Submission to the Review of the Reserve Bank

7 November 2022

Who we are

ACOSS is the peak body of the community services and welfare sector, and the national voice for the needs of people affected by poverty and inequality.

Our vision is for a fair, inclusive and sustainable Australia, where all individuals and communities can participate in and benefit from social and economic life.

What we do

ACOSS leads and supports initiatives within the community services and welfare sector, and acts as an independent non-party political voice.

By drawing on the direct experiences of people affected by poverty and inequality and the expertise of its diverse member base, ACOSS develops and promotes socially and economically responsible public policy and action by government, community and business.

First published in 2022 by the Australian Council of Social Service

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Website: www.acoss.org.au

ISSN:

ISBN:

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Summary

This review of the Reserve Bank is timely. As ACOSS argued at the recent Jobs and Skills Summit, with unemployment at a 50 year low, the Government has a unique opportunity to change lives for the better and reduce entrenched inequalities by restoring and sustaining full employment while containing inflation.

For people on the lowest incomes, high inflation is a struggle but unemployment is a disaster.

Our advocacy for full employment with low inflation stems from our core goals: to ensure that people on the lowest incomes are free of financial hardship and able to participate fully in the community, and to reduce entrenched inequalities.

As inflation surged this year, the rising cost of living has become the main concern for many people, including those with low incomes. Within the next two years, it is likely that the focus of public concern will return to unemployment. An international recession may be the legacy of the rapid rise in interest rates by central banks across the world and Australia would not be immune from its impact.

For those with the least, unemployment – the lack of a wage - has a more profound and lasting impact than the erosion of the value of their wages by inflation.

For too long, policy makers have accepted unemployment rates of 5-6% or more as an unavoidable price to pay to contain inflation. As the 750,000 people relying on unemployment payments for more than year can attest, prolonged unemployment leads to poverty, anxiety and depression, family conflict and for many a constant risk of homelessness. Sustained periods of high unemployment also have wider social and economic impacts: wages grow more slowly, jobs are less secure, people cannot get the paid working hours they need to get by, and inequalities of income become entrenched. High unemployment is also a huge waste of resources.

The current priority to reduce inflation over reducing unemployment is unbalanced.

Since full employment was abandoned in the 1970s, policy makers have struggled to balance the often-competing goals of reducing unemployment and containing inflation. Since the 1990s, governments and the RBA have given priority to keeping inflation within a narrow band of 2-3%. There is no official target to reduce unemployment or underemployment.

It is possible to sustain full employment while keeping inflation low. Australia managed to do this for 30 years after World War II. This requires far-reaching changes to fiscal and monetary policy settings.

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A full employment target should be set and it should be given equal weight to the inflation target.

Full employment targets should be set independently of inflation targets, and the RBA should be required to explicitly strike a balance between the two goals when they are in conflict – especially when there is a significant risk of a recession.

Given the high level of part time employment in Australia and the widespread employer practice of adjusting paid working hours rather than staffing levels in response to booms and recessions, full employment targets should take account of under-employment as well as unemployment. The targets should have two dimensions – for underutilisation (unemployment plus underemployment) and for the number of people unemployed or underemployed for every job vacancy.

Both the Government and the RBA should routinely measure and track broader indicators of financial wellbeing including poverty, income inequality, and gender inequality. The RBA should hear from people who are economically vulnerable, including in the boardroom.

The GFC and subsequent period of economic stagnation call into question the current approach to macro-economic management.

After its introduction in the 1990s, inflation targeting kept inflation low and seemed to ward off recessions for over a decade. However, since the Global Financial Crisis (GFC) many experts and people affected by those events have questioned the 'fight inflation first' approach.

Between the GFC and the pandemic Australia went through a period referred to as 'dog days' or 'secular stagnation', in which incomes for most people barely grew, investment was weak, and unemployment and underemployment remained stubbornly high. As inflation fell below target, policy makers internationally become concerned about the risk of deflation.

The long-term reduction in interest rates towards zero also means a new approach to monetary policy is needed.

During the pandemic recession another problem emerged that called the present inflation targeting approach into question. The 'neutral' interest rate, at which monetary policy is neither stimulatory nor deflationary, had declined since the 1990s. As the RBA's cash rate target approached zero, there was little room to reduce interest rates further to support recovery from the recession and it relied instead to unconventional policies such as bond purchases.

A modest increase in the inflation target – for example to 3-4% - would help reduce the risk of a return to secular stagnation. It would also create more room for the RBA to lower interest rates in the event of a downturn. This would not affect the RBA's commitment to reduce inflation from higher levels but would avoid the potentially large increase in unemployment required to achieve the last percentage point reduction back to the target band - from say, 4% to 3%.

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Governments should play a greater role in restoring full employment with low inflation.

Fortunately, the prevailing orthodoxy that economic stabilisation was largely a job for the RBA rather than governments was abandoned in the GFC and pandemic recession. There is no doubt that Australia would have undergone a recession during the GFC and that the COVID recession would have been much deeper and more prolonged if Governments had not pursued timely economic stimulus policies.

To achieve and sustain full employment, governments will have to play a greater role not only to stimulate growth in downturns, but also to curb inflation during booms. Governments should use their regulatory and taxation powers to contain excessive price increases in poorly functioning markets (e.g. housing and energy), invest in infrastructure to ease supply chain bottlenecks, remove barriers to competition in sectors dominated by monopolies, and invest in skills and labour market assistance for people unemployed long-term to ease labour and skills shortages. Much more should be done to support paid workforce participation by women, people with disability and older workers.

Tax reform and stronger prudential regulation are needed to prevent excessive asset price inflation (especially housing) and private debt levels.

Increases in asset prices are part of the normal process of economic development, but when interest rates are low for a prolonged period and the economy booms, there is a risk of asset price 'bubbles'. These distort investment from more productive purposes and increase economic volatility – exaggerating growth in booms and prolonging recessions. Over-investment in housing also undermines affordability.

Rather than respond to asset price bubbles with high interest rates (when higher rates are not otherwise justified), the best solution is to:

- Remove distortions in the tax system such as the Capital Gains Tax discount and negative gearing, that encourage over-investment in assets like housing and shares that yield capital gains;
- Strengthen prudential regulation to prevent excessively risky borrowing or investment; and
- Give the RBA powers to require APRA (the prudential regulator) to limit access to credit in exceptional circumstances where financial or macroeconomic stability are threatened.

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Recommendations

A. Target both full employment and low inflation and give them equal priority.

1. **The Reserve Bank (pursuant to its statutory objectives) and the Government should commit to work together to achieve a full employment target in addition to an inflation target, and those targets should be given equal weight.**

2. **The full employment target should be set independently of the inflation target. It should be developed in consultation with experts and organisations representing unions, business, and civil society (including people directly affected by unemployment) as a combination of:**
   - **A labour underutilisation rate (the sum of unemployment and under-employment) below a threshold level; and**
   - **A ratio of workers who are 'underutilised' to job vacancies below a threshold level).**[1]

3. **The Reserve Bank's inflation target should be modestly increased, for example from 2-3% to 3-4%.**

B. A greater role for direct government action (agile use of fiscal and regulatory policies) to secure full employment with low inflation.

While this is strictly speaking beyond the scope of the present review, it is not possible to consider major changes to the conduct of monetary policy without also examining the role of fiscal and regulatory policies in sustaining full employment with low inflation.[2]

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[1] In the post-war period of full employment, targets were set for both the level of unemployment and the ratio of people unemployed to job vacancies.
One way to set a target for *unemployment* is to use unemployment rates at the end of the last period of full employment in the early 1970s. From 1969 to 1974 this was 3% (rounded up from 2.6%) and the average ratio of unemployed people per vacancy was 1:1 (rounded up from 0.8). Under-employment was not measured at that time (and was presumably very low as the vast majority of people in employment had fulltime jobs).
One way to set a target for *underemployment* is to multiply the unemployment rate target by the average ratio of unemployment to under-employment rates from 1999 to 2019 (the two decades before the pandemic) which was 1 (1.2 rounded down).
An underutilisation target based on the above calculations would be 6% (3% unemployment + 3% underemployment) and the target ratio of underutilisation to job vacancies would be 2:1 (1 person unemployed plus one person underemployed). This would be around one third lower that current levels of unemployment and underemployment. Currently, the unemployment rate is 3.5% and underemployment is 5.7% (so underutilisation is 9.2%), and the ratio of people who are 'underutilised' to vacancies is 3.4 (one person unemployed per vacancy plus 2.4 people underemployed per vacancy).

[2] These issues are discussed in more detail in our policy document for the Jobs and Skills Summit (ACOSS 2022, *Restoring full employment: Policies for the Jobs and Skills Summit*. Sydney.

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4. **In cooperation with the Reserve Bank, Governments should play a more active role to stabilise economic growth (easing the impact of booms and downturns) and entrench full employment with low inflation by:**
    - **Permanently increasing the size and effectiveness of 'automatic economic stabilisers', especially unemployment and related income support payments;**
    - **Providing additional payments to people on low incomes and timely public investment during downturns, as required;**
    - **Targeted and timely adjustments to regulation, public investment and tax settings to contain excessive price increases in goods, services and financial markets during economic booms, as required (for example, removing blockages in critical supply chains and intervening in energy markets to curb excessive price increases and speed the transition to renewables);**
    - **Stronger regulation of competition, including tighter controls over mergers and takeovers and ongoing monitoring of mark-ups and the treatment of suppliers and consumers in sectors dominated by a small number of businesses;**
    - **Incomes policies that support steady and predictable growth in real incomes, including wages and social security payments, consistent with improvements in productivity;**
    - **Workforce planning and skills development policies to prevent labour and skills shortages in a full employment economy;**
    - **Policies to strengthen paid workforce participation and improve equity in employment (including gender equity) including improved income support for people out of paid work, investment in programs to reduce prolonged unemployment, investment in quality affordable childcare, pay equity for women and people with disability, combatting discrimination in employment, and improvements in job quality and security (especially in entry-level jobs and care services).**
5. **A more active role for Governments in supporting full employment with low inflation should be supported by institutional changes, including:**
    - **A permanent advisory council to Government (with an independent secretariat) that draws expertise across key stakeholders including business, unions, civil society organisations and academic experts, to advise on policies to achieve full employment with low inflation and help secure cross-sector support for those policies.**
    - **Time-limited Expert Commissions to report to the advisory council on policies to overcome major barriers to full employment with low inflation.**

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C. **Contain inflation in asset prices (especially housing) and strengthen financial regulation to rein in excessive borrowing and speculative investment during booms.**

6. **To help contain inflation, sustain full employment and improve housing affordability, tax distortions that encourage speculative, debt financed investment in assets yielding capital gains should be removed by:**

    - **Increasing Capital Gains Tax rates (across the board, not only for housing);**
    - **Quarantining deductions for expenses associated with investments yielding capital gains to offset income derived from those investments (restricting 'negative gearing').**

    - **progressive replacement of Stamp Duties for the purchase of dwellings with broad-based Land Taxes (including owner-occupied dwellings).**

7. **Gaps in prudential and consumer protection regulation of financial institutions and transactions should be closed, especially the regulation of financial products and transactions offered by organisations other than Authorised Deposit-taking Institutions (banks), insurers and superannuation funds.**

8. **Pursuant to its macroeconomic and financial stabilisation roles, the Reserve Bank should have powers in exceptional circumstances to direct APRA to constrain excessive borrowing for investment in appreciating assets such as housing.**

D. **Strengthen the diversity of knowledge and expertise on the RBA Board by appointing a combination of economic experts and people from a wider range of backgrounds**

9. **The Reserve Bank Act should specify that its Board is appointed from suitable candidates drawn from people with relevant economic expertise and a wider range of backgrounds and perspectives, including from unions, civil society and business.**

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1. The tension between reducing unemployment and containing inflation

This submission focusses on Theme One in the Discussion Paper: *monetary policy arrangements,* rather than the performance of the Reserve Bank of Australia (RBA) or its organisation and culture.

Of necessity it also discusses fiscal (budgetary), prudential regulation and other government policies that support the RBA in carrying out its role, since these issues cannot be separated out. For a more detailed discussion of fiscal and other policies to achieve and sustain full employment (some of which are briefly outlined here), see our policy paper for the recent Jobs and Skills Summit.[3]

This Part focusses on two key goals of monetary policy: reducing unemployment and containing inflation, and the tensions between them.

The RBA's inflation target is one-sided

The Reserve Bank Act (1959) outlines three objectives: '*stability of the currency* (which is closely related to control of inflation)*, full employment, and the economic prosperity and welfare of the Australian people'.*

We can see no reason to alter those statutory goals and removing one of them would send the wrong message to the community – for example that the bank should not concern itself with '*the welfare of the Australian people'*.

What matters more than the high-level statutory goals are those that are measured, targeted, and given priority. As discussed later, this has changed fundamentally over time from a priority to sustain full employment to a priority to contain inflation. Containing inflation is enshrined as the primary goal in the Statement on the Conduct of Monetary Policy last agreed between Government and RBA in 2016:

> *'These [statutory] objectives allow the Reserve Bank Board to focus on price (currency) stability, which is a crucial precondition for long-term economic growth and employment, while taking account of the implications of monetary policy for activity and levels of employment in the short term.'*[4]

The statement specifies an explicit, measurable target for inflation: to '*keep consumer price inflation between 2 and 3 per cent, on average, over time'.* There is no equivalent full employment target.

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[3] ACOSS (2022), *Restoring full employment: Policies for the Jobs and Skills Summit*. Sydney.

[4] Treasurer and Reserve Bank Governor (2016), *Seventh Statement on the Conduct of Monetary Policy*.

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There is a tension between reducing unemployment and curbing inflation

Policy choices to prioritise lowering unemployment or containing inflation, especially those made during the peaks and troughs of the business cycle in booms and recessions respectively, have profound impacts on people's incomes and wellbeing, on income inequality, and long-term economic development.

If the RBA aggressively increases interest rates and keeps them high for too long to contain inflation, this can trigger a prolonged recession such as that experienced in the early 1990s (see below). Recessions are more than economic events. Many people experience a recession as a personal crisis as they become unemployed, find it harder to secure employment or more paid hours, their business shuts down, or their savings leach away.

It is often argued that there is no long-run trade-off between inflation and unemployment.[5] Yet due to a process known as hysteresis, major economic downturns also have long-term effects, especially for people who become unemployed.[6] If people are unemployed for a long time they are likely to lose skills, confidence and connection with employment and their chances of returning to employment steadily diminish. Young people unlucky enough to enter the labour market in a recession often have lower incomes many years later.[7]

Since the start of the inflation targeting era in monetary policy (discussed later), tensions between reducing unemployment and containing inflation have been downplayed through statements such as '*price (currency) stability is a crucial precondition for long-term economic growth and employment,'* and by redefining full employment as a secondary goal behind keeping inflation low (as discussed later).[8]

It is possible to sustain *genuinely* low unemployment with low inflation, but that ideal state will not be reached if one goal (inflation control) is permanently privileged over the other (full employment), or (as discussed later) if we rely on the blunt instrument of monetary policy alone.

High unemployment is harmful, especially in recessions

High levels of unemployment lead to high levels of poverty, especially in Australia where the reduction in income for people transitioning from fulltime employment to unemployment

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[5] RBA (2022), *Response to question* from House of Representatives Economics Committee, 16 September 2022.

[6] Ball L & Onken J (2021*), Hysteresis in unemployment: evidence from OECD estimates of the natural rate*. European Central Bank, Working Paper No 2625, December 2021.

[7] Andrews D et al (2020), *The Career Effects of Labour Market Conditions at Entry*. Treasury Working Paper 2020-1.

[8] Macroeconomic models often assume that after a downturn or boom, the economy will return to equilibrium, regardless of interest rate and fiscal policies. If a large increase in unemployment is sustained over time, this is explained as a structural shift on the supply side of the economy, for example a less efficient labour market.

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is very steep. The $48 a day Jobseeker Payment is less than half the minimum fulltime wage, and among the lowest unemployment payments in the OECD.[9]

High unemployment also has wider health and social impacts, including widespread anxiety and depression, family conflict and homelessness. Governments must spend more over both the short and long-term to alleviate these social impacts.

High unemployment also suppresses growth in wages and diminishes the quality and security of employment.[10] Together with the lack of paid work, these broader labour market impacts divide the community between those not adversely affected and those whose living standards and life chances are diminished by high levels of unemployment.

Further, high unemployment is a huge waste of resources, since we are not producing the goods and providing the services we need within our full capacity to do so.[11]

High inflation is harmful, especially in booms

If interest rates remain too low during an economic boom and consumer price inflation is too high, the mix of private investment is likely to shift towards the risky and speculative end of the spectrum, individuals and businesses are likely to borrow more, home prices are likely to rise steeply, and people with modest incomes will struggle to cover their basic expenses.

If wages grow sharply in response to inflation and people expect it to remain high, then a higher level of inflation may become entrenched.

Elevated housing costs, poor investment decisions, and high levels of household or business debt all have long-term impacts on our wellbeing and economic development.[12]

Monetary policy can increase economic inequality, especially in recessions

Monetary policy affects inequality of incomes and wealth, mainly through its impacts on employment, inflation and asset prices.

If increased interest rates lead to a sustained increase in unemployment, this would suppress the incomes of households in the lower half of the income distribution through the loss of paid work and slower growth in wages, especially for entry level jobs.

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[9] OECD (2022), *Benefits and wages statistics*.

[10] Bernstein J & Bentele K (2019), *The Increasing Benefits and Diminished Costs of Running a High-Pressure Labor Market*. Centre of Economi8c and Budget Priorities. Washington.

[11] Coates B & Alex Ballantyne A (2022), *No one left behind - Why Australia should lock in full employment*. Grattan Institute. Melbourne. environmental constraints.

[12] Bullock, M (2018) *The Evolution of Household Sector Risks*, Speech at Ai Group, Albury, September 10 2018. Reserve Bank of Australia; Maclennan D et al (2021), *Housing in the economy: Scale, cycles and stability*. UNSW City Futures Research Centre. Sydney.

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If reduced interest rates lead to a sustained increase in inflation, this would disproportionately impact people with low incomes as they have less capacity to adjust to a sudden increase in prices, for example by reducing spending on luxuries or buying in bulk.

Further, sustained low interest rates trigger increases in asset prices (such as housing and shares), which disproportionately benefit people with high incomes, while those with modest means are increasingly locked out of home ownership.

International research findings on the effect of monetary policy on inequality are mixed. On balance, high unemployment has a greater impact on income inequality (mainly disadvantaging people with low incomes) while inflation in asset prices has a greater impact on wealth inequality (mainly benefiting people with high levels of wealth).[13]

Conclusion

There is a trade-off between reducing unemployment and reducing inflation, in both the short and longer term. In pursuit of its statutory objectives, the RBA should be required to balance these goals explicitly and transparently, giving each equal weight.[14]

Recommendation:

1. **The Reserve Bank (pursuant to its statutory objectives) and the Government should commit to work together to achieve a full employment target in addition to an inflation target, and those targets should be given equal weight.**

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[13] RBA (2019), *Monetary policy and the distributions of income and wealth*. Response to question on notice, House of Representatives Economics Committee Inquiry into the RBA 2018 Annual Report. Raczyński N (2021), *Monetary policy and economic inequality: a literature review*. Bank i Kredyt Vol 53(2) 2022, pp231-278. Coibion O et al (2012*), Innocent bystanders? Monetary policy and inequality in the US*. NBER Working Paper 18170; Furcer D et al (2017), *The effects of monetary policy shocks on inequality*. Journal of International Money and Finance. Vol 85, pp168-186.
Researchers at the Bank for International Settlements have found the reverse effect: that higher income inequality increases economic volatility (Awazi L et al (2022), *Inequality hysteresis and the effectiveness of macroeconomic stabilisation policies,* Bank of International Settlements. Zurich.)

[14] Another option is to target unemployment and inflation using a measure that accounts for both, such as the level or growth in nominal gross domestic product or expenditure (Holden R, McKibbin W & Quiggin J 2020, *The RBA needs a new post-virus monetary policy game*. Australian Financial Review May 5, 2020). This approach avoids the risk with 'dual mandates' for unemployment and inflation (such as that followed by the Federal Reserve Bank in the US), that one of the two objectives becomes dominant (in the US case, inflation reduction). On the other hand, it may obscure the trade-off between the two. Further, in a major commodity exporter like Australia, a nominal GDP target could lead to counter-intuitive outcomes in the event of a mining boom (Gross Z 2021*, Revisiting the RBA's target Does NGDP targeting live up to the hype?* See also the Canadian Reserve Bank's review of its monetary policy settings for a comparison of the impact of different targets on macroeconomic stability. Bank of Canada 2021, *Monetary Policy Framework Renewal*.)

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2. A brief history of economic stabilisation policy in Australia

This section provides a short overview of developments in inflation and unemployment and related shifts in economic thinking, from the era of full employment after World War II to its abandonment in the 1970s, the adoption of inflation targeting in the 1990s, the new ideas that emerged in the decade of 'secular stagnation' after the Global Financial Crisis in 2008, and the challenges for monetary policy during the pandemic.

The full employment era (1944-74)

Following the Great Depression of the 1930s and World War Two, the Curtin and Chifley governments committed to a 'full employment' policy to keep the economy running close to its full capacity and unemployment low. Public investment and other expenditure and taxation policies, together with interest rate settings, were deployed to keep demand for goods and services sufficiently strong to achieve full employment without triggering excessive inflation. As a result, unemployment remained below 3% and inflation remained below 5% for most of the next 30 years.

> *'Governments should accept the responsibility to stimulate spending on goods and services to the extent necessary to sustain full employment. To prevent the waste of resources which results from unemployment is the first and greatest step to high living standards. But if our living standards are to increase to the greatest extent possible, we must produce more efficiently. Australian Government (1945), Full Employment in Australia.'*

'Fighting inflation first' (1975-1982)

In the 1970s to the 1990s, full employment was abandoned in favour of a 'Fight Inflation First' approach.

After the Nixon administration devalued the American Dollar (in effect, to meet rising expenditure on the war in Vietnam) and the OPEC cartel increased oil prices, economic policy makers around the world were confronted with the unusual combination of higher inflation (well over 10% in Australia) and higher unemployment (now above 5%). Wages rose sharply in response to price increases, creating a so-called 'wage price spiral'.[15]

Under the stewardship of Federal Reserve Governor Volcker, interest rates were increased aggressively in the US in the early 1980s to curb inflation, and Australia followed suit. High interest rate hikes triggered an international recession in 1982 and unemployment rose above 10% in Australia.

[15] ACOSS (1978), *Whatever happened to full employment?*

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The attempt to restore full employment through prices and incomes policies (1983-86)

After the recession in 1982, the recently-elected Hawke Government attempted to restore full employment through prices and incomes policies negotiated in an Accord between the Labor Party and Australian Council of Trade Unions. The main purpose of the Accord was to prevent a wage price spiral and curb inflation without relying on the blunt instrument of high interest rates.

> *'Sustained economic recovery sufficient to restore and maintain a situation even remotely resembling full employment is not possible whilst reliance is placed-solely on conventional economic weapons of fiscal, monetary and exchange rate policy, however varied and applied.*
>
> *This is because economic recovery will soon lead to increased inflation, thus forcing the Australian Government to adopt contractionary anti-inflation policies which will truncate the recovery and prevent any restoration of full, or even near-full employment.'*
>
> ***The continuance of widespread unemployment is abhorrent, and economic policies which rely on unemployment to control inflation are completely rejected.****' [emphasis added]. ALP-ACTU (1982), Prices and Incomes Accord.*

Abandonment of prices and incomes policies and introduction of inflation targeting (1986-2008)

The strategy to use prices and incomes policies instead of high interest rates to restore full employment was not pursued for long. In the late 1980s, the Australian economy was booming, but in a lop-sided fashion. Low interest rates, removal of restrictions on credit and the restoration of 'negative gearing' for real estate investments fuelled speculative investment in housing and high levels of household and corporate debt.

These factors gave rise to an increase in Australia's current account deficit (driven mainly by a rise in private debt as the Australian Government's budget was in surplus), which deeply concerned policy makers at the time. In response to those concerns, and the risk that a wage-price spiral *may* emerge, the RBA increased interest rates aggressively (home loan interest rates rose to 17%).[16]

To drive inflation lower, the RBA and the Government delayed action to speed the recovery from the recession in 1991 – the opposite approach to that advocated in the Accord.

By this stage, economic orthodoxy had swung to the view that it was the RBA's role to stabilise growth in the economy, while governments should focus on balancing their

[16] Blundell-Wignall A & Bullock M (1992), *Changes in the characteristics of the Australian business cycle – some lessons for monetary policy from the 1980s and early 1990s*. Reserve Bank of Australia Research Discussion Paper No 9212.

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budgets and lifting speed limits to growth through microeconomic reforms to boost productivity.

While inflation fell from 8% to 3% in the early 1990s, this came at a high social and economic cost. Unemployment reached a post-war high of 12%. By 1993, 350,000 people were unemployed long-term (over 12 months). Under-employment rose sharply at this time, especially among young people.

In 1996, the priority now given to curbing inflation over reducing unemployment was enshrined in an agreement between the RBA and the Treasurer that set a target for inflation at 2-3%. No such target was set to reduce unemployment, although this remained one of the Reserve Bank's statutory objectives.

An informal target was set for unemployment, but this was a floor or *minimum* level, above which it was assumed inflation would accelerate – the Non Accelerating Inflation Rate of Unemployment (or NAIRU, which we discuss later). This was generally held to be around 6%. This biased fiscal and monetary policies against any reduction in unemployment below that level. The Accord policies were now turned on their head.

Secular stagnation and the emergence of new economic thinking (2008-19)

Through the 2000s, inflation was generally held within the target range though unemployment for the most part remained above 5%.

When the Global Financial Crisis (GFC) struck in 2008, the Rudd Government broke with the (now) orthodox view of the Government's role in managing the economy. It acted quickly and effectively to prevent another recession, using a combination of direct payments to households and infrastructure investment. Nevertheless, unemployment rose from 4% to 6%.

After the GFC and the end of a mining boom we were confronted with a new set of problems: inflation was tamed but growth in jobs, real wages and investment was weak. The latter half of the 2010s has been referred to as the 'dog days' or a period of 'secular stagnation'. At this time, policy makers and experts began to question the priority given to keeping inflation very low and the idea that unemployment could not be reduced below 5-6%. They argued that the problems had changed and so should the solutions.[17]

Critics of the RBA's monetary policy settings at this time argued that it held interest rates too high for too long despite a lack of hard evidence that inflationary pressures were building.[18]

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[17] Summers (2015), *Demand Side Secular Stagnation*. American Economic Review: Papers & Proceedings. 2015, Vol 105(5), pp60–65; Garnaut (2021), *Reset: Restoring Australia after the Great Crash of 2020*. Blackinc books. Melbourne.

[18] Gross I & Leigh A (2022), *Assessing Australian Monetary Policy in the Twenty-First Century*. ECONOMIC RECORD, VOL. 98, NO. 322, pp271–295.

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COVID, economic stimulus, falling unemployment, and the rekindling of inflation (2019-22)

After it imposed the first COVID lockdowns in 2020, the Morrison government moved to keep people connected to their jobs and sustain incomes by doubling unemployment payments and providing a large-scale wage subsidy scheme advocated by unions and employers (JobKeeper). The RBA reduced its cash rate target close to zero and purchased government bonds on the market, supporting the borrowing required to fund those payments.

Due in large part to stimulatory economic policies and the role of wage subsidies in keeping people connected with their employers during the COVID recession, unemployment has fallen from an 'effective unemployment rate' (which included workers stood down due to COVID restrictions) of 12% in 2020 to 3.5% and under-employment has fallen to 6% of the labour force. Both are at historically low levels.

Nevertheless, 760,000 people on unemployment payments have still had to rely on income support for more than a year – twice the number after the previous recession in the 1990s.[19] This is a reminder of both the human cost of unemployment and the long shadow cast by economic downturns.

During 2022, inflation surged internationally due to supply blockages arising from COVID restrictions, sudden changes in spending patterns (from services to goods) in wealthy nations, and the war in Ukraine. Economic stimulus policies pursued during 2020 and 2021 also raised consumer demand and employment, triggering growth in wages in some countries (including the US but not Australia to date).

It is likely that the increase in consumer price inflation in Australia from an annual rate of 3.5% up to the December quarter of 2021 to 7.3% up to the September quarter of 2022 is due to a combination of supply side bottlenecks and stimulus-induced increase in demand.[20]

Along with central banks internationally, the RBA has lifted interest rates aggressively, from 0.1% in March 2022 to 2.6% in October. It was inevitable that as the economy recovered, interest rates would rise from emergency levels. However, we have reached a point where further increases could trigger a major downturn next year. In the October 2022 Federal Budget statements, Treasury estimates that the unemployment rate will rise by almost one third from 3.5% in September 2022 to 4.5% by June 2024, which we estimate will add approximately 150,000 people to the unemployment queue.[21] A recession is increasingly

[19] Department of Social Services, *Income support statistics, June 2022*.

[20] Gross Z (2022), Breaking down inflation - Supply, demand or ambiguous? 28 June 2022..

[21] Chalmers J & Gallagher K (2022), *Budget Paper No 1.* October 2022, Canberra. In a scenario in which Treasury tests the impact of an international recession, unemployment in Australia rises to 5%, equivalent to approximately 225,000 more people unemployed.

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likely in Europe, the United Kingdom and the US, after the largest simultaneous (yet uncoordinated) increases in official interest rates since the 1980s.[22]

Regrettably, the outcome may be similar to the sharp interest rate increases of that era – a deep international recession and the loss of the opportunity to restore full unemployment in most countries. In Australia, that opportunity remains, but the window is rapidly closing.

3. Set a full employment target for fiscal and monetary policy

This part defines full employment, outlines its benefits, explains why the RBAs implied full employment target (the NAIRU) is not fit for purpose, and argues for a full employment target that is independent of the inflation target.

3.1 The social and economic benefits of low employment

The benefits of full employment are the converse of the economic and social harms brought about by high unemployment discussed previously. They include:

- higher overall living standards, as the capacity of the paid workforce is fully utilised;
- low unemployment, especially long-term unemployment which is very socially and economically harmful;
- lower underemployment, so that people can secure the extra paid hours they need;
- depending on workplace relations arrangements, faster growth in wages and lower wage inequality;
- a reduction in poverty and income inequality due to lower unemployment and higher wages for entry level jobs;
- depending on workplace relations arrangements, improved job quality including greater security of employment (since employers are more reluctant to let people go);
- higher labour productivity, as employers have more incentive to invest in training for their workforce rather than 'poaching' skilled workers from other employers.[23]

Importantly, sustained full employment and the related reduction in inequality strengthens political and social cohesion. It is no accident that politics in many countries has become

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[22] IMF (2022), *World economic outlook update, July 2022 – Gloomy and more uncertain*. Washington; Obstfeld M (2022), [Uncoordinated monetary policies risk a historic global slowdown.]() Peterson Institute, Washington.

[23] ACOSS 2022, *Restoring full employment: Policies for the Jobs and Skills Summit*. Sydney; Bernstein J & Bentele K (2019), op cit, Okun A (1968), *Upward Mobility in a High-pressure economy.* Brookings Papers on Economic Activity, Vol 1, 1973.

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more volatile since the GFC and the period of secular stagnation that followed it. Another international recession will sharpen the political and social tensions that are already there.

Against this, in a full employment economy there is a greater risk of excessive inflation and labour and skills shortages. Governments took care to guard against these risks in the post-war full employment era and must do so again if full employment is restored.

3.2 Defining and measuring full employment

Full employment means people can secure the employment or additional paid hours they need and the capacity of the workforce is fully utilised

Full employment means, broadly speaking, that people can secure the employment and paid hours they need. It also means that employers are running their businesses or services at close to full capacity.

There will always be a degree of unemployment in a capitalist economy as people take time to find the right job when they enter the labour market or change jobs ('frictional unemployment'). Further, there will always be a degree of mismatch between the skills and capabilities of the paid workforce and the jobs available ('structural unemployment'). Nevertheless, both frictional and structural unemployment can be kept to a minimum if the right mix of policies is adopted, as shown by the 30 years after World World Two when Australia's unemployment rate rarely exceeded 3% and the vast majority of people who were unemployed quickly found jobs.

Unemployment alone is no longer a reliable measure of labour market 'slack'

The labour market and society have changed greatly in the 50 years since full employment was abandoned. The most important changes include growth in employment among women and the associated rise in part time employment. Due the inequitable distribution of unpaid care work between women and men, and a preference among employers to employ people part time in entry level jobs in sectors such as retail and hospitality, Australia has the fourth-highest part time employment rate in the OECD (30% of workers according to ABS estimates).[24]

Consequently, unemployment on its own is no longer a reliable measure of 'slack' in the labour market since under-employment (insufficient paid hours, mainly among people employed part time) grew strongly, and at a faster pace than unemployment, after the recession of the early 1990s. As demonstrated during the COVID recession in 2020, employers increasingly reduce paid working hours as well as the overall number of employees during economic downturns, especially among workers engaged on a casual

[24] OECD, *Employment statistics*. ABS, *Labour Force Australia*.

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basis. This means they can retain their workforce and offer more paid hours as business recovers.[25]

This implies that, when assessing the risk that a tightening of the labour market may trigger inflation, a broader measure of labour market 'tightness' than unemployment is needed. [26]

Both unemployment and under-employment are included in Australian Bureau of Statistics (ABS) measures of 'labour underutilisation'.[27]

Unemployment is close to levels reached in the full employment era and underemployment is at a 30-year low

Figure 1 shows long-term trends in unemployment and under-employment since the end of the full employment era in the early 1970s. The key trends are consistent with the changes in economic stabilisation policy discussed in Part 2 above:

- very low unemployment (averaging around 2%) until a recession in 1974;
- a steep rise in unemployment to over 10% in the 'fight inflation first' period up to 1982;
- a decline in unemployment to 6% during the Accord period, until the recession of 1991 which followed a sharp increase in interest rates;
- A steep rise in underemployment (which was not regularly measured in the full employment era) during and after the 1991 recession;
- a more gradual but persistent decline in unemployment (but not underemployment) in the inflation targeting period, to 4% just before the GFC in 2008;
- a rise in unemployment to 6% and very slow progress in reducing it, together with a steady increase in underemployment, in the secular stagnation period up to 2019;
- sharp increases in unemployment and underemployment during the COVID lockdowns in 2020, followed by sharp reductions in both over the next two years as lockdowns were eased and the impact of economic stimulus (low interest rates and payments to households and employers) took effect.

[26] This may not be necessary if underemployment follows the same trend as unemployment, but as Figure 1 below shows, that has not been the case. For a discussion of this issue focussing on the US labour market, see Blanchflower D (2022), *The Wage Curve after the Great Recession*. *IZA DP No. 15465.*

[27] There are broader measures of underutilisation which also include 'discouraged job-seekers' (people who are available for paid employment but have given up searching due to barriers such as age or caring roles).

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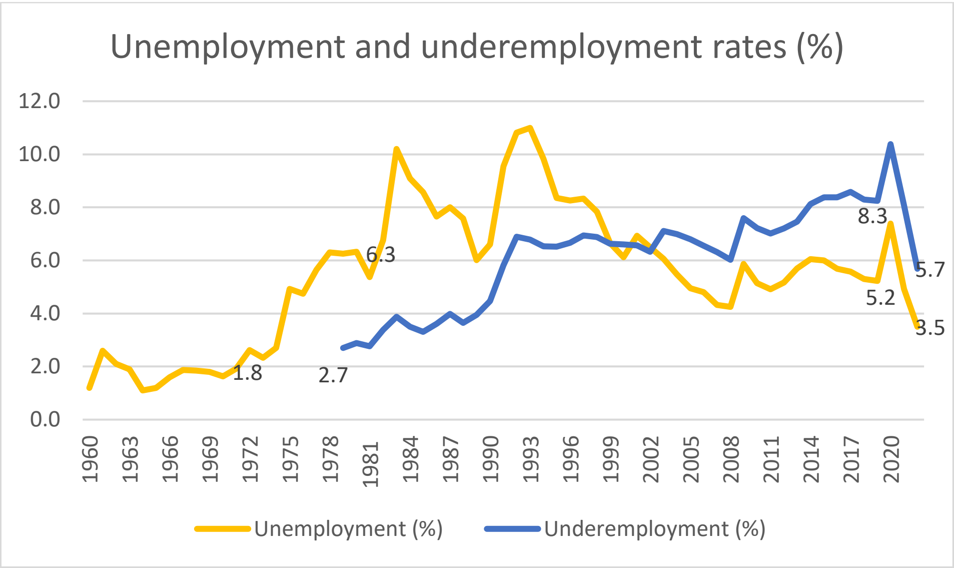
Figure 1: Long-term trends in unemployment and underemployment



Sources: ABS, *Labour Force Australia* (from 1978); Department of Employment and Industrial Relations, *Commonwealth Employment Service Statistics* (to 1978).

Another measure of labour market slack is the ratio of unemployed or underemployed people to job vacancies

When full employment policies were introduced in Australia and the United Kingdom at the end of World War II, the authors of those policies (Coombs in Australia and Beveridge in the UK) also used a second definition based on the ratio of people unemployed to job vacancies: [28]

> *'A high and stable level of employment means, therefore, that there will be a few more jobs available than men and women to fill them, that there will be a slight but persistent shortage of labour.'* (Coombs H (1944), *Problems of a high employment economy.* Fisher Lecture, Canberra.)

One challenge of the full employment era was to avoid lengthy delays in filling vacancies. This was the main function of the Commonwealth Employment Service, established to help place soldiers in civilian jobs and support the post war full employment policy. Beveridge,

[28] Beveridge W (1944), *Full employment in a free society*. London.

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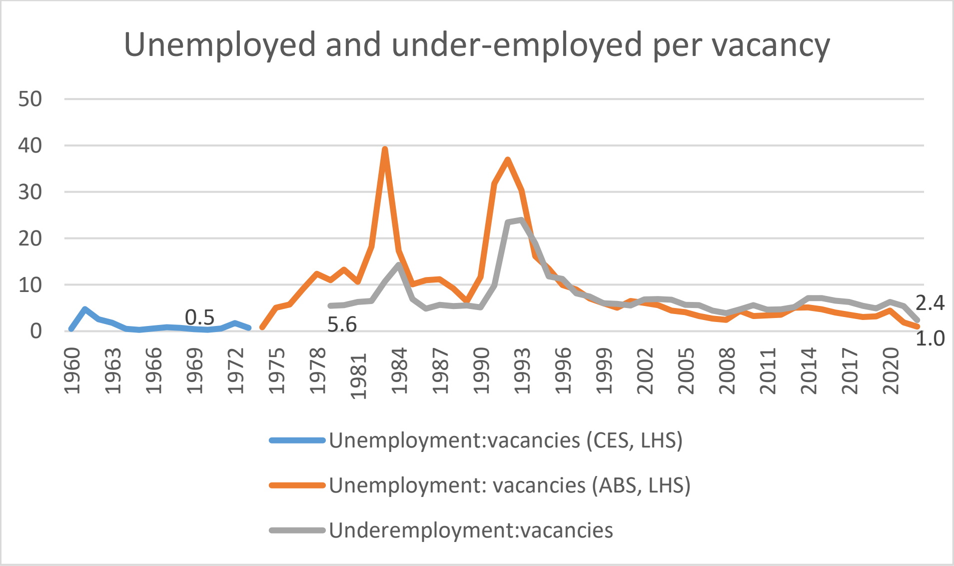
who established the public employment service in the United Kingdom developed a measure (later called the 'Beveridge curve') of the efficiency with which vacancies were filled.[29]

Figure 2 shows that, although a ratio of one person unemployed per vacancy is today considered by many employers as an indicator of severe labour shortage, this was sustained for many years during the full employment era. Policies to prevent labour and skills shortages in conditions of full employment are discussed in Part 5 below.

It is worth noting that a ratio of one person unemployed to every vacancy does not mean there is only an average of one applicant for every advertised job. In addition to people who are unemployed, new entrants to the labour market (for example, young people leaving school), people re-entering it after caring for children (mainly women) and existing employees changing jobs, are also competing with those who are unemployed for each advertised job.

Further, employers have less need to recruit extra workers if some of their existing staff are underemployed. They can offer those workers more paid hours instead, and this appears to be happening as the labour market has tightened. Therefore, ixs it makes sense to include people who are underemployed in the calculation of this measure of full employment.

Figure 2: Trends in the ratio of unemployed and underemployed people to job vacancies2



Sources: ABS, *Job Vacancies and Overtime, Australia*; ABS, *Job Vacancies, Australia*; Department of Employment and Industrial Relations, *Commonwealth Employment Service Statistics* (to 1973).

[29] Price D (2000), *Office of Hope*. Policy Studies Institute, London. The Beveridge curve measures the relationship between job vacancies and unemployment.

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3.2 How full employment was redefined in the inflation-targeting era

Since the 1990s, full employment has been redefined within the strict confines of anti-inflationary policies

At the beginning of the inflation-targeting era of monetary policy in the 1990s, full employment was not formally abandoned – rather it was redefined as the lowest level of unemployment that could be achieved without triggering an outbreak of inflation, that is, *as a subsidiary goal to containing inflation*.

The standard measure of full employment used by central banks and Treasury since the 1990s is the so-called 'natural' or 'Non Accelerating Inflation Rate of Unemployment' (NAIRU), a measure first developed by economist Milton Friedman in the 1960s.[30]

> *'At any moment of time, there is some level of unemployment which is consistent with equilibrium in the structure of real wage rates. At that level of unemployment, real wage rates are tending on average to rise at a 'normal' secular rate, i.e., at a rate that can be indefinitely maintained so long as capital formation, technological improvements, etc., remain on their long-run trends. A lower level of unemployment is an indication that there is an excess demand for labor that will produce upward pressure on real wage rates. A higher level of unemployment is an indication that there is an excess supply of labor that will produce downward pressure on real wage rates.'*[31]

In short, the NAIRU is based on the idea that, depending on wage fixing institutions (such as minimum wages, wage indexation arrangements and the level of unemployment benefits), any sustained reduction in unemployment below its 'natural' level would trigger wage increases which in turn would return unemployment to that level.

This has implications for the relationship between unemployment and inflation (expressed statistically in the 'Philips Curve'). If unemployment falls below its 'natural rate' there is a greater risk of a wage-price spiral as workers and employers adjust to expectations of higher growth in prices and wages. Thus, the idea of a 'natural rate' of unemployment became a part of the orthodox economic explanation for the surge in inflation in the 1970s.[32]

Early estimates of the NAIRU in Australia centred on an unemployment rate of around 6%.[33]

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[30] Reserve Bank of Australia, *The Non-Accelerating Inflation Rate of Unemployment (NAIRU)*.

[31] Friedman M (1968), The role of monetary policy. The American Economic Review, Vol LVIII, No 1.

[32] However, as described in Part 2 above, in the Accord era of the early 1980s policy makers in Australia believed that negotiated restraint in wages and prices could reduce unemployment and lower inflation at the same time.

[33] Gruen D & Pagan A (1999), *The Phillips curve in Australia*, Reserve Bank of Australia.

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After the Global Financial Crisis, the government and RBA continued to fight yesterday's war on the 'wage-price spiral'.

A major problem with the NAIRU as a measure of the state of the labour market (along with 'inflation expectations' as a predictor of the future path of inflation) is that unlike the standard measure of unemployment it cannot be directly observed, only inferred from historical changes in the relationship between unemployment, wages and inflation or from international comparisons.[34] This left plenty of room for people to project their own labour market policy biases onto the measurement of the NAIRU and explanations for the persistence of high unemployment.[35]

It also meant that the NAIRU was backward-looking. If policy makers assume that unemployment could not fall below around 5-6% without a wage-price spiral and an unsustainable upsurge in inflation, they risk 'fighting yesterday's war' at a time when labour market institutions are vastly different to those of the 1970s.[36]

Since the GFC, there has been little evidence of a 1970s style wage-price spiral on the horizon, at least beyond the United States (Figure 3).[37] On the contrary, from 2008 to 2019 policy makers grew increasingly concerned that other wealthy nations would follow Japan down the path of wage stagnation and deflation. This post-GFC period of secular stagnation led to the 'new thinking' described by Brainard and others (see Part 2 above).

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[34] Ellis L (2019), *Watching the Invisibles*. 2019 Freebairn Lecture in Public Policy, University of Melbourne – 12 June 2019. Reserve Bank of Australia. Sydney.

[35] For a critique of NAIRU as an ideological concept see Richardson D (2019), *The Contradictions of NAIRU Policy-Making in Australia*. Australia Institute, Canberra.

[36] The balance of power between employers and employees has shifted markedly towards employers, wages are no longer automatically indexed, and pay rises in one sector or industry no longer 'flow on' readily to others.

[37] Although wages have grown strongly in the US, there is little sign of a wage price spiral in other wealthy nations despite high inflation and low unemployment. See IMF (2022), *Wage Dynamics Post–COVID-19 and Wage-Price Spiral Risks*. World economic outlook report, October 2022. IMF, Washington; Boissay F et al (2022), *Are major advanced economies on the verge of a wage-price spiral?* BIS Bulletin No 53. Zurich.

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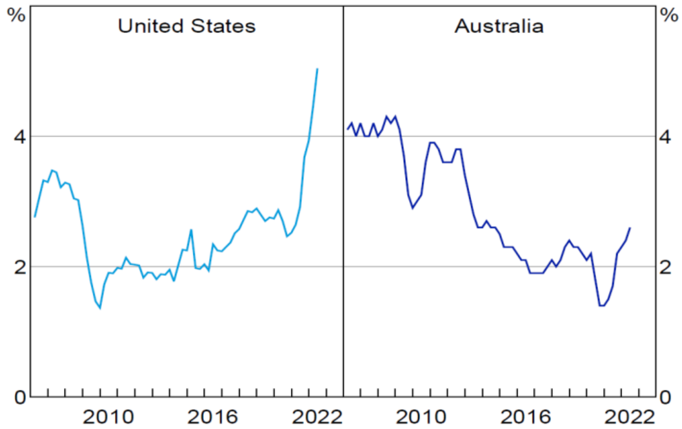
Figure 3: Annual wage growth: Australia and the United States compared

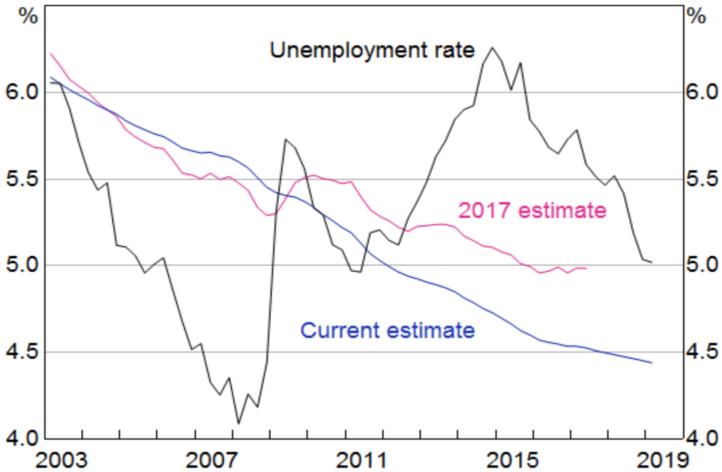


Source: Lowe P (2022), *Inflation and the monetary policy framework*, Speech to Anika Foundation, Sydney 8 September 2022. Reserve Bank of Australia.

The validity and usefulness of the NAIRU is increasingly questioned

During secular stagnation, the validity and usefulness of the NAIRU was widely questioned as the historical relationship between unemployment and inflation appeared to have broken down.[38] In 2019, the RBA lowered its estimate of the NAIRU to 4.5%. In 2021, in response to employer concerns about labour shortages, it encouraged employers to lift wages.[39]

Figure 4: RBA's revised estimates of the NAIRU



[38] Blanchard O (2017), *Should We Reject the Natural Rate Hypothesis*? Peterson Institute. Washington.

[39] Lowe P (2021*)*, *From Recovery to Expansion*. Australian Farm Institute Conference. Toowoomba – 17 June 2021.

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Source: Ellis L (2019), *Watching the Invisibles*. Freebairn Lecture in Public Policy, University of Melbourne – 12 June 2019, Reserve Bank of Australia.

Even as inflation has risen sharply in 2022, there is no evidence of a wage price spiral in Australia that could entrench it at a higher level.[40] While it is likely that demand as well as supply pressures are now contributing to the increase in inflation, it is not at all clear that it will *continue* to rise, as that would require much larger wage increases.

On the other hand, some experts believe that the breakdown of the historical relationship between unemployment and inflation means that a much sharper downturn, and a much larger increase in unemployment is now needed to contain inflation:

> '*monetary policy faces an unfavorable trade-off when attempting to stabilize inflation in response to cost-push shocks, due to an extremely flat Phillips curve. Lowering inflation requires a deep and protracted contraction, regardless of the policy strategy underlying the pursuit of this objective.'* (Del Negro M et al 2022, Disinflation Policies with a Flat Phillips Curve Liberty Street Economics, New York Federal Reserve Bank, March 2, 2022)

Regrettably, if central banks continue to raise interest rates aggressively this may well be the outcome *whether or not an unemployment rate around 3.5% is sustainable.*

The RBA should be required to explicitly balance these two often-conflicting objectives: reducing unemployment and keeping inflation low.[41] If the price of lowering inflation is a steep rise in unemployment, that risk should carefully assessed and explicitly taken into account.

Recommendation

Set a full employment target that is independent of the inflation target

2. **The full employment target should be set independently of the inflation target. It should be developed in consultation with experts and organisations representing unions, business, and civil society (including people directly affected by unemployment) as a combination of:**

    - **A labour underutilisation rate (the sum of unemployment and under-employment) below a threshold level; and**

    - **A ratio of workers who are 'underutilised' to job vacancies below a threshold level).**[42]

[40] Suthaharan N et al (2022), *Wage-price Dynamics in a High-inflation Environment*: The International Evidence. RBA Bulletin September 2022.

[41] Tulip P (2022), *Structural reform of the Reserve Bank of Australia*. Centre for Independent Studies. Sydney.

[42] In the post-war period of full employment, targets were set for both the level of unemployment and the ratio of people unemployed to job vacancies.

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4. Lift the inflation target

The 2-3% inflation target agreed between the RBA and successive governments is not sacrosanct. There are two good reasons to revise it upwards:

1. As interest rates decline towards zero, they are less effective in preventing recessions;
2. The interest rate increases required to reach a very low inflation target would trigger larger increases in unemployment than in the past.

4.1 As interest rates decline towards zero, they are less effective at preventing recessions.

The long-run decline in the 'neutral' interest rate has prompted new thinking on monetary policy.

As discussed in Part 2, after the GFC in 2008 the balance of economic risks shifted from too much inflation to the danger of deflation. This altered the thinking of governments and central banks on fiscal and monetary policy. Official interest rates were held at historically low levels.

When central banks subsequently reduced interest rates in response to the COVID recession, this amplified another emerging concern. Policy makers believed interest rates were close to their 'effective lower bound', below which lower interest rates would no longer stimulate demand for goods and services.[43] The effective lower bound is generally estimated to be close to 0%, the point at which savers would be *charged interest* instead of receiving it for risk-free investments such as deposit accounts:

One way to set a target for unemployment is to use unemployment rates at the end of the last period of full employment in the early 1970s. From 1969 to 1974 this was 3% (rounded up from 2.6%) and the average ratio of unemployed people per vacancy was 1:1 (rounded up from 0.8). Under-employment was not measured at that time (and was presumably very low as the vast majority of people in employment had fulltime jobs).

One way to set a target for underemployment is to multiply the unemployment rate target by the average ratio of unemployment to under-employment rates from 1999 to 2019 (the two decades before the pandemic) which was 1 (1.2 rounded down).

An underutilisation target based on the above calculations would be 6% (3% unemployment + 3% underemployment) and the target ratio of underutilisation to job vacancies would be 2:1 (1 person unemployed plus one person underemployed). This would be around one third lower that current levels of unemployment and underemployment. Currently, the unemployment rate is 3.5% and underemployment is 5.7% (so underutilisation is 9.2%), and the ratio of people who are 'underutilised' to vacancies is 3.4 (one person unemployed per vacancy plus 2.4 people underemployed per vacancy).

[43] See this explainer from the RBA.

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'Policymakers in advanced economies are confronting a different constellation of challenges today than those that dominated the canon of U.S. monetary policymaking over the previous half-century, which I refer to as the 'new normal.' A key feature of the new normal is that the neutral interest rate--the level of the federal funds rate that is consistent with the economy growing close to its potential rate, full employment, and stable inflation--appears to be much lower than it was in the decades prior to the crisis.

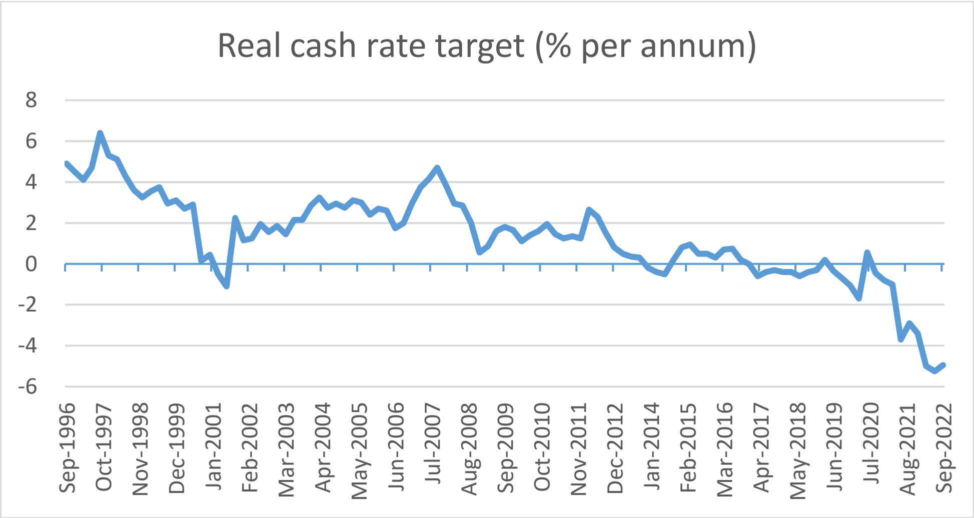
The low level of the neutral rate limits the amount of space available for cutting the federal funds rate to offset adverse developments and thereby can be expected to increase the frequency and duration of periods when the policy rate is constrained by the effective lower bound, unemployment is elevated, and inflation is below target. In this environment, frequent or extended periods of low inflation run the risk of pulling down private-sector inflation expectations, which could amplify the degree and persistence of shortfalls of inflation, thereby making future lower bound episodes even more challenging in terms of output and employment losses'. (Governor L Brainard (2017), *Rethinking Monetary Policy in a New Normal.* Rethinking Macroeconomic Policy conference, Peterson Institute. Washington, October 12, 2017.)

Notwithstanding recent increases in the RBAs cash rate target, the decline in interest rates towards the effective lower bound is a long-term trend.[44] Although the cash rate target remained just above zero (at 0.1%) during the COVID recession, if we adjust it for inflation it was already below zero (in real terms) before the pandemic (Figure 5).[45]

[44] Recent research suggests that the neutral *long-term* interest rate has been declining for centuries (Rogoff K et al (2022), Long-run trends in long-maturity real rates, NBER Working Paper 30475. Washington). One explanation for the decline in the neutral interest rate in recent decades is that household and business debt have increased exponentially since the 1980s, increasing their sensitivity to any increase in interest rates, so that growth can only be sustained by keeping interest rates low (Mian A et al 2018, *Indebted demand.* NBER Working Paper No 26940).

[45] Figure 5 adjusts the cash rate target for inflation since decisions to save, invest and spend are influenced by inflation as well as interest rates.

Figure 5: RBA Cash rate target, adjusted for inflation



Source: RBA*, Cash rate target;* ABS, *Consumer Price Index*.

In response to the COVID recession, the RBA switched to unconventional monetary policies rather than reduce interest rates below zero

During the COVID recession, the RBA responded to the 'new normal', and avoided imposing negative interest rates, by pursuing unconventional policies including purchase of government bonds and 'forward guidance' (that is, it announced that interest rates were unlikely to rise for years).

As employment and consumer demand recovered through 2021, the RBA saw an opportunity to achieve full employment with low inflation. Consistent with the more flexible approaches to inflation targeting adopted at the time in the US, it elected to wait for firm evidence that inflation had risen sustainably to its target band, rather than pre-emptively increasing interest rates [46]:

> *'the Board will not increase the cash rate until inflation is sustainably within the 2 to 3 per cent range….It is also relevant that Australia is within sight of a historic milestone – having the national unemployment rate below 4 per cent. This is important because low unemployment brings with it very real economic and social benefits for many Australians and their communities. Full employment is one of the RBA's legislated objectives and the Board is committed to playing its role in achieving that objective, consistent with also achieving the inflation target.'* (Governor Lowe 2022, *The year ahead,* Address to National Press Club of Australia. Sydney, 2 February 2022.)

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[46] US Federal Reserve Bank (2020), *Statement on Longer-Run Goals and Monetary Policy Strategy*. Washington, August 27, 2020.

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The RBA would have more scope to reduce interest rates in an economic downturn if the inflation target was 3-4% rather than 2-3%.

To stem the risk of deflation in future and make room for reductions in interest rates in the event of another downturn, experts including Professor John Quiggin advocate a modest increase in central bank inflation targets – for example to 4% in Australia.[47]

This is part of a shift in expert opinion in response to the 'new normal' in monetary policy referred to above. As long ago as 2010, officials at the IMF urged an increase in central bank inflation targets to around 4%, noting that if that target had been adopted in Japan, *'such a policy would have reduced Japan's output losses during the "Lost Decade" [of the 1990s] by half.'* (Leigh D 2010, '*A 4% inflation target?'* Centre for Economic Policy Research, London).

A slightly higher inflation target of 3-4% instead of 2-3% would still require the RBA to reduce inflation substantially from its current annual level of 7.3% (at September 2022). It would make little difference to inflation but would make a big difference to future levels of unemployment.

4.2 The interest rate increases required to reach the inflation target would come at a high cost in job losses

The RBA may struggle to reduce inflation to its target without a large increase in unemployment

Recalling our discussion in Part 3, the relationship between inflation and unemployment observed from the 1970s to the 1990s has broken down. On the one hand, this means that low unemployment is unlikely to have the inflationary impact assumed in the past since the risk of a wage-price spiral has dissipated. It is likely that unemployment would have been much lower over many years, without triggering a breakout in inflation, if interest rates were set at lower levels. [48]

Conversely, if we rely on increases in interest rates alone to bring inflation down to the RBAs target band, this is likely to trigger larger increases in unemployment than in the past. Reducing inflation to very low levels would come at a higher cost to employment. [49]

[47] Quiggin J (2022), *Memo RBA: we ought to live with inflation, more of it.* The Conversation, 7 June 2022; Krugman P (2018), *Credible Irresponsibility Revisited,* Seminar in Applied Economics, 11 March 2022. Stone Centre on Social and Economic Inequality. New York; Andrade P et al (2019), *The Optimal Inflation Target and the Natural Rate of Interest*. Brookings Papers on Economic Activity (Fall) pp173-255; Eberly J et al (2019), *The Federal Reserve's Current Framework for Monetary Policy: A Review and Assessment*. International Journal of Central Banking, February 2020.

[48] Gagnon J et al 2022, *25 Years of Excess Unemployment in Advanced Economies - Lessons for Monetary Policy*. Peterson Institute Working Paper No 22-17. Washington; Gross I & Leigh A (2022), op cit.

[49] Del Negro M et al 2022, op cit.

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A low inflation target forces the RBA to increase interest rates too aggressively to maintain credibility.

When central banks signal a shift in policy, for example to curb inflation, they rely on their store of credibility with financial markets, consumers, employers and workers to achieve their goal. For this reason, central banks have recently expressed their determination to get inflation down to target levels, *regardless of the consequences*.

In August 2022 - two weeks before the Australian government's Jobs and Skills Summit - the Chair of the US Federal Reserve Jay Powell signalled his determination to curb inflation in language similar that used by his predecessor Paul Volcker, whose aggressive interest rate increases triggered an international recession in 1982.[50]

The RBA is using more nuanced language to describe its present approach:

> *'the RBA will do what's necessary to make sure that the higher inflation does not become entrenched, and we are committed to returning inflation to the two to three per cent target range. And we're seeking to do this in a way that keeps the economy on an even keel. I think it is possible to achieve this, but the path here is a narrow one and it's clouded in uncertainty.' (Governor P Lowe, Statement to House of Representatives Standing Committee on Economics, 16 September 2022).*

Nevertheless, the latest round of increases in the RBAs cash rate target is the steepest since the 1980s, and this comes at a time when an international recession is increasingly likely. If the price to pay for restoring inflation to very low levels is too high, we should question whether the inflation target is the right one:

> *'When, some time next year, inflation gets down to 3 percent [in the US], there will be an intense discussion of whether it is worth slowing down activity further to get to 2 percent. The Fed may decide to state mission accomplished, and stay at 3 percent, if not forever, at least for a while.'* Blanchard O (2022), Inflation and unemployment. Where is the US economy heading over the next six months? Peterson Institute, 8 August 2022.

The current pace of interest rate increases puts restoration of full employment at risk

In Australia, where inflationary pressures are not as strong as in the US, it is possible that further increases in interest rates may bring inflation down to the RBAs target band without a recession, though as Governor Lowe indicates in the above quote '*the path is a narrow one and clouded in uncertainty'*.

In the October 2022 Budget, Treasury estimates that in 2023-24, inflation will fall to 3.5% (just above the target band) and unemployment will rise by one percentage point to 4.5% (Chalmers J & Gallagher K 2022, op cit). We estimate that in that event, 150,000 more

[50] Cranston M (2022), *Powell says Fed will 'keep at it until the job is done.'* Australian Financial review 27 August 2022.

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people would face unemployment, an increase of almost one third from the current level (which is 3.5% or 500,000 people).

The Budget Papers warn that the risks are on the downside and estimate that higher than expected inflation (and associated interest rate increases) or an international recession would trigger a downturn that lifts unemployment to around 5%. In that event, there would be around 225,000 more people unemployed – an increase of over 40% from the present level.

We should not accept a return to the high levels of unemployment that prevailed before the pandemic. This would crush hopes of a return to full employment, along with the hopes of the 750,000 people already struggling on unemployment payments for over a year.

Recommendation:

3. **The Reserve Bank's inflation target should be modestly increased, for example from 2-3% to 3-4%.**

5. Use fiscal as well as monetary policy to reduce unemployment and contain inflation

It is now widely accepted that fiscal policy (the government's taxation and expenditure decisions) has a major role to play in avoiding recessions, especially when interest rates are close to their effective lower bound.

If we are to achieve and sustain full employment, fiscal policy must play a much greater role in containing inflation and easing labour and skills shortages during economic booms.

While this is strictly speaking beyond the scope of the present review, it is not possible to consider major changes to the conduct of monetary policy without also examining the role of fiscal and regulatory policies in sustaining full employment with low inflation. These issues are discussed in more detail in our policy document for the Jobs and Skills Summit, and we briefly summarise them here.[51]

[51] ACOSS (2022), *Restoring full employment: Policies for the Jobs and Skills Summit*. Sydney.

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Having learnt from the mistakes of the early 1990s, governments were quick to use their spending and taxing powers to ease downturns in 2008 and 2020.

In Part 2 we described how the then Australian Government and RBA delayed action to stimulate growth in consumer demand and incomes in the recession of the early 1990s, and the high social and economic cost of that mistake.

In the GFC and the pandemic recession, governments acted quickly to restore growth by temporarily lifting the incomes of people with the least, supporting employers to keep their employees, and/or investing in infrastructure. These timely actions averted the increase in unemployment, business failures, financial hardship and personal and family stress that would otherwise have occurred.

One lesson from these economic stimulus policies is that the quickest way to boost consumer demand and prevent a rise in unemployment is to lift the lowest incomes. The income support system for people of working age plays a crucial role as an 'automatic stabiliser' to smooth growth in recessions and booms. Yet it is hampered in this role by the low level of payments for people affected by unemployment.[52]

The impact of the Coronavirus Supplement during the pandemic recession (which effectively doubled unemployment payments) demonstrates that unemployment and related payments would be much more effective in reducing poverty and easing or preventing recessions if those payments were adequate.[53]

Fiscal policy should also play a greater role in containing inflation in booms.

To restore and sustain full employment, we must rely more on fiscal policy, and less on increases in interest rates, to contain inflation during economic booms. That is especially so in the present circumstances, where the increase in inflation arose largely from blockages on the supply side (for example, higher fuel and energy costs due to war).

Further, where markets are clearly not functioning properly – for example where a lack of competition gives rise to large markups (taking advantage of high inflation to lift profits) or where prices in key sectors such as housing and energy are inflated by market distortions (such as ineffective regulation or tax incentives for speculative investment) – it is better for governments to fix the problem at its source rather than slow the entire economy and lift unemployment through interest rate increases.

In the 1960s during the era of full employment, the OECD urged wealthy nations to invest in what were then called 'manpower policies' to lift workforce participation, improve the employment prospects of people who had been overlooked by employers (such as people

[52] Jobseeker Payment is the lowest unemployment payment in the OECD, taking account of rent assistance (OECD *Benefits and Wages statistics)*.

[53] ACOSS & UNSW Sydney (2022), *Covid, poverty and inequality in 2020 and 2021*; ACOSS (2020), Deloitte Access Economics (2020), *Estimating the economic impacts of lowering current levels of income support payments*.

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with disability), and better match the skills of the workforce with the needs of industry. Australia under-invests in skills and in labour market assistance for people who are unemployed. To restore and sustain full employment, governments must lift investment in those programs and work closely with business, unions, and community organisations to match the right people with the right jobs.

An enduring collaboration between government, business, unions and civil society would also help strengthen commitment to full employment and the policies needed to maintain it.

Recommendations:

4. **In cooperation with the Reserve Bank, Governments should play a more active role to stabilise economic growth (easing the impact of booms and downturns) and entrench full employment with low inflation by:**
    - **Permanently increasing the size and effectiveness of 'automatic economic stabilisers', especially unemployment and related income support payments;**
    - **Providing additional payments to people on low incomes and timely public investment during downturns, as required;**
    - **Targeted and timely adjustments to regulation, public investment and tax settings to contain excessive price increases in goods, services and financial markets during economic booms, as required (for example, removing blockages in critical supply chains, and intervening in energy markets to curb excessive price increases and speed the transition to renewables);**
    - **Stronger regulation of competition, including tighter controls over mergers and takeovers and ongoing monitoring of mark-ups in sectors dominated by a small number of businesses;**
    - **Incomes policies that support steady and predictable growth in real incomes, including wages and social security payments, consistent with improvements in productivity;**
    - **Workforce planning and skills development policies to prevent labour and skills shortages in a full employment economy;**
    - **Policies to strengthen paid workforce participation and improve equity in employment (especially gender equity), including improved income support for people out of paid work, investment in programs to reduce prolonged unemployment, investment in quality affordable childcare, pay equity for women and people with disability, combatting discrimination in employment, and improvements in job quality and security (especially in entry-level jobs and care services).**
5. **A more active role for Governments in supporting full employment with low inflation should be supported by institutional changes, including:**
    - **A permanent advisory council to Government (with an independent secretariat) that draws expertise across key stakeholders including**

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business, unions, civil society organisations and academic experts, to advise on policies to achieve full employment with low inflation and help secure cross-sector support for those policies.

- **Time-limited Expert Commissions to report to the advisory council on policies to overcome major barriers to full employment with low inflation.**

6. Contain inflation in asset prices through tax reform and financial regulation.

The Review is considering policies to improve macroprudential regulation to ensure financial stability. We argue in this Part that excessive borrowing, excessively risky and inefficient investment, and asset price inflation pose risks to macroeconomic stability as well as financial stability, by entrenching higher inflation in booms and prolonging economic downturns.

Using the blunt instrument of interest rate increases to 'lean against' speculative investment and inflation in asset prices is not the solution to these problems. Tighter prudential supervision helps, but in addition tax arrangements that distort borrowing and investment decisions should be reformed and the RBA should have powers to direct financial regulators (APRA and ASIC) to restrict access to credit in exceptional circumstances where financial or macroeconomic stability is at risk.

Household debt and housing prices in Australia are high by international standards

Australia's housing prices have grown much more rapidly than Gross Domestic Product (GDP) and household incomes, putting people under financial pressure and undermining financial stability. A related problem is the level of household debt, which is among the highest in the OECD (Figure 6). These developments undermine financial stability and amplify economic booms and downturns.[54]

[54] Maclennan D et al (2021), *Housing in the economy: Scale, cycles and stability*. UNSW City Futures Research Centre. Sydney;

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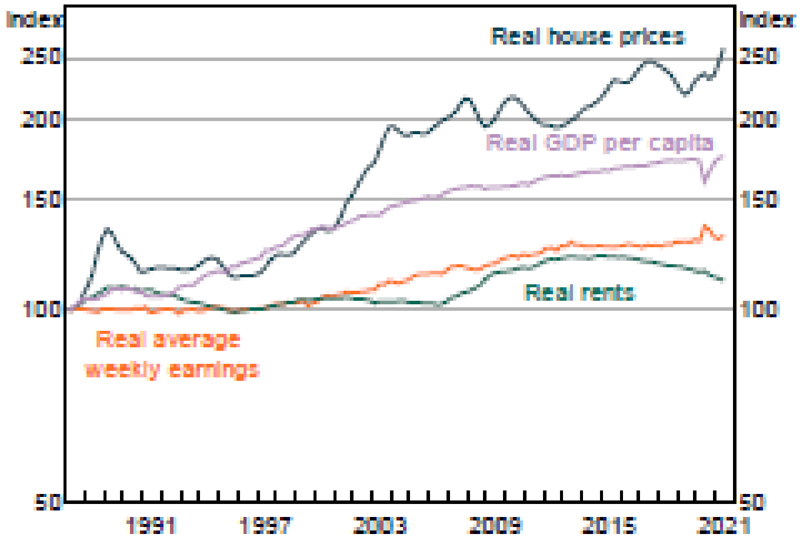
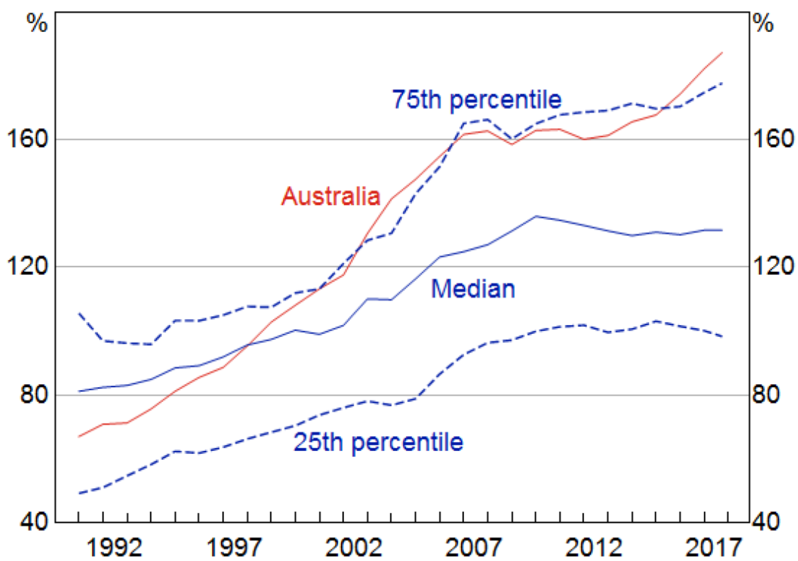
Figure 6(a): Growth in house prices, incomes and GDP (after inflation)



(b) Household debt to income ratios in wealthy nations



Sources: Reserve Bank of Australia (2021) *Submission to the inquiry into housing affordability and supply in Australia, September 2021*; Bullock, M. (2018), *The Evolution of Household Sector Risks*, Speech at AiGroup, Albury, September 10 2018. Reserve Bank of Australia.

Excessive borrowing and speculative investment during booms pose serious risks to financial and macroeconomic stability.

Inflation in housing and other asset prices and increases in household and business borrowing are broadly pro-cyclical: asset prices and credit to purchase assets tend to increase in booms and contract in downturns. This is part of the normal functioning of investment and credit markets, which contributes to Australia's economic development

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where people borrow prudently and invest wisely. However, excessive borrowing and speculative investment is also common, especially in booms. This can cause enduring harm by lifting inflation in booms, destabilising financial institutions, and prolonging economic downturns. If interest rates are low for a prolonged period and the economy is booming, asset price 'bubbles' may emerge. Dealing with these events is a long-standing challenge for policy makers. [55]

In Australia, over-investment in housing and the related rise of household debt are the main underlying sources of these vulnerabilities.[56]

Higher interest rates are not the best solution to excessive debt or asset price bubbles: tax reform and prudential controls should play a greater role.

When interest rates have been low for some time, increasing them can curb these excesses, but as the experience of the late 1980s shows high interest rates are too blunt an instrument to do this job without putting jobs and incomes at risk across the economy. [57]

> *'Other important issues include those regarding the interaction of monetary, fiscal and prudential policies in dealing with asset price bubbles, both on the way up and on the way down. Monetary policy is not the only policy that can moderate asset price bubbles - and in many situations may not be the most effective or the most precise.*
>
> *Fiscal authorities, for example, can use tax policies to deal with the distortions that asset price bubbles create for consumption and investment decisions. And it may be important for fiscal authorities to fight the temptation to adopt procyclical spending patterns that may accompany transitory changes in revenues due to bubbles. Prudential authorities can also play a key role by being vigilant about future vulnerabilities in the financial sector if an asset price bubble were to burst.*
>
> *As history has shown, the collapse of credit in the aftermath of a deflated asset price bubble can create a vicious downward economic spiral. Such a possibility puts a premium on prompt corrective prudential actions to remove impediments to a*

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[55] Richards A et al (2003), *Asset prices and monetary policy. Conference proceedings*, Reserve Bank of Australia Sydney, 18–19 August 2003; AHURI, Melbourne; Bullock, M. (2018) *The Evolution of Household Sector Risks*, Speech at Ai Group, Albury, September 10 2018. Reserve Bank of Australia.

[56] Maclennan D et al (2021), *Housing in the economy: Scale, cycles and stability*. UNSW City Futures Research Centre. Sydney; Yates J et al (2018), *Housing prices, household debt and household consumption*.

[57] Blundell-Wignall A & Bullock M (1992), *Changes in the characteristics of the Australian business cycle – some lessons for monetary policy from the 1980s and early 1990s*. Reserve Bank of Australia Research Discussion Paper No 9212; Saunders B & Tulip P (2019), *Cost-benefit Analysis of Leaning against the Wind*. Reserve Bank of Australia Research Discussion Paper 2019-05. Sydney; Selody J & Wilkins C (2004), *Asset Prices and Monetary Policy: A Canadian Perspective on the Issues.* Bank of Canada Review, Autumn 2004.

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financial system.' (Filardo A 2004, *Monetary policy and asset price bubbles: calibrating the monetary policy* trade-offs. BIS Working Papers, No 155).

The tax reforms required to curb speculative debt-financed investment in housing and other assets that appreciate (such as shares) are well known:

- The concessional tax treatment of capital gains compared with other investment incomes (a 50% reduction in tax) encourages speculative investment in those assets rather than more economically productive purposes.
- In addition, investors can deduct related expenses (mainly the interest on borrowings) annually from their non-investment income (mainly wages), even though income from the investment (mainly capital gains) may only be brought to tax many years later when the asset is sold (a practice known as 'negative gearing').
- Over the long-term, the under-taxation of land in Australia encourages over-investment in housing and contributes to the high prices we have to pay for it. Stamp Duties for the purchase of dwellings, an inefficient tax that reduces mobility, should be progressively replaced by a broad-based tax on land. [58]

The RBAs role in macroprudential management should be strengthened.

Macroprudential regulation, which is mainly undertaken by the Australian Prudential Regulation Authority (APRA), can help reduce excessive borrowing and excessively risky investment by requiring financial institutions to hold adequate capital reserves and properly assess risk when they lend money or offer investments. However, tighter prudential regulation alone is not the solution to these problems:

- Not all financial institutions and large-scale transactions are regulated (for example APRA lacks jurisdiction over private equity firms and the burgeoning cryptocurrency market is hardly regulated at all);
- The objectives of prudential regulation - the *'financial safety of institutions and the stability of the Australian financial system'* - are different to the macroeconomic management goals of reining in excessive debt and containing potentially harmful inflation in asset prices (though of course prudential regulation can contribute to those goals);[59]
- As discussed, improved prudential controls are not the solution to distortions in investment markets such as tax incentives for speculative investment in housing.

The RBA should have reserve powers to restrict excessive borrowing and speculative investment in exceptional circumstances, for example where an asset price bubble is triggering an increase in inflation that would otherwise require monetary policy action.

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[58] ACOSS (2022), *Budget priorities statement*. Sydney.

[59] Australian Prudential regulation Authority (2022), *APRA's Policy Priorities*.

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These interventions would be more nuanced and targeted than the blunt application of higher interest rates.

In 2014, when the housing market was overheating, APRA tightened access to credit, especially for investment properties. This intervention was effective in curbing speculative investment over the following years. While it was coordinated with the RBA as chair of the Council of Financial Regulators, it arguably took APRA beyond its formal prudential regulation role. The RBA is the more appropriate agency to oversee interventions in credit markets in exceptional circumstances such as *when macroeconomic stability is threatened as well as financial stability*, but it lacks direct powers to perform this role:

> *'The RBA does not, however, have any specific tools that it can use to deal with financial stability issues, though in stress periods it can provide liquidity to solvent institutions. While its monetary policy framework provides the RBA with the flexibility to set policy to achieve its broad objectives over time, including financial stability, addressing systemic risk typically involves identifying and communicating risks and working with other financial regulators to address them.'* (Bullock M & Orsmond D 2018, 'House Prices and Financial Stability: An Australian Perspective', in 'Hot Property The Housing Market in Major Cities.' Springer).

Recommendations:

6. **To help contain inflation, sustain full employment and improve housing affordability, tax distortions that encourage speculative, debt financed investment in assets yielding capital gains should be removed by:**
   - **Increasing Capital Gains Tax rates (across the board, not only for housing);**
   - **Quarantining deductions for expenses associated with investments yielding capital gains to offset income derived from those investments (restricting 'negative gearing').**
   - **Progressively replacing Stamp Duties for the purchase of dwellings with broad-based Land Taxes (including owner-occupied dwellings).**
7. **Gaps in prudential and consumer protection regulation of financial institutions and transactions should be closed, especially the regulation of financial products and transactions offered by organisations other than Authorised Deposit-taking Institutions (banks), insurers and superannuation funds.**
8. **Pursuant to its macroeconomic and financial stabilisation roles, the Reserve Bank should have powers in exceptional circumstances to direct APRA to constrain excessive borrowing for investment in appreciating assets such as housing.**

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7. Strengthen the diversity of knowledge and expertise on the RBA Board

The quality of monetary policy decision-making on the RBA Board would be enhanced if it included people drawn from more diverse sources of expertise, including the union movement and community organisations with knowledge of the impact of public policies on people who are economically vulnerable.

Recommendation:

9. **The Reserve Bank Act should specify that its Board is appointed from suitable candidates drawn from people with relevant economic expertise and a wider range of backgrounds and perspectives including people drawn from unions and civil society as well as business backgrounds.**

Acknowledgements

In preparing this submission, ACOSS consulted with members of its Income Support and Employment Policy Network and received helpful advice from Professor John Quiggin at the University of Queensland.

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