Australian Banking Association

08 November 2022

Panel – Reserve Bank of Australia Review
Confidential Submission lodged via online portal

Dear Panel

Review of the Reserve Bank of Australia

The Australian Banking Association ('**ABA**') welcomes the opportunity to make this submission to the Review of the Reserve Bank of Australia. The ABA notes the significant role of Australia's central bank in delivering good economic outcomes for the nation. We support the ongoing independence of the Reserve Bank of Australia in executing its mandate.

The ABA's responses to the panel's questions in the Issues Paper (15 September 2022) are contained in the annexure to this letter. Key points raised are:

- We consider the three objectives to be appropriate, noting there may be an opportunity to update the expression of the objectives in Section 10(2) of the Reserve Bank Act (1959) ('**the Act'**) (theme 1).
- We see opportunities for Reserve Bank of Australia ('**the RBA**' or '**the Bank**') to augment its communications to explain the complexities underlying the decisions as well as greater explanation of the trade-offs made between the Bank's objectives (theme 2).
- We see the independence of the RBA as critical to ensuring a well-functioning economy. To this end, we have made suggestions for improvements to the Bank's governance structure by suggesting a dual governance board (theme 3).

The ABA would be pleased to provide further detail should it be required by the panel.

Kind regards

About the ABA

The Australian Banking Association advocates for a strong, competitive and innovative banking industry that delivers excellent and equitable outcomes for customers. We promote and encourage policies that improve banking services for all Australians, through advocacy, research, policy expertise and thought leadership.

Australian Banking Association

Annexure

Theme 1: Monetary policy arrangements

Question 1 RBA objectives

What changes, if any, should be made to the objectives set out in the *Reserve Bank Act (1959)*: stability of the currency, maintenance of full employment, and economic prosperity and welfare of the Australian people – or do these remain the right objectives?

We consider the three objectives to be appropriate but note that with evolving practice this review could be an opportune time to consider updating the expression of the objectives in Section 10(2) of the Act.

Stability of the currency

This objective should be updated to reflect current practice of the RBA that the intention of maintaining currency stability is to ensure price stability. The Act was enacted in an era of pegged exchange rates where exchange rate volatility was a mechanism for domestic inflation to occur. Presently, the RBA and economists interpret 'stability of the currency' to mean price stability. RBA intervention in the currency markets typically only occurs in exceptional circumstances and is more an operational issue than a core part of the Act. We suggest this objective could be reworded to be '*price stability within the Australian economy*'.

Maintenance of full employment

We support the objective to maintain full employment ('**FE**'). We note that the objectives imply a requirement that the RBA maintain FE <u>and</u> price stability concurrently. However, there are continual trade-offs between FE and price stability based on the economic circumstances. It could be helpful to acknowledge the Bank's task of managing the trade-offs.

Economic prosperity and welfare of the Australian people

This objective is considered within the context of the first two objectives as the RBA does not set fiscal policy which is generally the main tool for promoting economic prosperity and welfare of the Australian people. Therefore, this objective is generally understood as a requirement for the Bank to support financial stability, although we note this interpretation is not consistently accepted.

Overall, we note the interdependence between the three objectives and the need for the RBA to clearly communicate when it is making trade-offs between the objectives. We do not support legislation as a mechanism for determining how the RBA manages the trade-offs between the objectives.

Question 2 Inflation targeting

What adjustments, if any, are warranted to the RBA's flexible inflation targeting arrangement as described in the *Statement on the Conduct of Monetary Policy*, or what alternative arrangement is most appropriate, in light of current and future challenges? How should the RBA balance its objectives in its approach to monetary policy?

The RBA's target inflation band of 2-3 per cent provides it with flexibility to respond to the prevailing circumstances and to consider the trade-offs as described above. We note other central banks have moved beyond target inflation ceilings or points; for example, the European Central Bank (ECB) has adopted an average flexible inflation targeting approach and the Bank of Canada has flexible inflation targeting.

We support maintaining inflation targeting compared to other approaches such as nominal income targeting for several reasons. First, a move away from inflation targeting will set the RBA apart from global peers. Second, other measures, such as nominal income, are not generally known or understood by the population, are not simple to explain or forecast, and would require significant education. Third, inflation is a reference point in economic decision making, such as price setting and influencing salary rate setting.

The world may be entering a period of greater geopolitical instability and increased energy transition activity, with nations, including Australia, mobilising quickly to decarbonise. However, it is not clear that these developments present a very strong argument to shift monetary policy ('**MP**') regimes.

Question 3 Monetary Policy, Fiscal Policy, Macroprudential policy

How should monetary, fiscal and macroprudential policies complement each other, including during economic downturns and when interest rates are close to their effective lower bound? What implications does that have for the design of Australia's monetary policy framework, and its interaction with fiscal and macroprudential policy arrangements?

We highlight the distinction in time-horizon of the two macroeconomic policies. Common understanding holds that MP has been mainly targeted towards managing the cycle. Fiscal Policy ('**FP**') is generally a longer-term structural lever to maintain a good growth trajectory and to expand the productive capacity of the economy (although in Australia the focus has been on budget surpluses rather than long run structural policies). FP is however very useful in boosting growth in recessions and has the benefit of being able to be more easily targeted at a specific sectoral objective. FP should usually not act in contradiction to MP objectives.

One way to consider this alignment is for the broad positioning of FP and MP (as expansionary or contractionary) to operate together. There may be limited or exceptional times when MP and FP stance do not completely reinforce each other, however, generally MP and FP should work together through the economic cycle. The practice of the Treasury Secretary holding a position on the RBA Board (which is unusual internationally) is an effective approach to ensuring this alignment of FP and MP, and, promoting cooperation between relevant policy makers whilst maintaining the Bank's independence. As such and in reference to our response to theme 3, we support this practice continuing.

Macroprudential tools have generally been applied in pursuit of financial stability. We note that APRA has used to good effect the macroprudential tools at its disposal. A case in point was the tempering of excessive investor lending for housing in the middle of the last decade.

In the decade prior to COVID, the RBA, as chair of the Council of Financial Regulators ('**CFR**'), worked to respond to risks of financial instability though the implementation of macroprudential tools by the Australian Prudential Regulation Authority ('**APRA**'). This included the 10 per cent cap on the growth rate for investor lending and the limitation to 30 per cent of interest-only loans in new lending[1]. In this context, the operational independence of the RBA (and APRA) from the government has been key to managing through that period of house price inflation. One key lesson from the recent pandemic experience was that when MP, FP and macroprudential policy are all aligned, they can have very powerful and positive results supporting the economy.

Given the need for harmonization of FP stance, MP stance and operations, and macroprudential settings, we see the CFR as a positive development and enabler to this alignment. We support the charter of the CFR as noted on its website[2].

[1] https://www.rba.gov.au/speeches/2018/sp-dg-2018-11-15.html
[2] https://www.cfr.gov.au/about/charter.html

Theme 2: Performance Against Objectives

Question 4 Lessons from MP

What lessons can be drawn from the RBA's performance against its objectives to strengthen the future decisions and implementation of monetary policy?

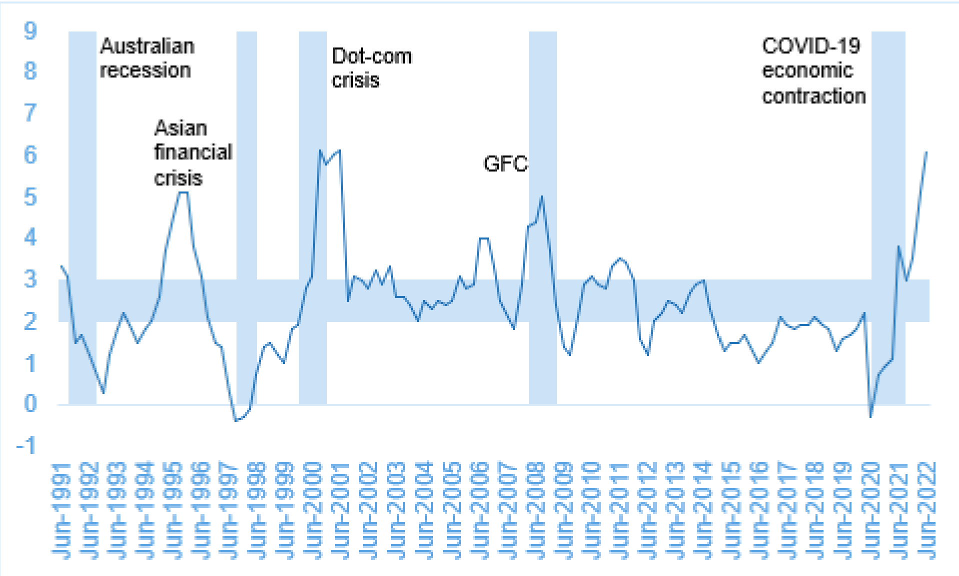
Hindsight provides a perspective for constructive feedback on the recent performance of the RBA noting that policy regimes have evolved and changed over time. We would note the following points.

On the last two decades:

On inflation: We consider that over the majority of the last two and a half decades, MP has achieved reasonable outcomes when measured against its inflation target inflation band.

On financial stability: The period 2013 through to the COVID-19 outbreak exemplifies the challenge experienced by the RBA in balancing its objectives of financial stability with FE. Some argue that the RBA kept the target cash rate too high on financial stability grounds, resulting in below target inflation outcomes and higher than desirable unemployment outcomes.

Figure 1: CPI, Change from corresponding quarter of previous year, %, 1990 – 2022



Source: ABS; CPI Tables 1 and 2. CPI: All Groups, Index Numbers and Percentage Changes

On the COVID-19 response: The pandemic was a significant non-financial exogenous shock to the Australian and global economies; initial lockdowns caused significant disruption to economic activity, work patterns, the nation's borders were closed, and over one hundred thousand people left Australia. The pandemic caused significant economic dislocation.

In response, the government deployed FP to support economic activity (COVID support payments). MP was used to lower cash rates to the effective lower bound (0.1%) and a series of unconventional monetary policies were deployed to support the economy and reinforce the support provided by FP. The combination of fiscal stimulus and low interest rates provided the necessary confidence for the economy and, as a result, the nation experienced only a brief recession, though the impact on activity was temporarily very large.

We support the actions of the RBA in lifting rates as prudent and appropriate to containing inflation and preventing expectations of higher inflation from becoming entrenched in business and consumer decision making. Containment of inflation and inflationary expectations remain important to the economy presently.

Question 6 Input improvements

What improvements could be made to the set of inputs the RBA draws on to support monetary policy decision making?

We support the RBA using traditional data sets but recommend improvements in respect to the traditional data sets as well as leveraging other data sources.

Traditional data sets: Most importantly we a very supportive that a more regular (monthly) measure of inflation being used; the recent ABS provision of monthly inflation figures is positive. We also suggest monthly wages growth data is essential. A clear, consistent monthly reading of these indicators is essential for decision making.

Leveraging other data sources: We suggest improvements in respect to additional data sources and the business liaison program:

(a) Additional data sources

A complement to traditional data sets would be the use of the data held by banks to enable timely and deeper insights. Australian banks hold data sets from which economic activity can be analysed on a weekly basis. Such analysis provides rich insight into disparate areas of inquiry including consumer and business sentiment, consumer spending quantum, direction of consumer spending and will therefore enable a more granular analysis of the economy. We note that some ABA members already provide weekly analysis based on credit card spending data to the RBA. We support formal incorporation of this additional data to the RBA's considerations.

(b) Business liaison

The RBA's business liaison program is an important qualitative data input that enables it to take a 'pulse' of the economy from the ground. We note ABA members, who participate in the business liaison, see the value of providing their insights as these discussions enable the RBA to discuss issues impacting their banking operations. Additionally, we support the diversity of participants involved in the liaison discussions.

From a markets perspective, there is an opportunity for the RBA to improve the business liaison program by sharing information about the its qualitative research methods, the use of the data, and publishing the research outcomes. We note that other central banks issue such information; for example, the US Federal Reserve produces a Beige Book of liaison information[3].

Finally, we consider transparency of data sets used in the RBA's formal considerations to be important and we make further comment in our response to Question 8.

Question 7 MP tools

What monetary policy tools should the RBA use in pursuit of its monetary policy objectives, and how can it use them most effectively in the future?

The official cash rate should remain the primary MP tool although, we support the use of unconventional tools to augment and support the effectiveness of conventional monetary policy tools as appropriate and as circumstances require. Regarding the tools, we note the following:

- Quantitative Easing ('**QE'**) and Quantitative Tightening ('**QT**'): Purchasing government bonds will be part of the Bank's tool kit especially in a near-zero interest rate environment. We note that QE is also a tool of other central banks, though it is unclear that QE in Australia had a very significant reduction in long-bond yields beyond what the very low cash rate delivered; additionally it will likely come at a large cost.

[3] https://www.federalreserve.gov/monetarypolicy/beigebook202210.htm

- Term Funding Facility ('**TFF**')[4]: The TFF was very helpful to local banks continuing to offer lower priced mortgages when the global markets were not functioning as normal.
- Yield Curve Control ('**YCC**'): The Bank's YCC activities to bring down the three-year bond yields was helpful in managing the borrowing costs of institutions and stimulating housing demand. However, the Bank's approach to exiting the arrangement made it difficult to execute well. In hindsight this deployment of the program was overly ambitious. Holding rates down for three years proved too long given the relatively quick recovery of the economy.
- Direct ADI liaison: RBA engages with banks (as does APRA) in times of crises.
- Central banks sometimes coordinate between themselves to provide direction to the global economy. For example, during the GFC the RBA, Bank of England, ECB, Bank of Japan, and others coordinated to ease MP within a week or two.

Question 8 RBA communications

What aspects of the RBA's approach to communications have worked well and helped it achieve its objectives, and where could its communications be improved?

The RBA utilises several methods of communication including releases of board decisions on the target cash rate, minutes from board meetings, statements, information papers, the quarterly bulletin, and speeches by the Bank's leadership. Whilst each are useful for informing the market the RBA could refashion, and potentially streamline, the existing communication channels when explaining its decision making. This would minimise the risks of unintended financial market reaction to comments or statements pertaining to a given matter but discussed in multiple RBA sources at different points in time.

We make suggestions as to what may be contained in the communications. First, there is opportunity for the RBA to provide additional context about its decision making by sharing details on:

- Data inputs such as data sets and data used as well as the qualitative research methods and outcomes of the Business liaison program.
- Board discussion and considerations. We note the practice of the US Federal Reserve in publishing the votes of members of the Federal Open Market Committee on cash rate (and other) decisions. We also note the practice of issuances of dissenting perspectives[5]. We support disclosures in the Bank's minutes on the decision making of the RBA board at a summarised level and without attribution of views or votes to specific individuals[6]. This type of public disclosure will provide stakeholders understanding of the nuance of the decision making of the board and will assist in minimising unintended financial market reaction to subsequent statements.
- The trade-offs the RBA is making in pursuing its objectives.
- Publishing scenarios around its point forecasts (i.e., fan charts) to highlight the wide range of possibilities and reduce the risk that stakeholders interpret the Bank's statements as specific predictions.

[4] Including previous iterations of the TFF.
[5] See for example the September minutes https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20220921.pdf
[6] https://www.rba.gov.au/monetary-policy/rba-board-minutes/2022/2022-10-04.html

Australian Banking Association

Theme 3: Governance

Question 9: Governance arrangements

What governance arrangements are best suited to discharging the RBA's monetary policy and corporate governance responsibilities?

The governance responsibilities for discharging Monetary Policy and Corporate governance are distinct though related. The Review Secretariat could consider a dual board structure – a Corporate Governance Board and the Monetary Policy Board.

We see a potential operational model for the boards as follows:

- There would be a small number of board members that sit on both Boards to ensure alignment.
- The Corporate Governance Board:
    - to be chaired by an independent director rather than the Governor
    - retain the Remuneration and Audit and Risk subcommittees
    - Board minutes and deliberations would be reported to the Treasurer and summarised publicly.
- The Monetary Policy Board:
    - would continue to execute on monetary policy and would incorporate the improvement suggestions contained within this submission.
    - continue to meet per their regular monthly cadence.

We further propose the charters of the board committees to be published and maintained on the RBA website (they are not public currently). The ABA notes that members have different views on this proposal, and it is not universally supported by all member banks.

Question 10: Board composition and appointment

Given this, what appointments process, composition, professional experience, qualifications and tenure of the Reserve Bank Board is most appropriate for fostering internal deliberation and effective decision making?

We see opportunity for refinement of the board as follows.

Monetary Board composition:

We see opportunity for a broadening of the board's skills matrix which could include:

- A limited number of members of the RBA (such as the Governor and Deputy Governor) as voting members.
- Monetary policy experts from outside of the RBA as voting members.
- Members with deep work experience from key sectors of the real economy including business and trade unions. The role of this category of member would be to reflect the practical impact on the real economy of monetary policy implementation. There are two potential models for board membership in this category:
    - Option 1: as advisory non-voting members. Non-voting members could continue to maintain their professional roles in industry.
    - Option 2: as voting members. Under this option members would have no current ties to for-profit or not-for-profit entities in the private sector.
- A Treasury Department member in an advisory non-voting capacity whose role would be to support alignment of fiscal and monetary policy stances and to confirm the independence of the Bank from government.

The geographic representation of the independent membership of the board to be diversified.

Board appointments: We suggest that further transparency can be incorporated into the board appointment process, including by advertising vacancies and the skills matrix.

Question 11: Communication practices

What communication practices would best promote accountability, transparency and support public understanding of the RBA's policy strategy and decisions?

For further discussion refer to Question 8.