[Philip Lowe and Reserve Bank about to face a moment of truth](https://www.smh.com.au/politics/federal/philip-lowe-and-reserve-bank-about-to-face-a-moment-of-truth-20220713-p5b16z.html)

**SMH**[**Shane Wright**](https://www.smh.com.au/by/shane-wright-h170pw)July 15, 2022 — 11.30am

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As the head of America’s central bank, Alan Greenspan could steer the global economy with just a handful of words. But he spent his years deliberately trying to be as obscure as possible.

“If I turn out to be particularly clear, you’ve probably misunderstood what I’ve said,” he remarked to a business audience in the 1980s.

RBA governor Phil Lowe concedes his guidance on interest rates late last year was “embarrassing”.

But there was little that was unclear in the words used by Reserve Bank governor Philip Lowe,[**in an address to the nation’s economists in November last year**](https://www.rba.gov.au/speeches/2021/sp-gov-2021-11-16.html)**,** where he touched on the future outlook for interest rates.

“Our central scenario is that underlying inflation reaches the middle of the target by the end of 2023,” he said of the RBA’s 2 to 3 per cent inflation target.

“If this comes to pass, it would be the first time in nearly seven years that we will be at the mid-point. This, by itself, does not warrant an increase in the cash rate. It is still plausible that the first increase in the cash rate will not be before 2024.”

Six months later, [the Reserve Bank would increase interest rates in the midst of the federal election campaign](https://www.smh.com.au/link/follow-20170101-p5ahzh). It was the first hike in rates in almost 12 years.

Federal government has responded by extending more concessions to 900,000 pensioners.

That was backed up by another two rate rises, half a percentage point each, with financial markets and economists expecting the RBA to lift rates again in August.

Lowe [has since described his suggestion](https://www.afr.com/policy/economy/lowe-admits-embarrassing-error-on-2024-rate-rise-20220503-p5ai9e) that interest rates would not rise until 2024 as “embarrassing”. Borrowers who believed the bank was going to sit on its hands for the best part of three years have shared more colourful words to describe the mistake.

Now the bank faces what is shaping as the nation’s biggest shake-up of economic policy in decades, with a formal review of the RBA.

The release of the review’s terms of reference by Treasurer Jim Chalmers is imminent.

It will mark the first review of the bank since the 1981 Campbell report – when Australians used Bankcard, people kept $1 and $2 notes in their wallets and mortgage interest rates were capped by the government of the day.

Reserve Bank governor Philip Lowe has maintained an upbeat assessment of the economy throughout his term.

The review was driven by concern about the bank’s handling of monetary policy before the COVID-19 pandemic. A [series](https://www.smh.com.au/politics/federal/the-central-bank-under-fire-has-the-rba-failed-australians-20210315-p57auu.html) of [articles](https://www.smh.com.au/politics/federal/crucial-but-not-beyond-reproach-labor-joins-calls-for-review-of-rba-20210316-p57b2i.html) in this masthead in April last year, outlining criticisms in economic circles of the bank, its handling of policy and its governance structures, proved the staging ground for the review demands.

Both sides of politics went to the election promising a review.

Chalmers made clear his review would be of the “RBA goals and objectives, tools and levers, processes and public commentary”. He also wants it to look at the “most appropriate relationship between fiscal and monetary policy”.

The developments in monetary policy since last year have only added to the argument for a review of the bank.

Grattan Institute household finances program director Brendan Coates, a former Treasury and World Bank official, says the inquiry has to be broad, taking in the RBA’s mandate, structure and policy tools.

He says all central banks, not just the RBA, face substantial issues that mean the framework that guides monetary policy in this country – the 2 to 3 per cent inflation target – should be up for debate.

“Monetary policy has been under strain globally in the years prior to COVID, as interest rates have fallen and conventional monetary policy has become less potent,” he says.

“Many of the drivers of declining interest rates – ageing populations, rising wealth inequality – are global, and likely to persist even if inflation has taken off in the short term.

“Is inflation targeting still the best approach, or should we be looking at alternatives like average inflation or nominal income targeting? It’s healthy to consider weighing the alternatives, even if the review decides the RBA should stick with what it already has.”

EY chief economist Cherelle Murphy says while institutions such as the RBA have performed well, there is scope for a review.*CREDIT:*

EY chief economist Cherelle Murphy says the case for a review is clear, especially in light of central banks from Europe to New Zealand going through similar examinations in recent years.

“There are considerable challenges ahead, and how we navigate those is vital to our economic prosperity and the welfare of the Australian people,” she says.

“I am keen to see a review that examines the institutional settings that drive monetary policy decision-making, rather than one that just examines the governor’s statements and rate changes over the recent economic cycle.”

At the heart of the Reserve Bank’s operation is its inflation target. The theory, embraced by central banks around the world, is that by moving interest rates to keep inflation within a narrow band, the economy can flourish.

The problem is that for the best part of seven years, inflation has either run below the 2 to 3 per cent target or more recently above it.

Some economists, such as former RBA board member Warwick McKibbin, believe the whole concept of inflation targeting should be revisited. He [told the Economic Society of Australia this week](https://www.afr.com/policy/economy/rba-inflation-target-has-run-its-course-says-mckibbin-20170718-gxdm1p) that, given hitting the inflation target had proven almost impossible, alternatives (such as nominal GDP) should be examined.

Chalmers’ terms of reference will go to the inflation target but also take on board lessons from around the world. When the European Central Bank conducted a review between 2020 and 2021, it canvassed issues including the rise of shadow banking, whether the way inflation is measured needed to change, its communication strategy, the future impact of digitisation and productivity.

A string of papers were prepared by it and other European central banks that canvassed economic modelling, the rate of digital takeup across the Union and the impact of globalisation on policy settings.

Following the review, the bank stuck with its 2 per cent inflation target, but it is now looking at ways to incorporate house price movements into its inflation measures. The bank is also assessing the impact of climate change and the shift to carbon neutrality on the economy.

Outside of the inflation target, there are a number of issues that will be in included in the review.

Independent economist Margaret McKenzie says there are question marks over the reliability of the macroeconomic models that underpin monetary policy.

“A review should consider much broader matters for the RBA than simply the mantra of inflation targeting through fiddling with the interest rate,” she says.

Treasurer Jim Chalmers will soon announce the terms of reference for the RBA review

“Years of doing this has not convinced one that that actually works anyway, any more than the previous discarded models did.”

McKenzie, formerly the economist at the ACTU, maintains full employment should be the goal of the Reserve Bank. She says even the actions of the RBA during the pandemic, when it took real interest rates negative (once inflation is taken into account), are open to debate.

“Wealth was shifted from lenders to debtors through the advantage for shares over bonds, and wealth shifted upwards in the distribution. Is that what a central bank wants?” she says.

McKenzie also argues the board needs to be far more representative of the general public, including the union movement. Chalmers has already signalled someone with a union or small business background will make their way on to the board.

The Reserve Bank board is unlike any other in the central bank world. A majority of its members are taken from the public, who oversee not just the bank’s operations but also monetary policy.

Ted Theodore, treasurer in the Scullin government, wanted the central bank board to take representatives from the community. The idea has become one of the defining features of the RBA.

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The idea of the general public having a direct say in monetary policy dates back to the early 1930s, when the Scullin government’s treasurer, Ted Theodore, proposed changes to the Commonwealth Bank (which acted as Australia’s central bank) to include a board with five outside individuals who were engaged in agriculture, commerce, finance, industry and labour.

Theodore’s plans were scuttled by a conservative Senate, but the idea stuck.

The current board features Lowe, his new deputy Michele Bullock and Treasury Secretary Steven Kennedy. Then there is an independent economist, Ian Harper, plus five people from outside the economic or central bank community.

They include Mark Barnaba (whose five-year term is due to end on August 30), Wendy Craik, Carolyn Hewson, Carol Schwartz and Alison Watkins (the most recent appointee to the board).

Two members have ties to the Centre for Independent Studies (Barnaba and Watkins), while two are non-executive directors with CSL (Watkins and Hewson).

While Lowe has borne the brunt of criticisms for the handling of monetary policy over recent years, the board to which he answers has escaped unscathed.

Communication from board members is restricted to Lowe, Bullock and Harper (while Kennedy speaks more often about macroeconomic trends). The non-economic experts on the board, who oversee the setting of interest rates in this country, are effectively mute.

Former RBA economist (and now chief economist with the CIS) Peter Tulip says it is important the review examines the way debate is handled within the institution. He fears too much discussion is around the bank’s “official narrative” rather than a contest of ideas.

Explanation for reasons to take a policy approach, and why alternatives were not taken, should also be examined.

“Regular reviews of central banks should examine whether the bank’s processes for accountability, transparency and decision-making are optimal in the light of research and recent developments, particularly among foreign central banks,” he says.

“The people that are best-placed to answer many of the questions above are current and former staff. It will be important that the terms of reference free them from restrictions of confidentiality, so they are authorised to fully and frankly communicate with the review.”

The RBA is the only major central bank in the world not to have gone through an outside review this century. The last outside examination of the bank formed part of the Campbell report that was delivered to the Fraser government in 1981.

That inquiry, while pivotal to many of the economic reforms put in place by the Hawke-Keating governments, is a relic of its time. In terms of the Reserve Bank, it backed the continuation of the now-discredited policy of targeting growth in the money supply.

Within a decade, the RBA – due to sweeping changes in global attitudes towards central banking – moved to its present policy of maintaining inflation between 2 per cent and 3 per cent.

Since Campbell, there’s been a series of inquiries into the financial and banking sectors (including the banking royal commission) but none have gone to the heart of the RBA and its role in the economy.

One of the driving reasons for a review was the bank’s handling of the pre-COVID economy. In 2018, Lowe was arguing the next likely move in interest rates would be up. But just days after the 2019 election, he revealed the bank would use its next meeting to cut rates.

Research by economics academic Zac Gross and Labor minister Andrew Leigh [this year estimated the failure to have interest rates lower ahead of the pandemic cost 270,000 people a year of unemployment](https://theconversation.com/the-rbas-pre-covid-failure-to-cut-interest-rates-faster-may-have-cost-as-much-as-270-000-jobs-185381).

The bank’s handling of the post-COVID period, especially its recent hikes in rates, could also cost people a job.

Victoria University economist Janine Dixon says the review should examine monetary policy settings throughout the pandemic.

The RBA cut the official cash rate to an all-time low of 0.1 per cent while engaging, for the first time, in [quantitative easing](https://www.smh.com.au/politics/federal/what-is-quantitative-easing-20190925-p52unt.html). That included the purchase of about $300 billion in federal and state government debt plus the extension of more than $100 billion in cheap cash to commercial banks.

Now the bank (along with its counterparts around the world) is rapidly unwinding its COVID-19 policy settings due to surging inflation.

“It’s not clear that the low rates were necessary in the presence of expansionary fiscal policy and may yet contribute to a bust that will leave people in mortgage or housing stress,” Dixon says.

People thronged to the opening of the Commonwealth Bank building in Sydney’s Martin Place in 1916. The bank would become the forerunner to the Reserve Bank.*CREDIT:RESERVE BANK OF AUSTRALIA*

The Commonwealth Bank was created by Andrew Fisher’s Labor government in 1911. Thirteen years later, the Scullin government decided to formally make the Commonwealth the nation’s central bank.

The only problem was that he did not explain to the bank’s directors what he meant by a central bank.

**EDITOR'S PICK**

**Explainer**

[**Australian economy**](https://www.smh.com.au/topic/australian-economy-1m3k)

[Where did reserve banks come from – and what’s monetary policy?](https://www.smh.com.au/politics/federal/where-did-reserve-banks-come-from-and-what-s-monetary-policy-20210218-p573tn.html)

Since then, the bank has evolved to become one of the key parts of the Australian economy. It stands alongside the federal government in terms of policy direction. Its decisions to lift or cut interest rates affect employment, wage growth and business opportunities for millions.

Despite its importance to the lives of almost every Australian, it remains mostly unknown.

A near year-long review is about to change that.

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