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CIS Pandemic to Prosperity

The End of Monetary Policy?

Warren Hogan

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Introduction

The onset of the coronavirus pandemic has seen central banks in nearly every advanced economy drop short-term interest rates close to zero as economic activity collapsed in the first few months of 2020.[1] Most central banks have either introduced unconventional monetary policies in response to the pandemic or increased the quantum of existing unconventional programs.

With short term interest rates at — or near — zero, it appears we have reached the end of monetary policy as an effective economic policy tool. At least that is what some economists would argue. Others do not believe there are effective limits to policy action and are pushing for central banks to do more.

Differing views about the short-term policy outlook highlight the broader issues underpinning the policy debate.

The common view is that central banks have not done — and are not doing — enough to achieve their statutory targets of full employment and inflation of 2%. Central banks are not fully embracing unconventional policies that can drive higher economic activity and inflation.

These economists will argue that central bank hesitancy is the result of an unfounded concern about inflation risks, financial instability and other functional costs of unconventional monetary policies.

The counter argument — which is the argument developed in this paper — is based on the assessment that the global inflation process has become insensitive to economic activity. While inflation control is fundamental to monetary policy, attempts to push inflation towards an arbitrary target through increasingly easy monetary policy settings ignores other costs that are emerging in this environment of persistently easy monetary policy.

When inflation is not responding to easy monetary policy, as has been the case in the past 10 years, the conventional wisdom is to do more. The counter argument is to respect the potential for structural changes within the economy that are impacting the inflation process and be cautious.

Monetary policy in most advanced economies is currently suffering from overreach. It is simply trying to achieve too much. Many of the problems these economies face cannot be solved by easy money. They are structural in nature and, as such, can only be remediated through adjustments to economic structures such as taxation, competition, industry and trade policy.

By pushing on the monetary policy string, central banks are distorting spending, saving and investment decisions in the underlying economy which is undermining economic vitality and performance.

The conduct of monetary policy in many advanced economies in the past decade may hamper the recovery from this pandemic and reduce economic dynamism in the economies most exposed to persistently easy monetary policy.

The use of unconventional monetary policies has become commonplace. These policies for most economies, including Australia's, should be directly compared to some of the massive fiscal interventions seen during this pandemic.

Emergency fiscal policy programs, such as Australia's JobKeeper wage subsidy and unconventional monetary policy actions like negative interest rates or quantitative easing, should be seen in the same light. They are interventions that can be justified in extreme circumstances, but they fundamentally undermine the efficient functioning of a free and open market economy.

These policies distort private sector decision making and ultimately reduce the productivity and efficiency of the economy. These emergency fiscal and monetary policies are necessary, but it is very important that they are wound back quickly when the crisis moment has passed, even if this comes at the inevitable cost of short-term economic disruption.

Over the past decade, the problem for many central banks has been that these policies are not being wound back. This has produced an economic environment characterised as secular stagnation. Weak productivity growth, low wages growth (both real and nominal) and of course, low consumer price

1 The traditional central bank target interest rate is the overnight interest rate. A zero or near zero rate is called the effective lower bound (ELB). The RBA for example has determined that the ELB for the Australian cash rate is 0.25%, given the need to operate an interest rate corridor of 25 basis points (bps) in its dealings with the financial system. The bottom of that corridor is therefore a zero interest rate even though the cash rate is targeted at 25bps, the top of the corridor.

inflation. It is not stretching the argument too far to suggest that some economies have already fallen into a sort of liquidity trap.

The damage being wrought by the worst perpetrators of super-easy monetary policies such as the Bank of Japan and the European Central Bank is not confined to their own economies. In a world of highly mobile capital and open trade easy monetary policies in large economies drag others with them via the effects of capital outflows and currency depreciation.

Central banks like the RBA are forced to respond to tightening financial conditions in their own economies as foreign central bank stimulus drives their own currency higher.

Thankfully, the RBA has been one central bank to resist this trend for overusing monetary policy. This has been clear for much of the last decade and is once again evident through the global pandemic of 2020.

Section One: Monetary Policy 2020

Global monetary policy has been complicated in the past decade by the widespread use of unconventional policy tools. There seems to be a never ending list of new programs and facilities that central banks use to affect financial conditions in the capital markets and banking system.

Gone are the days of monetary policy being a simple question of adjusting the overnight interest rate. The financial crisis of 2008 heralded a new era of unconventional monetary policies that have now become a permanent feature of the international financial system.

In 2020, any assessment of monetary policy must take into consideration both conventional policy actions as well as the unconventional. In Australia, with our open capital markets, monetary policy cannot be viewed in isolation. What the world's major central banks do with their monetary policy has profound implications for us, not least through the impact on capital flows, asset prices and the exchange rate.

Conventional monetary policy uses changes in the short-term interest rate to effect conditions in the financial system and the broader economy. Most central banks will explicitly target a stable rate of inflation of around 2%.

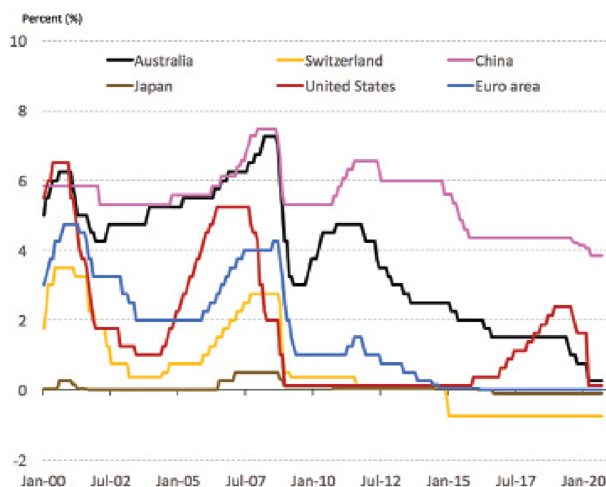
The central bank will operate in the money market to maintain the target level of the overnight interest rate. This will in turn impact longer-term interest rates, the exchange rate and other financial markets. Over time, these changes will impact saving, consumption and investment decisions by households and business.

Interest rate changes take approximately two years to flow through the economy. Conventional monetary policy is a short-term demand management tool. In changing the price of money, monetary policy shifts consumption forward and backwards through time. It does nothing to enhance the performance of the supply side of the economy.

Conventional monetary policy has virtually no positive impact on long-term economic outcomes. Beyond these short-term demand management objectives, monetary policy can only err, that is, to harm the performance of the economy over the long-run.[2]

Global central banks acted quickly during the onset of the coronavirus pandemic. All the world's major central banks reduced policy rates to the effective lower bound in March and, in the process, extinguished the last of the conventional policy tool.

Chart 1: Global Central Bank Policy Rates



Source: BIS

Unconventional Monetary Policy

The effectiveness of conventional monetary policy has been put in question over the past 15 years as nominal economic growth has fallen in many countries. As nominal economic growth has slowed, the short-term 'neutral' interest rate has declined. Central banks have been concerned that the zero lower bound for interest rates will act as a constraint on providing effective policy stimulus in times of economic weakness and/or financial crisis.

For countries where potential economic growth has slowed to or below zero, unconventional monetary policies have been used to provide monetary stimulus.

The other rationale for unconventional monetary policy has been in episodes of financial crisis, which unfortunately are happening with a higher frequency than in the past.[3] These policy tools are broadly grouped as liquidity operations and seek to push liquidity into the financial system when private sector participants take fright.

A sudden rise in financial market uncertainty or a deterioration in perceptions about the credit

2 The issue of the neutrality of money in the long run has recently been brought into question by leading academics. See Jordi, Singh & Taylor (2020) "The Long-Run Effects of Monetary Policy", Federal Reserve Bank of San Francisco Working Paper 2020-01. Much of this work focuses on the negative impacts over the longer term of holding policy in a contractionary setting. There has been less work done on the negative implications of holding policy in an expansionary setting for an extended period. In any case, this work looks almost exclusively at policy error confirming that monetary policy cannot enhance long-run economic outcomes, it can only damage them

3 Increased frequency of financial crisis is often cited as a result of easy monetary policy due to the build-up of leverage in the financial system and economy as well as the encouragement of speculative (short-term) financing activity when funding costs are artificially held below the natural market rate.

worthiness of financial institutions can cause a rush of money to 'safe assets' such as bonds, precious metals or money markets.

This withdrawal of money from riskier asset markets such as equities or lending markets to banks and business can result in an unwelcome wave of insolvencies which could propagate into a broader economic downturn.

Central banks can use unconventional tools to provide cover for the suddenly absent liquidity in the financial markets and forestall a vicious cycle of declining risk appetite and insolvencies that damages investment and employment in the real economy.

Unconventional monetary policy tools come in various forms. Some of these tools have been used before while some have been developed to address specific problems. The BIS has published an excellent report through the Committee on the Global Financial System that reviews unconventional monetary policy tools in a thorough and straight forward manner.[4]

There are five broad types of unconventional monetary policy tools being deployed by global central banks. Rarely are these policies used in isolation. Central banks will put together a package of policies that reflect the particular problems a central bank is confronted with.

Liquidity Operations and Short-Term Financing

Liquidity operations are a normal part of monetary policy and should be considered conventional when managing conditions in money markets to achieve the desired policy rate. In times of crisis, these liquidity operations can be extended to maintain a functional money market and banking system when risk perceptions deteriorate or uncertainty about credit worthiness infects the financial system.

The extension of liquidity operations into the realms of 'unconventional' monetary policy involves the central bank offering liquidity for a longer period than normal or accepting a broader range of collateral, typically of a lower credit quality, for these loans.

Quantitative Easing (QE) and Asset Purchase Programs

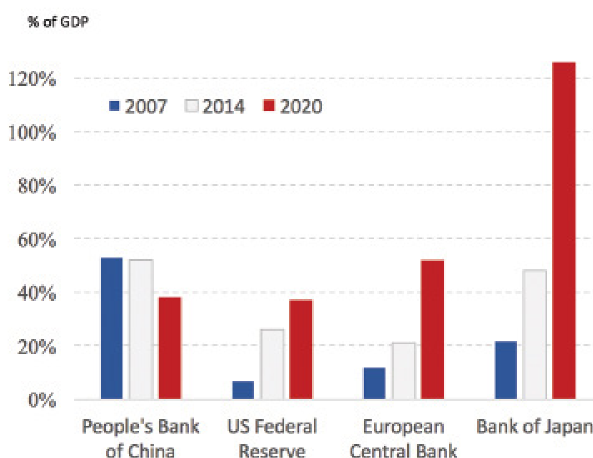
Central banks commit to purchase debt securities in the secondary markets, typically government bonds, with the objective of lowering term interest rates when the short-term policy rate hits its zero (effective) lower bound. However, under pure QE the central bank targets the amount of securities to be purchased rather than a particular level of term interest rates.

QE can be particularly important in countries where household and business loans are priced off the long-term interest rate. For example, in the United States mortgage rates are linked to the yield on the 10-year US Treasury security. By contrast, Australia has a very low proportion of loans priced off maturities beyond 3 years. A 'fixed' mortgage rate in Australia is typically set for 3 or 5 years.

QE can have objectives beyond the lowering of long-term interest rates. Asset purchases can be a further extension of liquidity operations targeting specific sections of the financial system that are experiencing liquidity problems due to acute economic and/or financial stress. The US Federal Reserve's purchases of agency debt (Freddie Mac and Fanny Mae etc.) during the 'Great Recession' of 2008 is a good example.

In March of this year, the US Federal Reserve embarked on one of the boldest unconventional monetary policy programs seen to date. The FOMC extended their QE program to a broad range of private sector debt securities, including junk bonds and some derivative products. This unprecedented intervention in private sector financing markets reflects growing fears of a liquidity problem evolving into a solvency problem for businesses in the US. It also represents one of the largest direct injections of liquidity into asset markets in history.

Chart 2: Major Central Bank Balance Sheet Size



Source: Central Bank Websites, EQ Economics

Yield Curve Control (YCC)

YCC is the targeting of a specific level for a long-term government bond yield to maintain a lower long-term interest rate than what the market would determine. The first major central bank to target a long-term interest rate was the Bank of Japan in 2016 when announcing a yield target of 'around zero' for the 10 year Japanese Government Bond (JGB).

4 Committee on the Global Financial System, CGFS Paper No.63 "Unconventional Monetary Policy Tools: a Cross Country Analysis", October 2019

YCC involves the central bank setting and then defending a price (yield) target on an identified bond maturity. YCC is QE with a yield target rather than a quantity target. The central bank must be prepared to buy and sell whatever quantity of bonds that is required to ensure the target yield level is met. It leaves the central bank open to 'taking on the market'. The presence of large sovereign investors in most of the world's government bond markets makes this a genuine risk factor, particularly in an environment of deteriorating international relations. Hostile foreign governments with a large central bank foreign exchange reserves could potentially break a yield curve target through their own actions in public markets. This could undermine confidence in the central bank and create unwelcome financial market volatility.

Federal Reserve Chairman Jerome Powell has publicly ruled out the use of YCC in the US this year despite the importance of long-term interest rates to funding costs in the underlying economy. While geo-political concerns were not put forward as the reason, it would seem to be a risky policy for the Fed, given the sheer volume of US Treasuries under the control of foreign governments, particularly the Chinese.

Negative Interest Rate Policy (NIRP)

The use of negative interest rate policy has only really emerged in the wake of the financial crisis of 2008. In the past decade, a range of European countries as well as Japan have instigated a negative short-term interest rate to add further monetary stimulus into an economy with structurally weak growth prospects; largely the result of a shrinking workforce.

The extent of negative interest rates has not been large, with most set above -1%. Negative interest rates introduce a whole set of operational and functional complexities that cast a long shadow over the policy's effectiveness.

For example, negative interest rates in the wholesale financial system are rarely passed through the commercial banking system to retail depositors, because banks fear losing these deposits.

The main channel through which negative interest rates are believed to work is the exchange rate. Central banks use NIRP to slow capital inflows that will drive up their currencies and hurt the competitiveness of the underlying economy.

Negative interest rates not only face practical problems with their implementation, but they come at a potentially high price to the long-term operation of the financial system. Critically, negative interest rates risk driving financing activity out of the regulated banking system reducing the capacity of the banking system to create credit. This will also have the effect of pushing financing activity away from the oversight of the regulator.

Forward Guidance

Forward guidance attempts to influence expectations about the future path of policy to reinforce the existing policy position. The most common objective is to put downward pressure on medium- to long-term interest rate expectations when policy rates are at, or near, the effective lower bound. The central bank is committing to keep policy at a highly stimulatory setting until — or even beyond — the point when the policy goal is met.

Forward guidance can also be helpful in keeping long-term interest rates in check in the absence of, or even in conjunction with, QE policies. It is a policy solution to a particular problem; that is: a fear of debt deflation when there are high levels of private sector debt and the neutral interest rate is close to zero.

The recent adjustment to the Fed's inflation targeting regime is an example of how forward guidance is playing an increasingly important role in the conduct of monetary policy through this pandemic. The Fed has shifted its inflation target from 2% to an average inflation rate of 2% over time. The central message is that the Fed will allow inflation to rise above 2% following an extended period of inflation being below target. As the economy recovers and inflation begins to rise, the Fed is essentially saying they will not reduce monetary stimulus or consider tight monetary policy until inflation has overshot the inflation target.

When the Unconventional Becomes Conventional

Unconventional monetary policies are used to deal with two types of situations: a low, or even negative, potential rate of growth in the underlying economy; and times of economic and/or financial crisis.

Unconventional policies, specifically negative interest rates become conventional when an economy experiences a decline in potential economic growth to zero or below. The main factor driving low potential growth is population dynamics. In 2020, it is the Japanese that are most 'demographically advanced' with a shrinking population. Many continental European countries are also confronting demographic headwinds to economic growth.

For other countries such as Australia or the United States, unconventional policies come into play in times of severe economic downturns. The biggest problem with unconventional policies is that they become a permanent feature once the crisis has passed. Emergency policy tools are ill-suited to a well-functioning economy in normal conditions. Unconventional policies can create disincentives for governments and financial institutions to effectively manage their financial position. There is growing evidence of impacts of these policies on the resource allocation and the supply of credit.

While using unconventional policies can be very effective at containing the damage done by a financial crisis, they do little to support balanced long-term sustainable economic growth. Indeed, unconventional policies can get in the way of a strong economic recovery if they distort investment decisions or act as a headwind to demand.

Has Global Monetary Policy Gone Beyond Its Effective Limits?

Over the past decade, monetary policy in many advanced economies has failed to achieve its inflation targets despite policy settings becoming increasingly easy; whether measured by the level of interest rates or the quantum of unconventional policies deployed.

One of the most worrying features of the world economy has been persistently weak productivity growth in many advanced economies. This apparent secular stagnation is characterised by a loss of economic dynamism, weak real wage growth and low consumer price inflation. Yet asset prices and debt levels are surging higher.

There is simply no evidence to allow anyone to draw the conclusion that this situation would have been any different with even easier monetary policy settings. There is however, an emerging evidence base that suggests that easy policy may in fact be helping to create these broader macroeconomic outcomes — seemingly at odds with the conventional view.

While there are many things that can be looked at to explain this situation, not enough attention is paid to the role of super-easy monetary policy. Specifically, the idea that once the monetary policy setting has become too easy or an easy stance is put in place for long enough, the impact on the economy becomes counter-productive.

There is more attention being paid to the idea of a reversal interest rate. This is a level of the interest rate or a characterisation of the unconventional stance of monetary policy where policy shifts from being stimulatory to the economy to becoming contractionary.

The technical work on this is in its infancy and is mainly focused on single monetary policy transmission channels like bank lending.[5] While work progresses on this the fact remains that monetary policy is not achieving its goals and in a post-Covid-19 world more of the same policy approaches may cause more problems than they solve.

Monetary policy in many countries has suffered from elevated expectations of what it can achieve (over ambitious), and an overreliance on monetary policies at the expense of more effective but politically difficult structural and fiscal policies (inaction bias from other policy arms).

There are three important themes that are not getting enough attention when reviewing the performance of monetary policy around the world since the start of the 21st century: over-ambition; regime breakdown; and the hidden costs of easy money.

Over-ambition

Over the past two decades, there has been a loss of perspective about what monetary policy can and cannot achieve. It is a tool to impact demand in the economy in the short-term (1-2 years). It cannot impact demand over the long run nor can it influence the supply side of the economy; at least not in a positive manner.

Looking back over the past 20 years, you would be forgiven for thinking that central banks can turn water into wine. Political independence and a favourable operating environment (the 'Great Moderation' from the high inflation 1970s) created an impression that monetary policy could tackle just about any economic problem.

The conduct of monetary policy has created a policy inaction bias in many countries. Central banks have let many governments off the hook on politically difficulty fiscal and structural polices.

The real question is whether, in their attempts to solve the world's problems, central bankers have inadvertently created bigger problems for themselves and the communities they serve. It is still too early to tell, but a real concern is that the magnitude of the economic and financial shock of 2020 may reveal some of the vulnerabilities created by easy monetary policy.

Have central banks used money policy as a short-term bandaid for fiscal and structural problems?

Has policy been driven well beyond its effective operating limits by the argument that central banks that fail to achieve their inflation targets should push harder (do more) on monetary stimulus?

Overactive central banks may also reflect a lower social and political tolerance for economic disruption in 21st century advanced economies. At times, it seems like there has been little appetite for tighter monetary policy and higher short-term unemployment to facilitate a reconfiguration of parts of the economy.

Or it might be that a technological revolution has increased the pressure for disruptive industrial structural change. Industrial change which can dislodge people from jobs and create financial problems for highly indebted households.

Has easy money protected weak firms and slowed the take up of productivity enhancing new technologies? Has easy money blunted the pressure to re-skill the vast service sector workforces of the advanced economies?

5 See Brunnermeier & Koby (2018), "The Reversal Interest Rate", NBER Working Paper No. 25406.

Economies are dynamic and are in a constant state of adjustment to changes in technology, preferences, and regulation. While it may be desirable to smooth these transitions of labour and capital from old to new enterprise and activities, policymakers should be careful not to slow the pace of change too much — or indeed halt the process altogether.

The pressure on central banks is enormous. In 2008, the *Daily Telegraph* newspaper ran a front page with a picture of the RBA Governor Glenn Stevens after an interest rate increase stating, "Is this the most useless man in Australia?" Populism to be sure, but it reflects just how politically difficult it is to run a balanced monetary policy with an eye to the long-term wellbeing of the community.

Are high global debt levels simply a function of lower interest rates and sophisticated financial management practices? Or is some part of the build-up in debt a result of too easy a monetary policy being run by the world's major central banks?

Regime Breakdown

In the past 50 years, we have seen a secular decline in consumer price inflation from the high point in the 1970s to a rate fast approaching zero. As this secular shift has taken inflation below central bank targets, monetary policy in most of the world's advanced economies has become progressively easier in its efforts to get inflation back to target.[6]

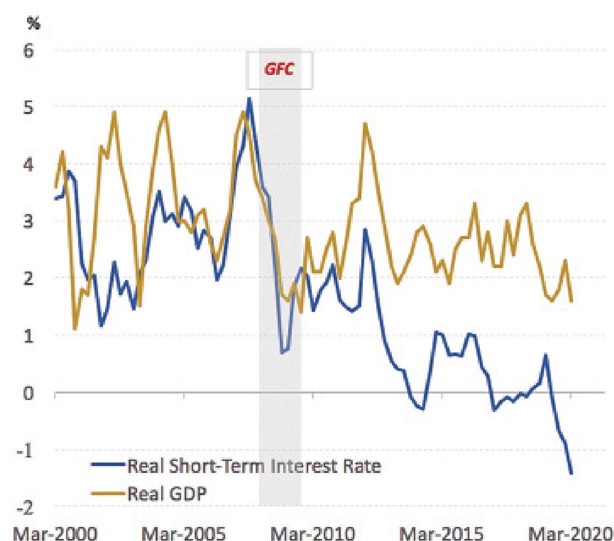
Monetary policy has evolved over the centuries. By the late 1980s, central bankers landed on inflation targeting. In line with monetarist thinking, the primary objective of monetary policy is to maintain price stability, defined in the early 1990s as consumer price inflation of 2%. Following the high inflation experience of the 1970s and 1980s, a critical element of the inflation targeting regime was to anchor inflation expectations to the target.

There was great success in the early years. We witnessed a 'golden era' of monetary policy from the early 1990s until the GFC. Through this period, real interest rates were broadly aligned with real economic growth and deviations from the so-called 'neutral' policy stance for short periods of time (12-18mths).

The relationship between an intermediate policy target such as the short-term interest rate and the ultimate economic target, the inflation rate, can change once this relationship becomes a central part of an explicit policy process.

A range of forces unleashed by globalisation and new technology have been putting downward pressure on consumer price inflation. One thing that gets very little attention is the possibility of a behavioural change within the community driven by the existence of a high-profile inflation target.

Chart 3: Real Interest Rates and Economic Growth



Source: RBA, ABS, EQ Economics

Note: Real short-term interest rate calculated using 90 day bank bill rate and the headline inflation rate adjusted for GST impacts in 2000/01.

Chart data is up to the start of the pandemic in March 2020.

Is it a coincidence that businesses have become increasingly reluctant to drive profitability through price increases in the past 30 years? Is the prospect of higher interest rates in response to higher prices impacting price setting behaviour?

Central banks have been unwilling to review their inflation targets to reflect lower inflation outcomes. For good reason, they believed that a change of inflation target could undermine the beneficial effects of that target for anchoring inflation expectations. They probably also believed they could still achieve a higher inflation rate at some stage.

Central banks have been consistently failing to hit their targets. It may be that their failure is not their fault. Regardless, the facts remain that:

(a) Central banks are failing to hit their targets

(b) These targets / rules are agreed with elected policy makers

(c) Central banks can not / should not unilaterally abandon these agreed targets.

6 A critical issue in analysing the conduct of monetary policy is to ascertain what constitutes a neutral policy stance. The most basic formulation is to compare the real short-term interest rate with the real rate of potential economic growth in the economy. As potential growth is unobservable but is somewhat sticky the best proxy for this is actual growth outcomes. There are sound theoretical foundations to this approach. The introduction of inflation targets has seen a shift in thinking by some to the policy stance being judged with reference to the policy target. If inflation is below target, monetary policy cannot be easy is the implication. This relies on a stable relationship between real interest rates, real economic growth, and the rate of consumer price inflation.

It could be argued that the current situation is undermining the rules-based system. The right solution is the negotiation of new, agreed targets.

Central to the argument that monetary policy is operating beyond its effective limits is that the level of inflation is not solely determined by monetary policy. Other factors are at work. Technology is the primary factor that may have seen the rate of consumer price inflation — consistent with the concept of price stability — fall over the past three decades. However, the implication is that if central banks do not adjust their policy framework to the realities of the inflation process, they can create problems.

It is another way of saying there are other costs to easy monetary policy than just rising consumer price inflation.

Hidden Costs of Easy Money

Beyond rising consumer prices, there are costs to persistently easy monetary policy that are not necessarily obvious in the short-term. Many of the costs of holding the short-term real interest rate well away from a neutral setting take time to play out. Furthermore, the emergence of persistently easy monetary policy is relatively new. We have not yet seen the full suite of costs that can play out over a longer time frame.

The simple Phillips Curve framework suggests that the main cost to easy monetary policy is rising consumer price inflation. The Philips Curve defines a simple relationship between unemployment and inflation. There is a trade-off. This relationship is foundational to modern macroeconomics.

In the absence of rising consumer price inflation, a major constraint on the central banks' ability to push unemployment down is lifted. Indeed, low inflation itself has become a major policy problem in the presence of high private-sector debt levels. Many economists rightly warn of the dangers of deflation, a situation where falling prices and wages increase the real burden of existing debts. How do you reduce the risk of a dangerous debt deflation — you stoke inflation!

Some economists have argued for higher inflation targets to mitigate the risks of deflation.[7] While there is merit in the argument to get inflation higher, and there would likely be beneficial (upward) implications for inflation expectations, the reality remains that central banks cannot achieve existing targets — let alone a higher one.

This framework is far too simple. The analysis of costs and benefits must be viewed over time, not just within the set period where most of the obvious impacts become apparent. Many of the costs of an easy policy position will accrue over time and will eventually outweigh the short-term benefits to activity and unemployment.

Outlined below are three broad types of long-term costs to the economy from persistently easy monetary policy. These costs will differ from country to country and may present themselves on different timelines. There are also likely to be other costs that are yet to emerge.

1. Financial Instability

Easy money and low interest rates put upward pressure on asset prices and debt levels. Holding the cost of money below its market rate for extended periods can encourage financial speculation and a misallocation of resources. This can create vulnerabilities to negative shocks within the economy and financial system.

As the BIS notes: "easy monetary policy designed to bring a stubborn inflation rate back to target can fuel financial booms and heighten economic risks."[8]

Financial instability is now a well-accepted cost of easy monetary policy and is managed by policymakers through the use of other policy tools, such as prudential regulation and oversight. It is still not clear whether these other policy tools have been effective in managing these risks — although the incidence of financial crisis and volatility appears to be increasing.

2. Impact on Savers and the Regulated Financial System

When interest rates are artificially held below a market level for an extended period of time, it can cause problems for savers. Combined with forward guidance (rates will be lower for longer), this can create a situation where people save more (and consume less) to achieve savings objectives. An expectation of lower interest rates (and returns in the economy) can also force people to save a larger nest egg for retirement. This means that easy policy can have a negative impact on current spending and economic activity.

There is also a risk that in the presence of persistently low interest rates, savers may adopt riskier savings strategies by taking more capital risk (buying equities) or credit risk (depositing in unregulated financial institutions).

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7 Gagnon & Collins (2019), "*The Case for Raising the Inflation Target is Stronger than you Think*", Petersen Institute for International Economics

8 Borio, Disyitat, Juselius & Rungcharoenkitkul (2018), "*Monetary Policy in the Grip of a Pincer Movement*", BIS Working Paper 706.

When interest rates where held above market rates through the fight against inflation, borrowers were incentivized to seek cheaper funding outside the core regulated financial system. Australia in the 1980s, and New Zealand in the 1990s, witnessed a wave of financial failures from unregulated 'shadow' financial institutions; which resulted in lost savings for many.

Now we are seeing savers seeking 'yield' in unregulated and risky parts of the shadow financial system. Whether it is the result of too tight or too loose a policy setting, this well documented phenomena of pushing activity away from the core regulated financial system is a key argument for why monetary policy has limited long-term effectiveness.

As interest rates approach zero, banks' margins tend to decline. A less profitable banking system will be less able to supply credit to the economy. Negative interest rates are diabolical for bank profitability, due to a zero bound for retail deposits.

It should never be underestimated how important the role of a stable and well regulated banking and financial system has been to Australia's economic success.

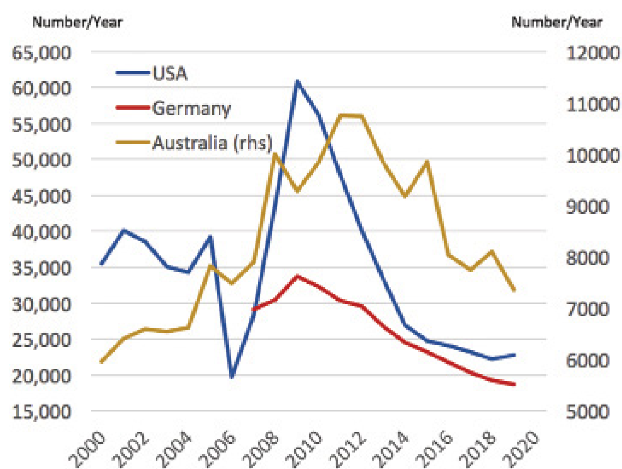
3. Allocative Efficiency and Bankruptcy

Low interest rates can allow financially weak firms to survive for longer than would otherwise be the case: the so-called 'zombies'. A critical element of the efficient allocation of capital in the economy is the extraction of capital (and labour) from businesses and industries in decline. A slowing of this process may be a desirable result of the normal operation of monetary policy; that is: to ease policy when growth is weak may prevent a rash of bankruptcies.

To 'trap' capital and labour in inefficient businesses can put downward pressure on productivity, wages and inflation. The 'art' of central banking is getting this balance right — particularly when unconventional policy tools are employed to directly address the liquidity/solvency issue.

In the current pandemic, the rising prevalence of zombie firms is a major risk. Work from BIS economists estimate that zombie firms have risen from about 4% of firms in the 1980s to around 15% currently. With the size of the economic shock in 2020, many advanced economies may be carrying a much larger number of financially-weak firms into this downturn than has previously been the case.[9]

Chart 4: Global Bankruptcy Trends



Source: Statistisches Bundesamt, US Courts, ASIC, EQ Economics

Note: Australian data is fiscal year (2000/01 = 2001 in chart)

Monetary Policy Could be Operating Beyond its Effective Limits

The traditional Phillips Curve view of the costs and benefits to changes to monetary policy is inadequate for a highly complex world. One concern is that these costs and benefits and policy effectiveness are assessed within too short a time frame. The costs to having monetary policy settings at extreme levels may take many years to materialise, particularly when those extreme policy settings are on the easy side.

More and more evidence is building of hidden costs to easy money that take time to reveal themselves. It remains to be seen how costly these 'hidden costs' will be. It may also be that excessively easy policy has plunged economies into a form of liquidity trap which they cannot extract themselves from without costly economic and financial re-structuring.

As the global economy continues to navigate the economic fallout from the pandemic, we should be watching closely to see how these potential problems are evolving.

For example, the existence of a larger than typical proportion of financially weak firms (zombies) may trigger a larger wave of insolvencies across the global economy than past recession would suggest.

9 Banerjee & Hoffman (2018), "*The Rise of the Zombies: Causes and Consequences*", BIS Quarterly Review, September 2018

High private sector debt levels may become a significant constraint on recovery. The use of unconventional policies such as negative interest rates may do more harm than good by further impairing the supply of credit from the banking system.

The global central banking community needs to take these risks and hidden costs from persistently easy monetary policy very seriously. We can only hope this pandemic does not reveal major vulnerabilities within the economy that have been worsened by easy money.

Global monetary policy has become too ambitious and too active over the past 15 to 20 years. A more modest policy approach is required; one that puts the onus on the other arms of government to address underlying structural as well as cyclical economic problems.

A review of effective monetary policy is required but any substantive changes to the monetary policy framework require a global effort when capital is free to move from one jurisdiction to another.

Monetary policy should retain modest ambitions for what it can contribute to the long run wellbeing of the community it serves.

There is a long history of monetary policymakers losing sight of the long-term costs of over-using monetary policy, which typically means keeping policy easy for too long. Traditionally, the cost of easy policy has been rampant consumer price inflation. This is not the problem in the current environment — not yet, at least. The costs of easy policy are potentially accumulating in terms of a loss of economic dynamism and a heightened vulnerability to economic shocks. We will learn much in 2021 as bank moratoriums are lifted and financially weak businesses and households are confronted with servicing their debts once again.

Section Two: The RBA and The Pandemic

The RBA has resisted, and continues to resist, the global trend for over-using monetary policy even though they have undertaken a series of unconventional policies in 2020. This is partly because Australia's economy has performed better than many others over the past decade. It is also because the Australian central bank has been less willing to experiment with these new interventions, which have long-term unknown consequences.

A strong banking system has also been helpful with many of the complex programs utilised in Europe and Japan; a reflection of weak banks that cannot effectively supply credit to their economies.

Although the RBA has already embarked on the use of unconventional monetary policy, it is not currently willing to initiate a range of unconventional monetary policy tools that other countries have deployed. A consequence of overambitious monetary policy is overreliance. There is a genuine concern in many countries that monetary policy has let other policy arms, and other policymakers, 'off the hook'.

Fiscal policies and structural reform to the economy are politically difficult to execute, but are much better placed to deal with many of the problems currently plaguing the global economy.

Australian Economic Policy Timeline at the Onset of the Pandemic

In early February 2020, the RBA Board was considering the outbreak of a novel coronavirus in China as a 'source of uncertainty'. Within seven weeks the RBA had reduced the policy rate practically to zero, announced a new policy instrument — Yield Curve Control (YCC) — and established a new liquidity facility for the banking system: the Term Funding Facility (TFF).

The RBA has ruled out a range of unconventional policy measures currently being utilised by central banks in other countries; effectively handing over the task of managing both the short-term and long-term economic policy program to the various Australian governments.

This is a watershed moment. After 30 years of reliance on monetary policy to manage the economy, the RBA is now effectively on the sidelines. Australian governments, both federal and state, will be primarily responsible for the navigation of what could be the biggest cyclical and structural challenge the economy has faced in 100 years.

Table 1: Australian Economic Policy Actions in March 2020

Date	Institution	Policy
3 February	RBA Board Meeting	Cash Rate Unchanged at 0.75%
3 March	RBA Board Meeting	Cash Rate Reduced by 25bp to 0.50%
11 March	RBA Deputy Governor Guy Debelle Speech	The Virus and The Australian Economy
12 March	Treasurers Press Release	Fiscal Package One ($17.6bn)
16 March	Council of Australian Financial Regulators	Unscheduled Statement on Coordination
16 March	Statement by RBA Governor	Intention to buy government bonds in response to market dislocations
17 March	RBA Press Release	Minutes of 3 March Board Meeting
19 March	RBA Special Board Meeting - Comprehensive Policy Package	Cash rate cut by 25bp to 0.25%, YCC with 3 year bond yield target of 0.25%, Term Funding Facility ($90bn), Exchange settlement balances to pay 10bp
19 March	RBA Governor Press Conference	Following Comprehensive Policy Package
20 March	Australian Banking Association Media Release	SME Loan Deferral Announcements
20 March	RBA Statement	$US Swap Line ($US60bn)
22 March	Treasurers Press Release	Fiscal Package Two ($66.1bn)
29 March	Treasurers Press Release	FIRB Threshold dropped to Zero
30 March	Treasurers Press Release	Fiscal Package Three ($130bn – subsequently revised to $70bn)

Source: RBA, Office of the Treasurer, ABA, APRA, ASIC, EQ Economics

The speed and breadth of the RBA's policy actions through the initial stages of the pandemic are unmatched in Australian monetary policy history. This largely reflects the speed with which the pandemic took hold around the world in February and March. It is also a testament to the RBA's confidence in making judgements about the future course of the economy.[10]

The federal government policy response has been equally as swift. The fiscal policy response came in a series of three progressively larger policy packages over the course of March. The federal fiscal response in March commenced with a $17.6bn (1% of GDP) package on 12 March and concluded with what was then thought to be a $130bn (14% of GDP) wage subsidy at the end of the month. The magnitude of what was unfolding within the global economy caught just about everybody by surprise over the course of March.

The RBA was able to see in real time the spread of the virus to other countries, but most importantly senior staff gained vital insights from other sources. The signals from financial markets would have been an important source of information, as were informal channels such as business liaison contacts and overseas connections at central banks and similar organisations.

A timeline of Australia's major policy actions through the initial stages of the pandemic is displayed in Table 1.

RBA Policy Actions Through the Initial Stages of the Pandemic

The single most important policy action from the RBA during the initial stages of the pandemic was the comprehensive package announced on 19 March following that day's special Board Meeting. But as Table 1 highlights, this was only one of a number of policy actions the RBA delivered through this period.

The RBA's policy response to the pandemic was multifaceted. The main elements of the monetary policy response are outlined below.

10 The RBA March expectation of the initial impact of the coronavirus shock was a contraction in GDP of 10%, which is what has happened in countries where health outcomes have been worse than Australia's. As it has turned out, Australia's GDP contracted by 'just' 7% in the June quarter of 2020, still the largest decline on record.

Conventional Monetary Policy Extinguished

Cash rate cut twice by 25bp taking it to 0.25%, the Effective Lower Bound (ELB)

The RBA reduced the cash rate to the effectively lower bound of 0.25%, which in practical terms is a zero interest rate, given the need to have a 25bp interest rate corridor for the bank's market operations.

With the announcement of the 25bp rate cut on 17 March, the RBA has all but extinguished the conventional monetary policy instrument. Incredibly, the question of conventional rate cuts has emerged once again in October 2020 with the RBA considering cutting the cash rate from 0.25% to 0.10%. The bank has explicitly stated that they will not take the lower bound of the operating corridor below zero but will shrink the corridor from 25bp to 10bp. Talk about squeezing the last drop out of the lemon!

Liquidity Operations

Money Markets. Financial market functioning came under pressure at the height of the 'pandemic shock' in March 2020. The RBA increased its activity in money markets.

Bond Markets. The RBA announced ahead of its comprehensive policy package a willingness to intervene in the government bond market to ensure smooth pricing and reduced volatility. Neither of these liquidity operations in money and bond markets had price targets. They were aimed specifically at market functionality.

Banking System. The RBA establish the Term Funding Facility (TFF) with the objective of providing liquidity directly into the banking system to fund new and existing loans to business. This was based on an assessment that banks may face difficulties in funding themselves should the volatility in financial markets persist.

With many business loans in deferral, the RBA wanted to ensure that banks had access to cheap funding for loans producing little income, should they need it.

While the utilisation of the TFF was low in the initial stages, the RBA extended the program into 2021 — most likely an insurance policy against disruptions to bank funding once the moratorium ends and defaults rise.

The TFF is potentially a major source of liquidity for the Australian economy with the facility now expanded to $200bn. This is a key channel through which new monetary stimulus can be provided in 2021 should it be needed. The RBA appears to be much more concerned with ensuring that banks and their customers have access to liquidity than governments which as of October 2020, had had very little problem raising money in public capital markets.

The prominence of this new facility in the RBA policy toolkit highlights the big shift going on in Australian monetary policy. With short-term interest rates all but zero, the operational objectives of monetary policy have shifted from the price of money (interest rates) to the quantity of money (liquidity). This is a big shift following 40 years where the focus of monetary policy was price.

Yield Curve Control

The RBA announced a target for the 3-year government bond yield of 0.25% as part of its comprehensive policy package on 19 March 2020.

The 3-year bond yield target is set at the same level as the cash rate which is on the ELB. The RBA will buy and sell bonds in the secondary market in whatever quantity necessary to establish and maintain this yield target. This is the most significant unconventional policy action from the RBA and although not QE in its pure form, this policy instrument is a potential stepping stone to QE.

The RBA will now be a regular and active participant in the secondary market for government bonds. Although the policy target is a price rather than a quantity, YCC is aimed at keeping the 3-year rate lower than it would otherwise be, and as such, is an asset purchase program that has seen the RBA balance sheet expand and liquidity in the financial system increase.

The RBA will not only buy the target bond; that is, Australian Government Bonds with maturities near 3 years. It will buy bonds of any maturity that it feels is necessary to maintain a well-functioning market.

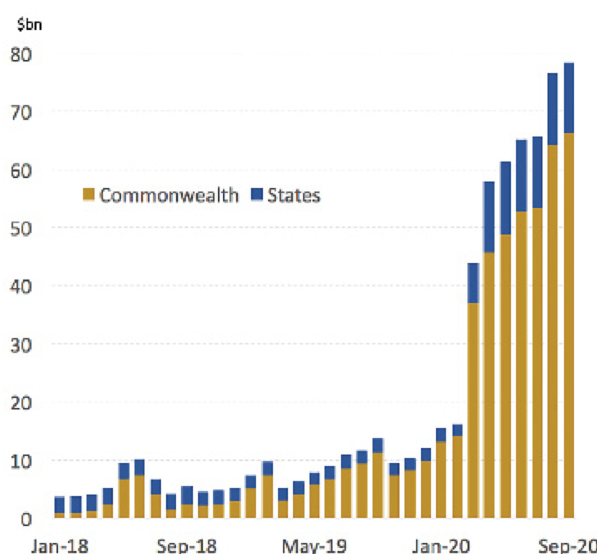
The RBA will also buy and sell state government bonds as part of this program, which at face value appears to be a move aimed at making sure all governments in Australia benefit from the cheaper funding costs that will result from the new policy instrument.

At the time of the announcement the 3-year government bond yield was trading at 0.50%. The yield quickly fell to 0.29% the day after the announcement highlighting the credibility the RBA has in the financial markets. Even so, the RBA had to subsequently buy a substantial amount of bonds to get the yield down to the target level of 0.25%.

Once the RBA showed the required commitment in volume, the market saw this as a credible commitment and the RBA was able to taper purchases off through the month of April. Only in late July did some upward pressure emerge on bond yields, and the RBA has acted once again to buy bonds.

In October 2020 RBA officials raised the prospect of buying more longer term government bonds as part of the YCC program in order to put downward

Chart 5: RBA Government Bond Holdings ($bn)



Source: RBA

Chart 6: RBA Cash Rate and 3 Year Government Bond Yield

Source: RBA

pressure on long-term yields which have been trading at higher levels than other countries in recent months. Presumably, the objective is to bring Australia's long-term rates closer to global rates and thus take some pressure off the currency. It doesn't appear to have anything to do with maintaining a 3 year yield at the desired level. This highlights the blurred lines between YCC and QE.

The targeting of a 3-year government bond yield can be seen as an extension of the existing practice of targeting a price (interest rate) rather than a quantity. It is simply extending the maturity of the interest rate being targeted.

The YCC program will allow the RBA to seamlessly launch a full QE program should the government run into any funding troubles in the future. At some stage, large and growing budget deficits may result in less willingness on the part of private sector investors to buy Australian government bonds.

If primary auctions begin to fail or the yields on long-term government bonds starts to rise rapidly, the RBA can announce a QE program if there is any concern about the impact of rising term interest rates on other interest rates in the economy or the government's financial position.

This probably explains why state government bonds were included in the program. It is inevitable that state government deficits will surge, and the RBA is positioning itself to be able to support state governments should the need arise.

It is important to consider that even under a full-blown QE program, Australian governments must issue their own bonds into the public markets. The central bank does not participate in those primary auctions. All central bank purchases take place in the secondary market.

Forward Guidance

As part of the RBA's comprehensive policy package of 19 March, forward guidance played an important role. The RBA made it very clear that it is committed to stimulatory monetary policy until progress is made towards the dual goals of inflation between 2-3% and full employment.

This has remained the enduring policy signal at subsequent board meetings.

At the October 2020 Board meeting the RBA has tightened their forward guidance further with an explicit commitment to easy policy until inflation is sustainably in the 2-3% target range. The RBA Board is also keen to emphasise that they will be putting more weight on current inflation outcomes than the expected future path of inflation in its policy deliberations in future. While this may be in response to criticism that they have constantly over estimated the future path for inflation over the past decade, it could also be interpreted as the first salvo in the war against deflation.

YCC plays an important role in forward guidance for the RBA. The RBA is explicitly stating that the 0.25% 3-year bond yield target reflects the RBA's expectation that the cash rate will stay at 0.25% for 3 years, at least.

YCC has objectives beyond forward guidance; that is: the lowering of the benchmark interest rates for many term or fixed loans in the Australian financial system.

But it also chimes in well with the forward guidance strategy where the bank wants to convince people in financial markets and the broader community that short-term interest rates will remain where they are for at least 3 years. The message is that the RBA will not be thinking about reducing the monetary stimulus in the economy until inflation and unemployment are on a sustained track to meet their targets.

Expectations for future policy actions are important. A reduction in short-term interest rates will be much more effective at encouraging investment when those rates are expected to remain low for an extended period rather rise back to what many would regard as a 'normal' level at some stage in the not too distant future.

The RBA's Monetary Policy in Hibernation

The RBA has made it clear in several speeches and statements that it is not prepared in 2020 to undertake further substantial unconventional policies. They have ruled out negative interest rates, quantitative easing and made a point of why they will not consider buying private sector assets as part of Australia's monetary policy.

The two most viable policy options for the RBA from here are negative interest rates and government bond purchases as part of a program of QE

In November 2019, the RBA Governor explicitly addressed the issue of why negative interest rates are 'extraordinarily unlikely' here in Australia:

"*We are not in the same situation that has been faced in Europe and Japan. Our growth prospects are stronger, our banking system is in much better shape, our demographic profile is better and we have not had a period of deflation. So we are in a much stronger position.*

More broadly, though, having examined the international evidence, it is not clear that the experience with negative interest rates has been a success." (Phillip Lowe, "Unconventional Monetary Policy: Some Lessons from Overseas", Speech in Sydney, 26 November 2019.)

The RBA's reluctance to engage in QE has also been clearly explained on several occasions. The primary concern is blurring the lines between monetary and fiscal policy. Australian governments, be they state or federal, should finance themselves in the public capital markets. They have plenty of scope to do this, and indeed, are funding some of the largest budget deficits in our history at the lowest interest rates in 100 years.

Since the pandemic struck, there has been much more public discussion about the ideas behind Modern Monetary Theory (MMT). The core insight from MMT is that governments do not face a constraint when financing their budgets in their own currency. According to MMT, the only constraint on government budgets should be the achievement of full employment.

Only once all the labour resources of the economy are employed does the government (and presumably the central bank) need to worry about the inflationary implications of running large deficits.

The financing of large budget deficits can be through the central bank's purchase of government bonds or the use of new money (currency) to pay for government expenditures.

While MMT sounds good in theory, its practical application is diabolical for a free and open market economy. It is not at all clear how an economy will maintain the right incentives for people and businesses to work, save and invest in a world of massive government interventions in the economy and/or cash handouts.

Moreover, it requires a high degree of precision on the part of the fiscal and monetary authorities to calibrate policies once the economy reaches full employment. Any miscalculation on this front can cause a damaging inflation pulse to run through the economy, which presumably has even more potential for economic disruption given the scale of debt racked up to achieve full employment.

The RBA Governor has dispelled any romantic notions of a MMT revolution in economic policymaking. The quote below is from the Governor's opening statement to the House of Representatives Standing Committee on Economics on 14 August 2020

> "*The reality, though, is that there is no free lunch. There is no magic pudding. There is no way of putting aside the government's budget constraint permanently.*
>
> *As I spoke about in a talk last month, it is certainly possible for a central bank to use monetary financing to affect when and how government spending is paid for. Depending upon how things are managed, it can be paid for through the inflation tax, by implicit taxes on the banking system and/or higher general taxes in the future. But it does have to be paid for at some point.*
>
> *I want to make it clear that monetary financing of the budget is not on the agenda in Australia. The separation of monetary policy and fiscal financing is part of Australia's strong institutional framework and has served the country well. The Australian Government and the states and territories have ready access to the capital markets and they can borrow at historically low rates of interest."*

RBA Governor Phillip Lowe, Opening Statement to the House of Representatives Standing Committee on Economics, 14 August 2020

However, just because the RBA is set for a period of little policy activity, it does not mean that policy is not playing a role in the economy. The current stance of monetary policy in Australia is highly accommodative and is expected to remain that way for a considerable amount of time. Monetary policy is doing a job.

Commentators and various economists with a focus on monetary policy will continue to put forward arguments for why the RBA should be doing more with its monetary policy. These arguments will partly reflect a genuine analytical view of what is best for the Australian economy and partly reflect boredom.

What will get Monetary Policy Active Again in Australia?

There is only one desirable scenario involving the next change in monetary policy in Australia; that is: a reduction of policy stimulus in the wake of strong economic growth and a sustained fall in unemployment. There is no reason why this should not be the most likely scenario for the monetary policy outlook. The reality is that if we do see an increase in interest rates off the current floor of 0.25%, it will be many years away.[11]

The RBA themselves have drawn a direct link to the expected time that the cash rate stays on its floor and the target for the 3-year bond yield. In no way does the 3-year target mean that the cash rate will rise in 3 years. Indeed, the first step to policy normalisation will be a wind-down of unconventional policies, including either the removal of YCC or a gradual rise in the 3-year yield target towards a market rate. The RBA will know what that market rate is, once it has signalled that the policy is being unwound, when no bond purchases are required. Emergency liquidity operations supporting the money market and banks can potentially be reversed quite quickly.

The undesirable scenarios

QE to support government financing. The RBA will launch into a program of QE with purchases of both state and federal bonds if Australian governments run into funding constraints in public markets. The RBA will be looking for a number of signals to take this policy action; the first being a rise in market interest rates that is not consistent with the outlook for the economy and monetary policy. The other red flag will be the ability of issuing authorities to raise money through the primary issuance of new bonds.

QE to ward off deflation. Deflation will remain a primary macroeconomic risk factor for the foreseeable future. Falling prices and wages within the economy will increase the real value of debts and act as a major constraint on spending and investment in the economy. An extended period of negative inflation will also risk unhinging inflation expectations from the RBA 2-3% target. Inflation expectations are largely determined by the current economic environment with an anchor provided by the RBA target. If that anchor breaks, Australia could be trapped in a deflationary mindset in a similar way to Japan at various times in the past 20 years. Deflation encourages the delay of discretionary expenditures and can see workers yield to employer demand for lower wages in an economy with spare labour capacity (high unemployment).

The Kitchen Sink. This involves QE, potentially expanded to private sector assets and also negative interest rates. Lowering long-term interest rates, ensuring bank funding and reducing insolvency risks for business will be key objectives if the RBA has its own ‘whatever to takes’ moment.

Whichever undesirable scenario comes into play, the most important channel for supporting the economy will be through the downward pressure that these policies will exert on the currency.

Watch and Wait into 2021

It is too early to speculate about the nature of the economic recovery now underway. The economy of 2020 — propped up with massive government spending programs and a bank moratorium — is going to be a very different economy to what we see in 2021 once these emergency supports are removed. And this assumes that the health situation improves in 2021, allowing for further easing of restrictions on people movements and social distancing.

The RBA appears to be happy to sit on the sidelines for the time being, comfortable with the view that a highly stimulatory policy setting will underpin a gradual yet ‘bumpy’ recovery.

11 RBA officials have flagged further easing of monetary policy which will involve the reduction in the cash rate to 0.10% which will presumably also result in a reduction in the 3 year target yield and the TFF funding rate to 0.10% as well. The rate paid on ES balances will likely also be cut from 10bp to 5bp.

Conclusions

Assessment of the Policy Actions at the onset of the Pandemic

The RBA's actions through the initial stages of the pandemic were characterised by:

Speed

The senior RBA staff and board members took the decision to utilise all available conventional policy space and to initiate new policy instruments and programs. This was done with the expectation that they would not be undertaking further unconventional policy actions; they were firing all their bullets in a short period of time.

Australian economic policy makers have become better at acting quickly to change policy direction as needed. This was a key learning from the recession of the early 1990s.

Within a few weeks, the RBA had extinguished the conventional policy tool, established a completely new unconventional instrument and launched a series of liquidity operations in money and bond markets as well as the banking system.

Co-ordination

In normal operating conditions, one could be forgiven for thinking that monetary policy operates in isolation. To some extent that is correct. The RBA Board take other policy settings as 'given' and they set the policy instrument they are responsible for, the cash rate, independently of that. This process has historically contributed to the policy inaction bias because other policymakers know the RBA will act.

Despite the speed with which events were moving and the uncertainty of deploying new policy tools, the RBA was acting with a high level of co-ordination with government and regulators (APRA and ASIC) as well as the major Australian banks.

Communications

The RBA went to great lengths to make sure their external communications were effective. This included the holding of a press conference by the Governor following the special board meeting on 19 March, the first time an RBA Governor has done a press conference after a policy announcement.

The RBA Governor, Deputy Governor and the Assistant Governors have maintained a steady program of public engagements and speeches despite the various restrictions placed on public gatherings, taking to Zoom just like the rest of us.

The RBA recognises the importance of communications in making monetary policy effective. The RBA has to pitch its message at various groups, from the broader community to highly sophisticated bond and money markets.

There have been a number of actions and policy views that were not in line with market expectations. With their policy tools largely depleted, the role of communications will take a prominent role for the RBA for many years to come.

A Broader Assessment of Australian Monetary Policy

The main criticism of the RBA is that they should be doing more. Many economists are calling on the RBA to pursue a more aggressive unconventional policy program to stimulate economic activity in 2020. This argument focuses on the use of either NIRP or QE (or both) to weaken the currency, which has risen by more than 15% since the market low point of $US0.55 in March 2020.

This is the same line of criticism that the RBA has been facing for a number of years: that they should be doing more to achieve the inflation target they have undershot since 2015. Some economists will argue that the RBA delayed taking action on interest rates in 2017 and 2018, despite below trend growth and inflation, and clear scope to cut rates, for fear of stoking house prices in the major metropolitan centres. Arguably, this left Australia in a weaker position than it could have been in coming into the pandemic.

There is no doubt that Australia was in a much weaker cyclical position going into the 2020 pandemic than it was ahead of the GFC, where inflation was 1.5 percentage points above the top of its target range and the cash rate was above 7%. In contrast, the economy in early 2020 was in the early stages of recovering from a global cyclical slowdown that had lasted two years, and the cash rate was 0.75%.

Could the RBA have materially changed the course of economic activity and inflation ahead of the pandemic? Maybe. Counter to this is whether this would have made any difference once the lockdowns had commenced and whether even easier policy could have created extra financial vulnerabilities in the household sector and banking system that will inevitability be uncovered through the course of this economic downturn. We will only know this in time.

There are other arguments that the RBA is stepping outside of its mandate. The RBA has been failing to achieve its primary objective (inflation of 2-3 per cent) for several years and expects to continue to miss for several years to come. Is the RBA stepping outside of its agreement with The Treasurer by pursuing a broader set of objectives than just price stability?

The key component of the latest agreement between The Treasurer and The Governor is:

"Both the Reserve Bank and the Government agree that a flexible medium-term inflation target is the appropriate framework for achieving medium-term price stability. They agree that an appropriate goal is to keep consumer price inflation between 2 and 3 per cent, on average, over time. This formulation allows for the natural short-run variation in inflation over the economic cycle and the medium-term focus provides the flexibility for the Reserve Bank to set its policy so as best to achieve its broad objectives, including financial stability. The 2-3 per cent medium-term goal provides a clearly identifiable performance benchmark over time."[12]

This was the first time the Statement has included a direct reference to financial stability as part of its flexible inflation targeting regime. It also makes clear that the RBA has broad objectives. This agreement explicitly gives the RBA Board discretion, i.e. flexibility, in its pursuit of the long-term objectives.

An overlapping issue that seems worth addressing is the question of governance. Even if the RBA is right to target prices and financial stability, should unelected authorities be free to set their own objectives? Or should their goals and scope for discretion be strictly and clearly limited? Surely, if the RBA believes it should have other objectives, shouldn't it renegotiate its agreement with the treasurer and publicly argue for a change of direction?

This is the challenge ahead.

The decline of rigid adherence to inflation targeting commenced many years ago. It never actually took hold in Australia, as the RBA was a standout in the early 1990s for its flexible approach.

Flexibility is the name of the game now. This can be seen by the US Federal Reserve's latest alteration to its inflation targeting approach, to one that is much more flexible.

The operation of monetary policy in the 21st century is too complex and uncertain for a rigid policy target, hard policy rules or modelling to dictate outcomes. Monetary policy requires judgement of seasoned economists that have been highly engaged in all forms of the analysis of monetary policy, the financial system, and the economy.

The policy framework needs to be transparent and the RBA needs to be accountable to the parliament. But to deliver the most effective policy, no central bank can be tied to hard and fast rules without the risk of pursuing policy paths that may not be optimal in the long run.

Unfortunately for many countries, a strict adherence to inflation targeting and overambitious central banks are playing a role in the loss of economic dynamism, read productivity, in their economies over the past decade.

The RBA Governor has been putting an increased emphasis on the statutory objectives for monetary policy as legislated in the Reserve Bank Act of 1959. This can be summarised as:

"It (the RBA Board) also recognises the limitations of monetary policy and the importance of keeping a medium-term perspective squarely focused on maximising the economic welfare of the people of Australia."

This approach has been criticised for not doing enough to achieve short-term objectives. The RBA Board is clearly taking a view that there is a pay-off between these short-term objectives and the long-term costs that may follow.

Reconsidering Monetary Policy

For a number of years, the RBA has been resisting calls for a review of the conduct of monetary policy and its inflation target. Few question the objectives of monetary policy as set out in law as the stability of the currency (*low inflation*), full employment and the welfare of all Australians. The question is whether inflation targeting is still the right framework to deliver on those objectives.

The power of the inflation target to anchor inflation expectations is also a potential weakness of the current monetary policy framework. Policymakers do not want to change the target for fear of undermining its credibility and hence its effectiveness as an anchor for those inflation expectations.

With deflation a tangible risk in the wake of the global economic downturn of 2020, this inflation anchor may be just as important to propping up expectations for prices as it was at holding them down in the 1990s. This will be a rationale for not substantially altering the inflation target over the next few years.

However, the rigid adherence to a target that is nearly 30 years old has the potential to restrict the capacity of monetary policy to respond to changes in the way the economy works or learnings from recent history.

The pandemic has demonstrated once again why the RBA is one of the world's most successful central banks and why Australia is one of the world's most successful economies. The RBA maintained flexibility in its inflation targeting from the start, preferring a 2-3% target to be achieved over a number of years to some of the stricter interpretations of inflation targeting. Only in 2020 has the Federal Reserve adopted such an approach.

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12 *Statement on the Conduct of Monetary Policy*, 19 September 2016.

Although beyond the scope of this paper, the way forward for monetary policy is being defined by important economic outcomes in recent years. A more modest policy framework is required that takes into consideration a longer timeframe of costs and benefits of any given policy action.

The main implication of these arguments is that monetary policy should operate in a more modest fashion, in terms of both objectives as well as the utilisation of policy instruments.

The starting point for any monetary policy that uses interest rates is to first establish what the neutral policy rate is. That is, the level of the short-term interest rate that is broadly neutral to the economy at any point in time.

This neutral rate is not static and will be calculated through a mix of long-term structural determinants as well as short-term economic conditions. The neutral rate can be expressed as a corridor of say 50bp or higher when rates are higher.

From this starting point, the central bank can attempt to influence the level of demand in the economy through taking the policy rate away from the neutral or market rate. Policy moves away from this neutral corridor should be modest and reflect a clear objective to stabilise growth and inflation.

The key considerations for looking at the next policy framework are:

1. Discretion in policy execution, transparency of framework, and accountability to parliament. Central banks need more flexibility in the achievement of short-term economic targets to ensure they do not undermine long-term policy objectives. Policymakers need more flexibility, not less.
2. The effective policy operating window needs more work. A conventional policy corridor needs to be defined with reference to nominal GDP growth and policy actions that move outside this effective corridor need greater scrutiny. For a country like Australia, unconventional monetary policies should be seen as emergency measures only.
3. The nominal growth anchor needs more attention and development. This has been put forward by economists as a flexible evolution of the inflation targeting approach.
4. The RBA needs to align its inflation target with the rest of the world. In a highly integrated global economy, inflation is increasingly determined outside a country's borders. The Australian inflation target of 2-3% is not readily achievable when the global inflation target is 2% on average over time. At the very least, the RBA should consider widening its inflation target to 1-3%.

About the Author

Warren Hogan

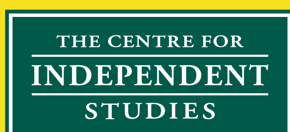
Warren Hogan has held the position of Industry Professor at UTS Business School in Sydney since 2018. He is also the founder of EQ Economics, a Sydney based micro advisory firm, with a focus on providing economic and strategic advice to businesses in Australia. Warren is a regular in Australian and international media, and a columnist for *The Australian Financial Review*. He has also published 20 articles in The Conversation over the last 2 years.

Warren was appointed for 1 year as a Principal Advisor to The Australian Treasury in 2016, supporting various Treasury functions including the Macroeconomic Group and the Foreign Investment Review Board. Previously, Warren's career had been in banking and financial markets where he had held various roles as an economist and financial markets strategist.

Warren was Chief Economist of ANZ Banking Group and Head of ANZ Research between 2009 and 2016. ANZ Research was a global research effort with a strong focus on Australia and New Zealand's growing ties to the Asian region. With 50 economists and analysts in Australia, New Zealand, Singapore, Hong Kong, China, the UK and the USA, ANZ research was recognised as a leading provider of economic, financial market and policy analysis in the region.

Throughout his banking career Warren was a constant presence at airports, travelling extensively around Australia and the globe presenting to clients about Australia, Asia and the global markets.

Prior to his 11 years at ANZ, Warren worked for Credit Suisse, Westpac Banking Corporation and the NSW Treasury Corporation. Warren lives in Sydney with his wife and two daughters. He is a member of the Board of Avondale Golf Club, where he is currently the Honorary Treasurer.



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Level 1, 131 Macquarie St, Sydney NSW 2000 • **phone:** 02 9438 4377 • **email:** cis@cis.org.au