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Keynes's Influence on the Design of the Australian Monetary Policy Framework

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Australia and Financial Inquiries

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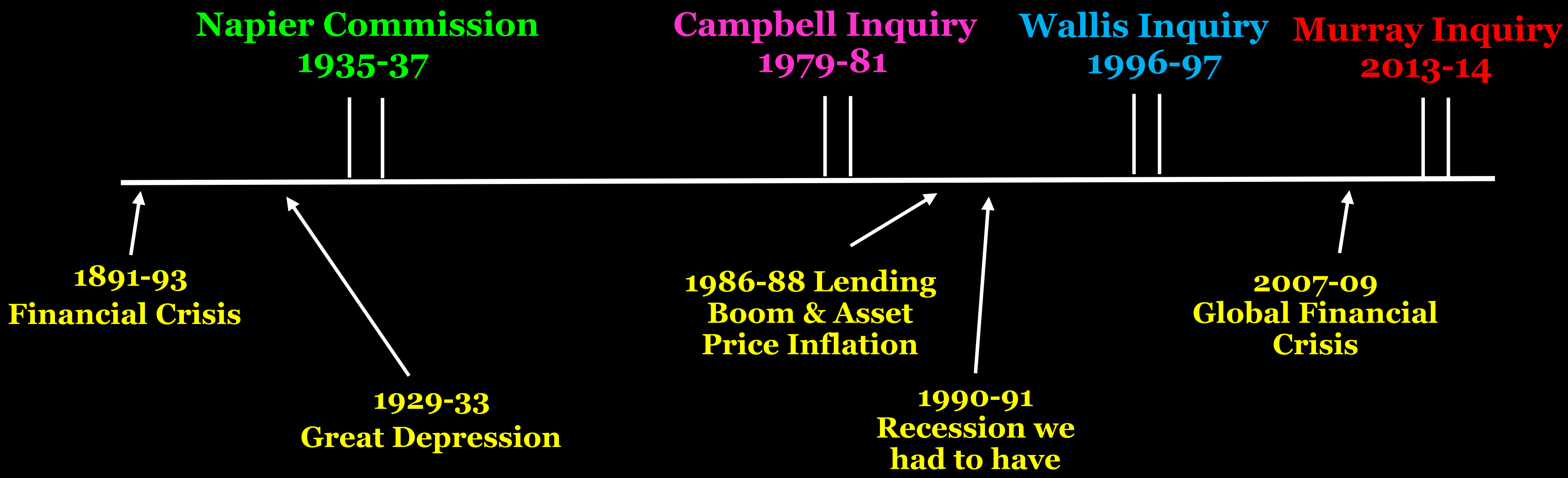
- Earliest was **Napier Royal Commission, 1935-37** which is often credited with recommending framework for **Australian monetary policy,** Lewis (1998).
- But evidence that objectives of this framework were **macro-prudential** in nature.
- This raises the question as to the **intellectual influences** on Napier – and a clear influence is from Keynes: *Treatise* and *General Theory*.
- This in turn raises question: was **macro-prudential regulation present in the work of Keynes?**

Australian Inquiries and Episodes of Financial Instability



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Nature of Macro-prudential Regulation

- Traditional **prudential regulation** aims to reduce exposure to excessive risk in the structure of **individual banks** (Mishkin 2001).
- **Macroeconomic policy** aims to affect conditions, including monetary conditions, to alter AD and thus output, employment and inflation.
- These two dimensions of policy, however, **interact**: macro conditions can affect bank viability; and ensuring banks are healthy can limit credit and thus AD and output.
- **Macro-prudential regulation** explicitly recognizes and exploits this interaction. It uses traditional prudential tools to influence macroeconomic conditions that have a feedback effect to multiple banks.
- **But** macro-prudential regulation ≠ ***all cases*** of macroeconomic-bank viability interaction.

Cycles within the Conceptual Structure of the *Treatise*

- Theoretical centre of the *Treatise* is made up of the **Fundamental Equations**.
- Prices depend on costs of production and the difference between **investment and saving**.
- Monetary framework is built around a **money supply multiplier model**.
- **Cycles** may be driven by monetary or real disturbances but **real** disturbances to equilibrium are **inherently cyclical**.
- Cycles have **real effects** in the short run.
- Typical cycles involve real-monetary **interaction**: $\uparrow$ Fin Exps $\rightarrow \uparrow$ Ps $\rightarrow \uparrow$ I $\rightarrow$ I-S>0 $\rightarrow \uparrow$P $\rightarrow \uparrow \pi \rightarrow \uparrow$ Y.

Propositions bearing on Macro-prudential regulation in the *Treatise*

i. Credit cycles require **monetary accommodation** by the banks.
ii. Monetary instrument adjustment should (conditionally) address **asset price booms**.
iii. Bank **reserve ratios** are **prudential** instruments.
iv. There is a difference between **individual** bank safety and **systemic** stability.
v. The central bank should target **systemic stability** with monetary instruments.
vi. Reserve ratios should be **varied** to promote systemic stability.

(iv) Keynes distinguished between individual bank safety and systemic stability.

So long as *the proportion of cash reserves which the member banks* are expected to maintain is determined solely by what they need for *their own safety and convenience*, there is much to be said for the traditional British practice of leaving it to the banks to decide for themselves what the appropriate figure is - especially when a stage has been reached, as is now the case in Great Britain, when mushroom banking is extinct. But as soon as further considerations are considered relevant-considerations, such as the above, affecting *the safety and efficiency of the banking system as a whole* rather than the interests of individual banks – it is not so clear that this is the best plan.

(*Treatise*, Vol. II, p.63)

Cycles in *The General Theory*

- Theoretical centre of the *General Theory (of course)* is the **Principle of Effective Demand,** consumption function, MEC, & liquidity preference theory of interest.
- **Cycles** are driven principally by:
  - variations in MEC for a given interest rate (Keynes 1936, pp.313, 315);
  - the pattern of over-optimism and correction in the "state of long term expectation" (Keynes 1936, p.315 ff); and
  - the separation of ownership and control in modern financial markets (Keynes 1936, p.154);
  - an "over-bought" market that raises asset prices.
- Keynes skeptical about **monetary policy** to fight depression.
- Keynes advocates greater proportion of **public investment** to stabilize output.

Propositions bearing on Macro-prudential regulation in *The General Theory*

a) The **principle weapon** for fighting a slump and also reducing fluctuations generally, is a greater role for **public investment**.

b) Tighter **monetary policy**, in the form of raised interest rates, should **not** be used to dampen **asset booms** as an alternative to greater public investment.

c) Tighter monetary policy, in the form of raised interest rates, might well be used to dampen asset booms **if** the alternative of greater public investment is not available.

(b) Keynes rejects tight monetary policy and thus macro-prudential measures.

Thus the remedy for the boom is **not a higher rate of interest** but a lower rate of interest! For that may enable the so-called boom to last. The right remedy for the trade cycle is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom.

(*General Theory*, p.322)

Preliminary Conclusions

- In the *Treatise*, Keynes **advocates** the active use of prudential instruments (bank reserve ratios) to address a macro phenomenon with the potential to feedback on bank viability (asset booms);
- In *The General Theory*, Keynes **does not advocate** such measures, principally because he offers an **alternative measure** of stabilizing output and anchoring the state of long term expectation with a greater proportion of public investment in aggregate demand.
- **Puzzle**: if the *Treatise had* contained macro-prudential measures, why in the **absence** of the *General Theory's* alternative of public investment does Keynes focus on monetary policy and not macro-prudential policy?

Additional Textual Evidence

Napier saw credit expansion as necessary for instability.

"Along with other parts of the system, the trading banks must bear some of the responsibility for the extent of the depression. *In the more prosperous times* preceding the depression, *they went with the tide and expanded credit*. There was no central bank to guide their policy, but, even in its absence, the banks might have taken concerted action which would have helped to check the boom, and thereby have lessened the extent of the depression."

(Final Report, 1937, para. 565, p.218)

(i) Keynes argued that credit cycles require monetary accommodation by the banks.

It is to be noticed that expansions of types (ii) and (iii) cannot come about without a substantial change in the monetary situation, since they involve an increase in aggregate earnings as well as in profits. *Thus it requires the acquiescence of the banking authorities*; though if the banks have got into the habit of concentrating their attention on the volume of the total deposits to the exclusion of other factors, the monetary adjustment may come about without arousing their notice. For an increased volume of money may be furnished for the industrial circulation as the result of a decrease of the financial circulation, i.e. of the savings deposits, since it is particularly likely that in the earliest phases of a boom there will be unanimity of bull sentiment leading to a decrease of the 'bear' position.

(*Treatise*, Vol. I, p.256)

(ii) Keynes argued that monetary policy should conditionally address asset price booms.

"I should say, therefore, that *a currency authority has no direct concern with the level of value of existing securities*, as determined by opinion, but that it has an important *indirect concern if the level of value of existing securities is calculated to stimulate new investment to outrun saving*, or contrariwise. For example, a boom in land values or a revaluation of the equities of monopolies, entirely dissociated from any excessive stimulus to new investment, should not divert a currency authority from keeping the terms of lending and the total supply of money at such a level as to leave over, after satisfying the financial circulation, the optimum amount for the industrial circulation . . . *The main criterion for interference with a 'bull' or a 'bear' market should be, that is to say, the probable reaction of this financial situation on the prospective equilibrium between savings and new investment*.

(*Treatise*, Vol. I, p.230)

(iii) Keynes regarded bank reserve ratios as prudential instruments.

In Great Britain *the reserve ratio to be maintained by the banks* has never been fixed by law. During the earlier period of English joint stock banking it was left to the banks themselves to keep such amount as was dictated to them by considerations of *prudence and of convenience*; and since the amount so kept was never published except in half-yearly balance sheets which bore little relation to the normal position, there was no motive for them to keep more. In February 1891, however, Mr Goschen, the Chancellor of the Exchequer (as he then was), made his celebrated speech at Leeds, in which he took advantage of the uneasiness ensuing on the Baring crisis of the previous year and its attendant circumstances, to argue that the *amount of reserves which the banks were in the habit of keeping was insufficient for the safety of the system*.

(*Treatise*, Vol. II, p.61)

(iv) Keynes distinguished between individual bank safety and systemic stability.

So long as *the proportion of cash reserves which the member banks* are expected to maintain is determined solely by what they need for *their own safety and convenience*, there is much to be said for the traditional British practice of leaving it to the banks to decide for themselves what the appropriate figure is - especially when a stage has been reached, as is now the case in Great Britain, when mushroom banking is extinct. But as soon as further considerations are considered relevant-considerations, such as the above, affecting *the safety and efficiency of the banking system as a whole* rather than the interests of individual banks – it is not so clear that this is the best plan.

(*Treatise*, Vol. II, p.63)

(v) Keynes argued that the central bank should target systemic stability with monetary instruments.

The first necessity of a central bank, charged with the responsibility for the *management of the monetary system as a whole*, is to make sure that it has *unchallengeable control over the total volume of bank money created by its member banks*. We have seen in chapters 2 and 25 that the latter is determined, either rigidly or within certain defined limits, by the amount of the member banks' reserve resources.

(*Treatise*, Vol. II, p.201)

(vi) Keynes thought that reserve ratios should be varied to promote systemic stability.

The possibility of an inadequacy of ammunition interfering in exceptional circumstances with the efficacy of open market operations makes it worth while to mention a further expedient which has never yet been put into practice, namely, *a discretion to the central bank to vary with due notice and by small degrees the proportion of legal reserves which the member banks are required to hold*.

(*Treatise*, Vol. II, pp.232-3)

(b) Keynes rejects tight monetary policy and thus macro-prudential measures.

Thus the remedy for the boom is **not a higher rate of interest** but a lower rate of interest! For that may enable the so-called boom to last. The right remedy for the trade cycle is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom.

(*General Theory*, p.322)

(c) . . . unless "major changes of policy" cannot be affected.

If we rule out major changes of policy affecting either the control of investment or the propensity to consume, and assume, broadly speaking, a continuance of the existing state of affairs, it is, I think, arguable that **a more advantageous average state of expectation might result from a banking policy which always nipped in the bud an incipient boom** by a rate of interest high enough to deter even the most misguided optimists.

(*General Theory*, p.327)