Introduction

Christopher Kent and Michael Robson

Around the globe, economies and policy frameworks have changed significantly since the Reserve Bank of Australia commenced operations in 1960. In most countries, the role of the government in product and labour markets has declined, trade barriers have been reduced substantially and there has been extensive liberalisation of financial systems. There have also been substantial changes to the framework for monetary policy and the way in which it is conducted. Along the way, policy-makers have faced numerous challenges, and while there have been occasional setbacks, significant progress has been made. The occasion of the 50th Anniversary of the Bank provided an opportunity to take stock of what has been learned over the past five decades, and to assess what needs to be reconsidered. To that end, the Bank held a one-day Symposium in Sydney, gathering a large number of leading central bankers, academics and business people from Australia and around the world.

The Symposium was organised around several topics of critical importance to central banks, with papers commissioned to examine each. The first topic was the conduct of monetary policy – its objectives, means of operation and its role in promoting macroeconomic stability. The second was the future shape of financial regulation, including the role played by international institutions and intergovernmental bodies. The third topic was supply-side issues – those factors influencing economic development and an economy's productive capacity and flexibility. In addition to keynote speakers, a number of distinguished panellists offered their views on the issues. This volume provides a record of the Symposium papers, the panellists' views and a summary of the associated discussions.

Monetary Policy Issues

In 1960, the global economic framework was one of tight constraints. Under the Bretton Woods regime of pegged-but-adjustable exchange rates and restricted capital flows, monetary policy typically took a back seat to fiscal policy in managing the macroeconomy. Banks were highly regulated and, in many countries, interest rates on loans and deposits were controlled, while product and labour markets were subject to extensive regulation and public sector involvement. In addition, some countries occasionally pursued direct controls of prices and wages as a way of combating inflationary pressures. Fifty years later, the economic framework looks quite different: the major currencies of developed economies are freely floating; capital flows are largely unencumbered in many parts of the world; and widespread structural reforms have led to more liberalised financial, product and labour markets. As the constraints were eased, monetary policy came to play an increasingly prominent role in the management of the macroeconomy.

The first paper of the Symposium, presented by Glenn Stevens and co-authored with Adam Cagliarini and Christopher Kent, discusses this transformation, draws out some lessons learned along the way and highlights some of the key future challenges. Perhaps the most critical lesson they highlight is simply that monetary policy matters – that high and volatile inflation is detrimental to growth and that sound monetary policy is a prerequisite for low and stable inflation. These ideas gained widespread acceptance following the global experience of high inflation in the 1970s, after which central banks adopted various approaches in an attempt to control inflation. An important lesson to emerge from this episode was the need for central banks to strike a balance between rules and discretion: rigid rules are impractical given economic uncertainty and ongoing structural change, yet too much discretion can make it difficult to establish a consistent and credible approach. The need for predictable behaviour and a strong commitment to long-term stability, while also allowing for some short-term flexibility, has led to a wider appreciation of good institutional design over more recent decades. Foremost here is the need for central banks to have a clear public mandate for maintaining price stability and the operational independence to achieve this objective. In return, this demands greater accountability and transparency on the part of central banks than had been the norm.

Another lesson that has gained wider acceptance of late is that financial stability is both very important for the smooth functioning of the economy and inherently difficult to maintain. While many countries experienced episodes of financial instability soon after the liberalisation of capital flows and of the financial system, financial stability has proven hard to come by even well after such transitions. The authors argue that a way needs to be found to improve the stability of the financial system while avoiding the inefficiencies and significant costs of the extensive regulation of earlier times. They observe that while much of the debate about the role of monetary policy in this arena focuses on asset prices, the broader concern is with financial imbalances, which tend to be associated with large increases in both asset prices and credit, especially when combined with a substantial decline in lending standards.

Just how monetary policy might contribute more effectively to avoiding such imbalances is one of the key challenges for central banks. The authors suggest that the chastening experience of the global financial crisis has led to a shift of opinion in favour of monetary policy giving greater weight to the containment of financial imbalances. While acknowledging that it is desirable to have a range of policy tools at hand, they argue that monetary policy needs, at the very least, to be careful to avoid contributing to the build-up of financial imbalances when interest rates are unusually low.

A second issue discussed in the paper is the interplay between monetary and fiscal policies. For some years now, the conventional wisdom has been that monetary policy was the more effective discretionary means of managing cyclical swings in the economy. In the recent crisis, fiscal policy was eased significantly, not least to provide direct support to distressed financial systems in a number of countries. This raises a set of issues that had been at the fore of policy-makers' minds in earlier times. These include the scope for fiscal policy to manage the business cycle and how this ability is influenced by the initial state of public finances. There are also the issues of the best way to balance the contributions of fiscal and monetary policies, and the costs and benefits of coordinated responses.

Financial Sector Issues

The issue of how risks can be managed more effectively in market-based financial systems is addressed in the paper by Jaime Caruana. His paper starts by noting that periods of financial instability are not confined to episodes of substantial financial deregulation. Rather, they are tied to the ongoing difficulties associated with measuring and responding to systemic risks in a liberalised environment, as clearly demonstrated by the global financial crisis. Accordingly, he sets out the case for an overhaul of the regulatory system to ensure that all types of risk are measured and accounted for appropriately. At the same time, he recognises the need to balance reforms with efficiency concerns, favouring strategic improvements over the type of blanket government controls that prevailed before deregulation.

In the paper, Jaime Caruana argues that risk-based capital requirements are a necessary part of the regulatory framework but that improvements are needed to account for risks more comprehensively and to improve the quality of capital. He also notes that it will be important to ensure that capital is built up in good times so that there are larger buffers to draw upon in bad times. While these improvements would go some way towards addressing the inherent procyclicality of the financial system, a more rigorous approach to supervision, with stronger enforcement of existing regulations, is also needed. Further, in line with the sentiment of Cagliarini *et al*, an argument is made for monetary policy to assist other arms of policy to 'lean against' emerging financial imbalances by pushing up the cost of leverage across the whole economy. In addition, Jaime Caruana suggests that central banks will need to find a way to influence macro-prudential settings but notes that, in some cases, changes to their mandates, resources and governance, among other things, may be required to achieve this end.

Turning to the issue of how to deal with the contribution of especially large or complex individual financial institutions to systemic risks, the paper reviews a number of policies that have been suggested, which include: developing schemes for an orderly resolution of such intermediaries; improving market infrastructure to reduce the risks associated with interconnectedness; taxing larger and more complex intermediaries; or going a step further by directly limiting the structure of firms or the scope of their activities. In weighing up these various options, Jaime Caruana largely dismisses this latter strategy – the 'narrow-banking' solution – on the grounds that stability requires a sustained supply of credit, not just secure deposits and a reliable payments system. A key limitation of the narrow-banking model is that it would simply push credit provision and risk-taking outside of the home country's regulatory net. Indeed, he argues that in a world in which national boundaries are becoming increasingly blurred for financial intermediaries, more needs to be done to build on existing institutions, such as the Financial Stability Board, to enhance international coordination across regulators, supervisors and those that set standards.

Andrew Crockett also deals with this theme in a paper on the evolution of the international financial architecture, presented in the lunchtime address to the Symposium. The paper outlines how the move towards more flexible economies allowed central banks and other supervisory authorities to take a more active role in economic management. The need to coordinate these increasingly important domestic institutions at an international level resulted, over time, in the strengthening of institutions such as the Bank for International Settlements and led to the formation of the G7. For a long time, these institutions oversaw international economic relations and helped to foster an environment of relative stability. However, he suggests that the subsequent proliferation of international bodies – including of various regulators and standard setters – led to a number of new problems.

In particular, Andrew Crockett argues that the diffuse system of international committees made it difficult to develop a coherent approach to managing the system as a whole, leading to regulatory blind spots in which risks accumulated and calls of concern went largely unheeded. The global financial crisis exposed the consequences of such oversights and provided a sobering lesson about the importance of widespread international collaboration. Current attempts to strengthen the regulatory framework are intended to remedy such weaknesses, with Andrew Crockett arguing that sustaining the momentum behind these efforts is critical to establishing a more flexible and resilient international financial system.

Supply-side Issues

Supply-side considerations are also important for monetary policy given their influence on an economy's productive capacity and its flexibility in response to unexpected developments. Anne Krueger's paper examines policies that affect the supply of factors of production and overall productivity and provides an overview of how the understanding of economics and the approach to economic policy-making has evolved over the past half century. She begins by highlighting the importance of supply-side reforms, arguing that they have accounted for much of the substantial rise in global living standards over this period. Fifty years ago, policy-makers' primary focus was on the goal of full employment; if this could be achieved, the notion was that longer-term economic growth would follow of its own accord. At the time, many thought that full employment could not be guaranteed by private markets left to their own devices, a view that emerged from the experience of the Great Depression and a general sense that individuals were not particularly responsive to incentives and price signals. This supported a strategy of strong government regulation, control and ownership affecting most aspects of economic life.

Anne Krueger then compares the policy experience of developed and developing economies in the post-War era. There were similarities in the overall approach, but the degree of public intervention was typically much greater in developing economies. Despite the potential for these economies to have grown more rapidly given the scope for their productivity and living standards to catch up, their growth tended to be below that of the developed world up to the early 1970s. She contends that this failure to catch up was a key factor leading economists to recognise the importance of private incentives and the problems of suppressing free-market outcomes. This was reinforced by increasing evidence of the high costs and limited benefits of trade protection and import substitution policies, as well as the expansion of the informal and unregulated sectors that prospered in an environment of excessive government regulations, taxes and bureaucratic inefficiencies. Around the same time, the benefits of alternative development strategies were being demonstrated by a handful of countries, most notably in east Asia, which were abandoning price controls, adopting outwardly orientated trade strategies, pursuing tax and other structural reforms to encourage private business activities, and supporting public investment in education and infrastructure.

The paper concludes with a discussion of some of the key challenges regarding structural reforms. Most notably, Anne Krueger supports calls for reforms to the global decision-making framework to give a stronger voice to developing economies, which now account for a larger share of global economic activity. She also argues that more needs to be done to foster institutional development in the least developed countries where living standards have not improved much, if at all, over the past 50 years.

Conclusions

One of the most important changes in the economic policy arena over the past 50 years has been the increased reliance placed on the price mechanism and on private markets more generally. This change built gradually across a number of fronts with the recognition of the costs of excessive government intervention and regulation, and the benefits of allowing prices to move in response to shifts in demand and supply. The integration of global markets for capital, goods and services, the liberalisation of financial, product and labour markets, and the greatly diminished role of the public sector in these markets helped to spur substantial gains in economic welfare around much of the world over the past half century. Progress in the area of monetary policy has also been substantial and been strongly influenced by these trends in the broader economic landscape. Most significantly, monetary policy frameworks are now geared towards ensuring low and stable inflation. This is important in a world where individual prices are more flexible, since overall price stability makes it easier to identify movements in relative prices, which in turn act as signals to reallocate scarce resources. Despite monetary policy frameworks differing in a number of respects across countries, there was considerable agreement among participants at the Symposium about the set of core ingredients required for price stability, including a central bank with a strong public mandate and operational independence, that behaves in a predictable and transparent way, but with room for some discretion.

While there has been considerable progress on many policy fronts, policy-makers continue to face difficult challenges. Three of these received particular attention during the Symposium. First, the scope and prospect for further supply-side reforms was discussed at some length. It was widely acknowledged that progress here is critical to support productivity growth over the longer term. There was, however, some concern about the difficulties of making progress, particularly at a time when supply-side reforms might be overlooked in light of what appear to be more immediate concerns associated with weaker near-term growth prospects across much of the developed world.

A second challenge that received considerable attention was the interplay between fiscal and monetary policies. This was at the forefront of the policy debate five or so decades ago, and has re-emerged in light of the substantial use of stimulatory fiscal policies around the world during the financial crisis and when interest rates were at, or very near, the zero lower bound in a number of countries. Views on how the interaction between these two arms of policy will play out varied, but most participants agreed on the need for substantial fiscal consolidation in countries with especially high levels of public debt.

A third challenge discussed at length was the need to enhance the stability of the financial system. Symposium participants supported calls for reform of the regulatory framework, pointing to the need to strengthen some regulations, encourage a more proactive approach to supervision in some jurisdictions, and develop new macro-prudential tools to help counter the procyclical tendencies of the financial system. There were, however, some concerns about how these changes would be achieved in practice, whether such changes would be sufficient to reduce systemic risks, and the potential for reforms to have an adverse impact on the efficiency of the intermediation process. Some thought that the process of reform would benefit greatly from a common approach across countries, but it was widely acknowledged that it is difficult for the international financial architecture to adapt to keep pace with innovations in increasingly globalised financial markets. On the scope for policies to 'lean against' emerging financial system imbalances, there was a fairly broad agreement that regulatory and monetary authorities both have some role, although there was debate about the right mix of these two types of policies and how vigorously this approach should be pursued.

In summary, the Symposium provided a forum for participants to review developments in economic policy over the past 50 years and a timely opportunity to discuss the challenges that lie ahead. In contrast to the concerns that dominated thinking 50 years ago, foremost among the challenges today is the need to enhance the stability of financial systems and to continue to improve the supply side of economies. There was considerable agreement about the need to strengthen prudential regulation and find ways to moderate cycles in the financial system. There was also agreement that central banks can make a valuable contribution by maintaining the hard-won price stability that has been achieved over the past couple of decades.