

This is not the kind of story told by mainstream theories of central banking politics. These generally argue that governments are selfish and myopic, likely to 'interfere' with monetary policy and to influence interest rates for short-term electoral advantage. Central bankers are likely to resist this, so the argument goes, and thus conflict arises between governments and central banks. Nor,

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according to this view, are governments likely to grant central bank independence because this will weaken government control and the options to manipulate monetary policy for electoral ends. Typically, central bankers are depicted as credibility-driven hawks and politicians as vote-calculus doves. The politics is said to involve opportunism by politicians in attempts to manipulate monetary policy for electoral ends and a degree of tension, if not conflict, between the central bank and the government. But reality speaks differently. There has been a large measure of common purpose as governments too have battled inflation. Moreover, governments almost everywhere have not been averse to granting policy independence to their central banks. Even when the RBA asserted more control over the policy agenda in the early 1990s, the government and Treasurer Paul Keating mostly acquiesced.

Politics will always matter, but financial forces and economic outcomes will most likely shape the future of central banking and determine whether monetary policy and central banks will retain their present clout and especially their independence. We have arrived at a new political economy of inflation where the major structural drivers of CPI inflation seem to have been substantially neutralised. Some now worry about deflation. Financial deregulation has helped produce a world of infinite credit, periodic bouts of severe asset inflation and subsequent crashes. Japan has gone through a shocking cycle of an asset bubble, financial collapse and deflation over the last decade. Other large economies, especially the United States, are also of concern. What can monetary policy and central banks do in such a world? As interest rates disappear towards zero in some countries, monetary policy loses its clout. And no one is sure what central banks and monetary policy should do about surging credit and asset inflation. The future looks uncertain for central banks.

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Slowly Building the Reserve Bank

The creation of a central bank in Australia was part of a general wave of central bank formation in a range of countries during the early twentieth century. This chapter briefly recounts the political history of central banking in Australia and provides further historical context to the current operations and especially the institutional underpinnings of the RBA. The role and institutional design of the Reserve Bank of Australia and its forerunner, the Commonwealth Bank of Australia, were established during bouts of political conflict in the first half of the twentieth century.¹ In Australia the central bank occupied a zone of conflict between Labor interests and the private banking and financial community. The main contest was over the banks' private prerogatives and their control of the financial and credit system, with Labor interests being especially keen to regulate them. The independent powers conferred on the central bank created tensions with various governments. Generally, the major shifts in central banking have occurred under Labor governments: this is true of the origins of central banking and also of the major changes of the 1940s and the 1980s, the two watersheds of Australian central banking.

ORIGINS OF CENTRAL BANKING

Walter Bagehot, the third editor of *The Economist*, coined the term 'central bank' in 1873. Although some central banks emerged in the seventeenth century (in Sweden and England), and a few were created in the early nineteenth century (in France, Austria, Norway, Spain, Netherlands, Denmark, Finland), there was no clearly defined concept of central banking at this time. Central banks have only become widespread and firmly established since the late nineteenth century.² At the turn of the twentieth century there were only eighteen central banks; by its end there were 173.

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Central banks first emerged for a range of reasons, often unrelated to what we now take to be the modern functions of central banking.³ The Bank of England, for example, was founded in 1694 as a private corporation to mobilise funds to help King William III wage war against the French;⁴ it did not really develop central banking functions until the nineteenth century. Wars and the mobilisation of finance to help fight them were the prime rationales behind early central bank formation. Indeed, the first twelve central banks established up to 1850 were created in a war context.⁵ Central banks were also increasingly given monopoly rights over note issue, and this, combined with their growing role as the government's banker, enhanced their privileged status in the financial system.⁶

Subsequently, depressions, financial crises, banking collapses, the growth of financial markets and government policy ambitions in the economy have shaped central banks. For example, the US central bank, the Federal Reserve, was finally established (after several attempts) mainly for the purposes of bank supervision and as lender of last resort in the wake of the financial crisis and bank runs of 1907.

Central banks often engaged in commercial banking functions. Their privileged and specialised position assisted them to slowly diversify their functions by holding the deposit reserves of other banks and by settling the balances between banks through the use of these deposits. Additional functions tended to be mutually reinforcing. The role of central banks in general liquidity management for the banking sector placed them in a prime position to manage total reserves within the system. The logical extension was for central banks to act as lender of last resort in periods of financial crisis. Because of the high levels of trust and confidence that are required to underpin a banking system, and because banks tend to have long-term assets but short-term, on-call liabilities, there is a strong argument for a 'lender of last resort' function in case major banks face liquidity crises or a creditor panic. This responsibility implied that central banks should have access to information about, and a degree of control over, the banking and financial sector. This kind of access and control was also implied by the need for the central bank to manage foreign reserves.

SLOWLY CREATING AN AUSTRALIAN CENTRAL BANK

The tradition of animus towards the 'money power' and the banks, particularly in Labor circles, goes back a long way in Australia.⁷ Government involvement in monetary management was first proposed by Governor Macquarie in 1810, but it was frustration with the performance of essentially unregulated financial markets and the private banking sector which produced the first substantial propos-

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als for a state bank from the aptly named Select Committee on Monetary Confusion, a body established by the New South Wales Legislative Council in the 1840s.⁸ By the 1890s, with severe boom and bust and a series of banking collapses, a state bank was on the parliamentary agenda in four colonies.⁹ But it was not until the aftermath of the banking crises of the 1890s, the formation of the state and federal Labor parties, federation, and the need for national note issue, that Labor interests successfully mobilised to create a national, central bank. The thrust of Labor's critique of the private banks and of free financial markets was that they were too vulnerable to collapse, that the banks were profiteering, and that their lending practices tended to be pro-cyclical (excessive in an upswing and too restrictionist in a slump, driven by rapid shifts in sentiment from excessive optimism to deep pessimism). The Fisher Labor government created the Commonwealth Bank of Australia (CBA), which commenced operations in 1912.

King O'Malley, the Minister for Home Affairs in the Fisher government, had been a strong proponent for such a bank (having given a five-hour speech on the topic to the House of Representatives in 1909). Generally speaking, however, there was little real understanding of central banking. H. C. 'Nugget' Coombs, the long-serving Governor of the Commonwealth Bank and later the RBA, describes the 'rare confusion of ideals and intentions' that gave rise to the Bank.¹⁰ The elaborate and lofty ideals of many Labor proponents saw the Bank as a weapon in the war against the private banks, a precursor to full nationalisation of the banking system, a mobiliser of finance for the Commonwealth, a provider of financial services to governments, a source of funds for developmental schemes, and a regulator of the banking system.¹¹ In fact, the Commonwealth Bank emerged as none of these. O'Malley's scheme for a central bank had been 'pasteurised'.¹² The Bank was the product of contest and compromise between radical Labor hopes and the political and institutional conservatism of the financial community. The latter largely won. As Gollan's history of the Commonwealth Bank argues:

A bank was on the fighting platform of the Labor Party and the government and was under two types of pressure: one from the left wing of the labour movement demanding a bank which would lead an attack on the Money Power; at the other extreme were those who were opposed to any form of government intervention. Fisher's bank was a compromise.¹³

The Bank emerged essentially as a conventional bank, albeit publicly owned. Historian Brian Fitzpatrick notes that the 'Commonwealth bank seemed at

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length to amount to nothing more than to obtain a share of what new banking business might be forthcoming as the national economy moved forward, so that out of the hypothetical profits some amounts might be set aside for the redemption of public debt'.¹⁴ The Bank was also created to act as the government's banker, 'a plain business-like and practical measure', according to Billy Hughes on the Labor side.¹⁵ Indeed, the Bank's first Governor, Dennison Miller, merely wanted the Bank to be a 'quiet bank', one that would provide support for the country's private banking system.¹⁶ The Commonwealth Bank did not even control national note issue – Treasury did. Nor under its first Governor was the Bank especially keen to compete for business with the private banks. Boris Schedvin, the major historian of the Bank in the post-war era, writes that Dennison Miller 'recognised that a central bank needed to win and maintain the confidence and trust of the commercial banks, and that this could not be achieved if these two levels were in active competition'.¹⁷ This search for trust and some form of accord became a central motif of relations between the Bank and the private banks; it was a long search, not completed until the 1950s.

The CBA was controlled by a Governor appointed for seven years, responsible for the management and direction of the Bank. Although the issue was a source of debate in the federal parliament prior to enactment,¹⁸ under the *Commonwealth Bank Act* the Bank's Governor was not answerable to a Board of Directors (there was no Board) and had almost complete independence from direct government control. There is a suggestion in the literature that independent central banks are created to enhance creditworthiness in the eyes of foreign lenders and investors.¹⁹ Although Australia was heavily exposed to the London markets, there is little evidence that this consideration was important. Instead, independence mainly reflected a desire to reduce local perceptions of the CBA as an instrument of the government amidst the cross-fire of partisan conflict.²⁰ Independence also reflected the well-established tradition in Australia of creating relatively independent statutory authorities. Prime Minister Fisher thought that the CBA was more likely to be independent if control was vested in one person. As he told the parliament, 'the Governor of the Bank is to be given absolute authority'.²¹

In World War I the Commonwealth Bank played a role in mobilising war finance and, over time, the Bank took on more government banking business. As Nugget Coombs reflected in his 1931 master's thesis on the development of the CBA, the war strengthened the Bank's role.

It emerged a national institution with a distinctive character and a definite place in the Australian economy. It had been the government financial agent in its dealings

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with the trading banks, the Bank of England and with the Imperial government; it had raised and administered government loans; it had acted as a representative of the trading banks and adjusted bank differences ... These were central bank functions ... Even though the Bank had not proved the restraining influence on government finance that a fully developed central bank might have been ...²²

This 'restraining influence' on government finance was to be asserted later, in the Depression – an episode that was to embroil the Bank in controversy and bitterness throughout the 1930s and 1940s.

Following World War I the CBA continued to make little effort to compete with the private banks and by the 1920s it was clear that the future of the Bank lay in the further gradual accretion of central banking functions. In 1920, for example, following CBA lobbying, note issue was transferred from the Treasury to an independent Note Issue Board (located within the Bank), and then in 1924 to the Commonwealth Bank proper.²³ Because the CBA posed little in the way of a competitive threat to the private banks, the latter were more inclined to place their reserves with it, a shift supported by the 1924 *Commonwealth Bank Act* which required the private banks to settle their accounts through the CBA.

'One-man central banking' did not last long. In 1924, amidst criticism in various quarters of the Governor's autocratic power and the restrictionist approach to note issue after 1920, the conservative Bruce–Page government, via the new *Commonwealth Bank Act*, installed an eight-member Board (including the Governor and the Treasury Secretary) to dilute the power of the Governor. The Labor Opposition criticised the move as an 'attempt to kill the Bank' by installing a Board that was not sympathetic to the broad aims of a truly national or central bank.²⁴ Even so, the government barred members of the private banking industry from sitting on the Board and appointed Board members with experience that reflected the economic and geographical diversity of the Commonwealth (a practice which still continues). Giblin, another historian of the Bank, writes that it was a 'Board of amateurs', playing less than a robust role, because its members were inexperienced and had little knowledge of central banking.²⁵

The next major accretions of central banking functions were partly a product of the exigencies of the Depression and World War II and partly the product of Labor's unfinished agenda for central banking and banking more generally. During the early phase of the Depression, in 1929, the CBA was given control over gold in a context of rapidly diminishing foreign reserves. In 1930, the Scullin Labor government, in a bid to strengthen central banking powers, introduced two Bills into the federal parliament that were designed to separate the central and commercial banking functions of the CBA. The *Central Reserve*

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Bank Bill established a separate central bank with extended powers. The *Commonwealth Bank Amendment Bill* abolished the CBA Board and placed the Bank back under the control of a single Governor. Both Bills, however, were defeated by an anti-Labor majority in the Senate, backed by the private banks.

In 1931, after the abandonment of the gold standard, the Bank was given control over the management of the exchange rate. In that year an event occurred that was to cause ongoing bitterness in Labor ranks and shape the future of Australian banking. Conflict erupted between the Commonwealth Bank and the private banks on the one hand, and the Scullin government on the other, when the Bank refused to extend finances to aid the government's plans for economic stimulation. Labor supporters saw this as an act of treachery and an attack by the financial establishment on an elected government. The refusal challenged the right of the government to determine its own budgetary policy. Coombs later wrote that the 'Commonwealth Bank had not behaved as a central bank should', and that the 'Bank Board had been politically motivated' in its unwillingness to accommodate the Scullin government.²⁶ The events of 1931 were to cast a long shadow over subsequent developments and, certainly, banking reform and the strengthening of central bank controls moved to the top of Labor's reform agenda.

In a re-run of the 1890s, though on a smaller scale, the excessive lending during the economic boom of the late 1920s, followed by the conservative and restrictionist attitude of the Commonwealth Bank and the private banks during the Depression, were widely thought to have contributed to the economic calamity and created considerable momentum behind banking system reform. Indeed, sentiments were increasingly critical of free financial markets. The issue was central to the 1934 federal election. Egged on by agrarian interests in the Country Party, the anti-Labor coalition government led by Lyons established the Royal Commission on the Monetary and Banking Systems of Australia in 1935. The commission's 1937 report recommended major new regulatory interventions. It was highly critical of the CBA's restrictionist approach to the Depression. It recommended a substantial strengthening of central banking powers and more control over the private banking system, including the requirement for the banks to lodge specified reserves with the CBA in order to help regulate credit, as well as government licensing of the private banks (thus giving the government a major sanction over their operation). It also recommended steps to coordinate CBA and government policy and, in the light of the events of 1931, that the government (not the CBA) should have ultimate authority over monetary policy: as Coombs puts it, this 'shook the doctrinal foundations of the Bank'.²⁷

But no effective legislative response to the commission's findings was undertaken in 1938–39. The delay was due largely to the private and public campaigns