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History and the Development of Central Banking in Australia 1920-1970

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Introduction

Writing devoted to explaining the development of central banking in Australia has often attached special significance to contemporary events and problems. L.F. Giblin, for example, who was both a practitioner and historian of central banking, asserted that 'The story of the development of central banking in Australia must be set against the contemporary political and economic background.' (Giblin 1951: vii) H.C. Coombs, the first Governor of the Reserve Bank of Australia (RBA) and the last Governor of the Commonwealth Bank, argued that 'a central bank cannot be created merely by legislative fiat. It must grow like a living organism within the environment provided by the financial and economic system in which it exists; its practices and structure must evolve in response to the needs and demands of that system.' (Giblin 1951: v) A recent Governor of the RBA, Ian Macfarlane, has endorsed this view: 'Looking back at the evolution of monetary and financial affairs over the past century', he said in his 2006 Boyer Lectures, 'shows that all policy frameworks have had to be adjusted when they failed to cope with the emergence of a major problem…The lightly regulated framework in the first two decades of the twentieth century was discredited by the Depression and replaced by a heavily regulated one accompanied by discretionary fiscal and monetary policy. This in turn was discredited by the great inflation of the 1970s and was replaced by another lightly regulated one'. (Macfarlane 2006:114)

Macfarlane dismissed the view that ideas or ideology had played a dominant role in the transformation of central banking in Australia. About the origins of the reforms to monetary policy and the operation of the RBA over the past quarter of a century, Macfarlane concluded that:

> It is sometimes claimed by opponents of these reforms that they were implemented because policy-makers were enraptured by the idea of the free market and so embraced the concept of laissez-faire. This may be true for a few, but for most I think the process was much more prosaic than this, at least in the macroeconomic sphere. I think politicians and economic bureaucrats came to realize that the process of setting key financial prices, such as interest rates on government bonds, lending rates by banks or the exchange rate, was not working. It was just too difficult to do it properly, and if you got it wrong, as you inevitably would, the consequences could be painful – for example, trying to defend an over-valued fixed exchange rate. (Macfarlane 2002: 45)

This paper highlights the development of central banking in Australia from 1920 to 1970. It emphasizes the importance of historical circumstances as determinants of the progress of central banking and the pivotal contributions of six men: Sir John Garvan (member of the Australian Notes Board and first chairman of the board of the Commonwealth Bank); E.G. Theodore (Treasurer of Australia); Sir Robert Gibson (the second chairman of the Commonwealth Bank board); Sir Leslie Melville (the Commonwealth Bank's first Economist); J.B. Chifley (Treasurer and Prime Minister of Australia); and H.C. Coombs.

The paper argues that their responses to contemporary issues and problems led to fundamental changes in the nature and governance of central banking in Australia.

Though the idea that a national bank should be created in the Australian colonies was canvassed on several occasions from the mid-nineteenth century, interest was heightened in the 1890s as a result of the severe financial and banking collapse in the early years of that decade. The Australian Labor Party (ALP), formed in the same decade, and owing its origins to the economic and industrial turmoil experienced at the turn of the 1890s, took up the idea that a people's bank should be formed to provide the Australian public with a more secure and less expensive supply of financial services than those provided by privately-owned banks. Also floated in Labor circles was the need for a central bank to avoid another banking collapse. At national conferences during the first decade after Federation, the ALP debated the possibility of creating a government-owned institution that would combine the functions of commercial and central banking. In 1908 the party wrote into its fighting platform a pledge to establish 'A Commonwealth Bank', which would serve as a bank of issue, deposit, exchange and reserve; in short, a composite commercial and central bank that would accept deposits from the public, would be responsible for the national note issue, the reserves of the banking system, the payment system and would re-discount acceptable bank securities.

In 1911 the labor government of Andrew Fisher introduced legislation to establish a national bank, to be called the Commonwealth Bank of Australia, a government-owned trading bank with a savings bank component. Contrary to the expectation that such a bank would be given central banking responsibilities, Fisher made it clear that the Commonwealth Bank would simply be a commercial bank, having the 'power to carry on the general business of banking'. 'Time and experience', he added, 'will show how its functions for usefulness may be extended.' (Fisher 1911: 2944, 2646) Here, Fisher was alluding perhaps to the possibility that the Commonwealth Bank might evolve into a central bank once it had established itself as a successful business enterprise. However, when he was asked whether it was intended that the Bank would have its headquarters in the proposed seat of government, Fisher replied that he was 'not of that opinion. This is a business concern pure and simple.' As it was, the Commonwealth Bank's only central banking function at the time of its creation was that of banker to the Commonwealth government, with an expectation that state governments would transfer their banking business to the Commonwealth Bank. It was not given responsibility for the note issue; that task had been assigned to the Commonwealth Treasury by the Notes Act of 1910.

Thereafter the Bank gradually acquired central banking functions. The First World War saw it heavily involved in managing the Commonwealth government's debt when the government began to borrow locally and overseas for the first time. It was also associated with various marketing arrangements undertaken by the government to overcome difficulties arising from the disruption to international trade in the country's traditional export products. Even though it had engaged in these national activities during the war, by the end of the war the Bank remained primarily a savings and trading bank.

Garvan and the Return to Gold

The first legislative attempt to create a central bank in Australia took place in 1924 when the government amended the Commonwealth Bank Act with the express purpose of establishing a central bank. This decision was the result of a series of historical events that culminated in the formulation of a monetary policy aimed at returning Australia to the gold standard. When the Commonwealth Bank was established in 1911, Australia adhered to the gold standard. This had been the case since the late 1850s. Before then, the rate of exchange between Australian currency and international currency (sterling in particular) had fluctuated, there being no fixed standard of exchange. But as a result of the gold discoveries in the 1850s and the accumulation of sizeable gold and sterling assets in London, the Australian banks were able to maintain a fixed rate of exchange at parity (£A100=£stg100) between Australian currency and sterling. From the second half of the nineteenth century to the early years of the twentieth century the exchange rate rarely departed from parity with sterling. Even during the depression of the 1890s, exchange with sterling remained within the gold points. External balance was maintained at that time by depressed activity and mass unemployment.

During the First World War the promise to redeem gold for Australian notes at the conventional fixed rate was suspended and an embargo placed upon the export of gold from Australia. Here, Australia was following Britain and other countries associated with the British Empire. Federal government spending on war and war-related activities expanded considerably and various devices were used to fund the expenditure. These financial arrangements added to inflationary pressures, made worse by a chronic shortage of resources, labour in particular. As a result, Australian prices rose at record rates, though not as fast as price inflation in the United Kingdom, but faster than in the United States. (Cornish 1988)

At the end of the war the British monetary authorities signaled their intention to return to the gold standard at the prewar parity with gold (and with the United States dollar, which had not departed from gold). Since British prices had increased more rapidly than American prices, Britain's return to the gold standard had to wait until the US-UK price level was restored roughly to the relationship that had prevailed between the two currencies before the war. Either prices in the United States would have to increase, or British prices would have to fall, or some combination of these outcomes would have to take place if monetary stability was to prevail in Britain. Since there could be no certainty that prices in the United States would rise, the authorities concluded that monetary tightening would have to be adopted in Britain so as to deflate prices there, or at the least to moderate any tendency for prices to rise. In Australia, some authorities began to demand restraint in government expenditure and slower monetary growth. A Commonwealth Royal Commission at the end of the war, chaired by Sir Robert Gibson, urged the federal government to reduce its spending with the intention of curbing inflation.

In these circumstances, the spotlight began to focus on government policy regarding the issuing of currency. The Governor of the Commonwealth Bank, Sir Denison Miller, had argued for some time that responsibility for the note issue should be transferred from the

Commonwealth Treasury to the Commonwealth Bank. This was because there was more expertise on monetary questions in the Bank than in the Treasury, and because the Bank had branches throughout the Commonwealth, whereas the Treasury had a single office – then in Melbourne. There can be little doubt that Miller also believed that control of the note issue was something for which a central bank should have responsibility, not a government department, which could too easily succumb to political pressure. Miller made several representations to the government along these lines, and actually drafted legislation providing for the transfer of the note issue from the Treasury to the Bank. The question of the excessive war-time supply of notes was now raised in the context of postwar monetary policy and the need for greater circumspection in the funding of government expenditure from an inflated supply of currency. This concern about the note issue, according to Miller, was a fundamental reason why the note-issuing authority should be transferred from the government-controlled Treasury to the more independent Commonwealth Bank.

When it created the Australian Notes Board (the ANB) in 1920, the government acceded in part to Miller's request to have responsibility for the note issue transferred to the Bank. The administration of the note issue was to be undertaken in a separate department of the Commonwealth Bank, but the ANB itself was to have its own board of four directors with the Bank's Governor as chairman *ex officio*. Once established, the ANB proceeded to adopt a policy, promoted in particular by one of its members, John. J. Garvan, a Sydney businessman, to contract the note issue, the aim being to reduce domestic price levels. The ultimate objective was to raise the existing devalued rate of exchange between the Australian pound and gold, thereby returning Australia to the gold standard at the prewar parity with gold. In the result, the ANB was highly successful in achieving its aim. By 1924 sterling had fallen to less than £A97 = £stg100 in the bank-dominated 'official' exchange market; in outside markets, dominated by non-banking institutions, the value of sterling against the Australian pound fell considerably further than it did in the 'official' market.

The technique adopted by the ANB was to refuse to exchange currency notes in Australia for gold and sterling accumulated in London by Australian banks from export proceeds and loan receipts. In this way it was expected that the money supply in Australia would decline. Refusing to exchange Australian notes for sterling in London was admittedly a crude procedure and the banks for a time were able to circumvent the ANB's intention by running down their domestic reserves of currency. But there were plainly limits to which the banks' cash reserves could fall. Having reached the minimum level, the banks were then forced to reduce their lending; activity contracted, prices eased and the exchange rate rose.

The ANB believed a reduction in the money supply arising from restrictions on the issuing of currency would lower domestic prices which, in turn, would raise the Australian exchange rate. Monetary contraction occurred as a result of refusing to exchange notes in Australia for assets in London. Particularly affected was the farm sector, whose export receipts were accumulating in London. Tightness in money markets in Australia meant there was difficulty transferring income from London to Australia.

Some relief arrived when gold was transferred from New York to Australia (there was an embargo on the export of gold from London), but the expansionary impact of the inflow of gold was nullified to some extent as a result of sterilization measures adopted by the monetary authorities. By deliberately selling government securities to mop up the monetary expansion arising from imported gold, the first open market operations in Australia's monetary history were performed.

This was the background to the amendments to the Commonwealth Bank Act passed in 1924. Earle Page, the Treasurer and Leader of the Country Party, aimed to end the monetary contraction, which was hurting his rural constituents, by abolishing the ANB and providing the Bank with responsibility for the note issue. A board of directors was created for the Commonwealth Bank, with members appointed from various sectors of Australian industry, including farm industries. The expectation was that such a board would be more accommodating than the ANB had been to the plight of exporters and farm communities. The government's intentions were soon dashed, however, when it appointed Garvan, the chief architect of the ANB's policy, to the new Board; the board itself then promptly elected Garvan to be its chairman. Therefore, very little changed, with Garvan reaffirming his belief that Australia should return to the gold standard as soon as possible, and insisting that a tight domestic monetary policy – based on limiting the issue of currency notes – should continue to be pursued in order to exert downward pressure upon local price levels.

By the early months of 1925 the Australian pound had reached the pre-war parity with gold and the United States dollar; as a result, Australia was ready to announce its return to the gold standard. Within the British Empire, South Africa had already returned to gold, as had some European countries. However the British government, acting upon advice from the Bank of England, persuaded Prime Minister Bruce to wait until Britain had made its decision to return to gold which, Australia was assured, would happen in the not too distant future. In his Budget speech on 28 April 1925, the Chancellor of the Exchequer, Winston Churchill, announced that Britain would immediately return to gold at the prewar parity. As a result of Britain's decision, Australia also returned to the gold standard. In his budget speech to the House of Commons, Churchill explained that the imminent return to the gold standard by some Empire countries, including Australia, was a major factor behind Britain's decision to return to gold.

The policy of monetary contraction, prosecuted at first by the ANB, and then by the board of the Commonwealth Bank, was the first conscious attempt at central banking in Australia. Open market operations were used for the first time, and the amendments to the Commonwealth Bank Act in 1924, motivated by concerns about the policy approach of the ANB, constituted the first explicit attempt to convert the Commonwealth Bank to a central bank. Page stated as much when he supported the amendments in his second reading speech to the parliament. Referring to the exchange rate problems that had plagued Australia since the end of the war, he remarked: 'In troubles such as these, one would naturally look to banking authorities to find a way out or at least to advise as to the remedies to be applied. But in fact there is no banking body which can be considered representative. Instead, we have a number of banks which, though loosely associated for some purposes, scarcely can express a corporate opinion. Chiefly mindful of their own interests, which is but natural, they can have no such regard for the public welfare as is undoubtedly required.' (Page 1924: 1265) It was Page's view that the 'important functions of banking can properly be performed only with guidance and control of a central bank.'

Theodore and the Central Reserve Bank

The government's aim in 1924 was to re-create the Commonwealth Bank as Australia's central bank, but the Bank continued to act primarily as a trading and savings bank. It was to take another thirty-five years before a separately constituted central bank was established in Australia. This occurred in 1959 when the central banking functions of the Commonwealth Bank were separated from the Bank's commercial banking functions to form the RBA. Several decades had elapsed between the creation of a separate central bank in Australia and the establishment of similar banks in other major countries forming the British Empire – the Reserve Bank of South Africa was established in 1920;. the Reserve Bank of New Zealand in 1933; the Bank of Canada in 1934; and the Reserve Bank of India in 1935. Had the plan by the Commonwealth Treasurer, E.G. Theodore, to establish in 1930 a Central Reserve Bank (CRB) been adopted, Australia would have had a separate central bank at about the same time as these other countries. When it was established in 1959, the RBA took the structure of the CRB that had been foreshadowed by Theodore some thirty years before.

With the failure of the Commonwealth Bank to act as a central bank following the 1924 amendments, advice was sought from the Bank of England as to how the Bank might become a central bank. The Governor of the Bank of England, Montagu Norman, was invited by the chairman of the Commonwealth Bank's board, Sir John Garvan, to visit Australia, but Norman declined the invitation. Instead, the Bank's Comptroller (and later Deputy Governor), Sir Ernest Harvey, came to Australia in 1927 and held consultations with the Commonwealth Bank and the federal government. When he was in Australia, Harvey presented a public address to the Victorian Branch of the Economic Society of Australia and New Zealand, in which he advanced 'certain fundamental principles' of central banking. (Harvey 1927: 3, 5) Though he did not refer directly to the Commonwealth Bank, it was obvious that where the Commonwealth Bank differed largely from these principles was its conduct of commercial banking activities. Harvey doubted whether a truly central bank should be engaged in such activities and for profit. If the Bank of England was the model to which all central banks should aspire, the commercial activities of the Commonwealth Bank were clearly an anomaly. Harvey argued that the 'primary function' of central banking – he preferred the term 'central reserve banking' – was 'the custody, regulation and protection of the central banking and currency reserves of the country.' Rather than each bank holding its own reserves, the banks' reserves should be held centrally by an institution that could stand ready to provide liquidity to the system when a lack of confidence was depleting the banks' deposits. A bank facing a run on its deposits would attempt sooner or later to liquidate its assets. But this could destabilize other banks. In these circumstances, what was needed was a central reserve bank that could draw upon the reserves of the banking system as a whole to assist banks that were solvent but experiencing liquidity problems of a temporary nature.

Harvey took the view that ‘The central bank, if its business has been conducted in conformity with the principles of true central banking, will probably not itself be involved in the causes which have rendered it necessary for other banks to turn to it for assistance, and it will be in a position to bring the whole weight of its resources to bear in any direction in which help is necessary.’ This obviously put the Commonwealth Bank at odds with the Bank of England’s conception of how a central bank should be constituted. For in conducting its own commercial activities, the Commonwealth Bank had deployed its funds in a somewhat similar portfolio of assets – including relatively illiquid investments – as the private banks. It was Harvey’s belief that a central bank should have its assets invested in short-term and highly liquid securities, not in mortgages on real estate, unsecured advances or overdrafts.

Following Harvey’s visit, the question of whether the Commonwealth Bank could be considered a legitimate central bank was quickly taken up by Alfred Davidson, then Inspector for Western Australia of the Bank of New South Wales, and soon to become the bank’s General Manager in Sydney and the dominant private banker of the depression and immediate post-depression years. In a speech to the Western Australian branch of the Economics Society in 1928, Davidson declared that the Commonwealth Bank’s commercial and central bank functions were incompatible. (Davidson 1929: 31) As a consequence, he recommended that the Bank should withdraw from commercial banking, retaining only its central banking functions. The alternative was to establish a separate Central Reserve Bank, to which the Commonwealth Bank should surrender its present and limited central banking responsibilities. Davidson’s position was that, as long as the Commonwealth Bank accepted deposits from the public, it would fail to fulfill its responsibilities as a central bank. This conclusion does not appear to have been based explicitly upon any concern that Davidson may have had at the time that the Commonwealth Bank might use its privileged position as a central bank to compete unfairly against the private banks, and for that reason would never win the respect of the private banks. Rather, and following the principles laid down by the Bank of England’s representative, the difficulty was that the Commonwealth Bank, as a predominantly trading and savings bank, had its assets tied up in long-dated securities. If there were a run on the banks by distressed customers who were concerned about the security of their deposits, the Commonwealth Bank might find itself unable to act as lender of last resort to the banking system. While this might never eventuate in practice, Davidson nevertheless had identified a possible source of systemic weakness in the structure of a central bank that also operated as a commercial bank. ‘How can the Commonwealth Bank be a Bankers’ Bank and assist other Banks in time of stress’, Davidson asked, ‘when it would be faced with a drain of many millions upon its public deposits together with a serious demand for increased advances from its borrowing customers, and at a time when many of its securities could not be in liquid form?’ Therefore he supported the ‘best authorities’, who ‘point out that the Commonwealth Bank, as at present constituted, is not, and cannot be, a true Central Reserve Bank.’

It was remarked earlier that when the Commonwealth Bank opened its doors for business in 1912/1913 it possessed no central banking responsibilities other than that of banker to the federal government. It became in principle – though not in fact - both a commercial bank and a central bank with the amendments to the Commonwealth Bank Act in 1924. The government at that time does not appear to have contemplated the creation of a separate central bank by removing the commercial functions of the Commonwealth Bank. Nor did the Treasurer – Earle Page - seek to justify in parliament the benefits that might be derived from having a composite bank that combined central and commercial banking. He did assert, however, that the Bank's traditional policy of 'not to enter into active rivalry with the trading banks' was 'fortunate…because by reason of the policy the conversion of the Commonwealth Bank has been rendered easier.' (Page 1924: 1277) By this Page meant that he had detected no visible signs of resentment of the Commonwealth Bank by the private banks, as there might have been had the Commonwealth Bank acted as an aggressive competitor of the private trading banks.

In 1928, and possibly as a result of the principles of central banking enunciated publicly by Sir Ernest Harvey, the government sought to put some distance between the central banking functions of the Commonwealth Bank and its savings bank activities by creating the Commonwealth Savings Bank. This was to have a separate administrative structure, though it would continue to share the same board of directors as the central banking and the trading bank functions of the Commonwealth Bank. The Bank had made no attempt, as Page explained, to attract existing trading bank customers away from the private banks, but rather had sought entirely new trading bank business. The growth of the Commonwealth Bank since its establishment in 1912 had derived principally from its savings bank activities, where it competed mainly against state-owned savings banks. In these circumstances, the private banks had seen no reason to feel threatened by the Bank's commercial activities, though they were opposed to any compulsory lodging of reserves with the Bank on the grounds that these reserves might sometime in the future provide the means by which the Commonwealth Bank could compete more actively against them.

An attempt had been made in 1924 to compel the private banks to lodge a proportion of their deposit liabilities with the Commonwealth Bank. But the government withdrew the provision from the proposed legislation when the banks vigorously opposed it. The government proceeded, however, with a requirement compelling the banks to clear their inter-bank balances by cheques drawn on the Commonwealth Bank. To facilitate this process, the banks began to deposit funds with the Commonwealth Bank. But the magnitude of these deposits was small, and they were made on an entirely voluntary basis. Further legislation late in 1929, at a time of growing economic instability, gave the Commonwealth Bank the power to requisition gold supplies in Australia; in exchange for gold, the banks received currency, which they deposited in part with the Commonwealth Bank. But these reserves, too, were not compulsory and could be withdrawn by the banks at short notice. The banks do not appear to have exhibited alarm at the idea of depositing funds at the Commonwealth Bank when it was convenient for them to do so; what was now beginning to cause them some anxiety was the prospect that a potential rival might use the banks' reserves to compete against them.

At the peak of the depression in May 1930 the Treasurer, E.G. Theodore, introduced a bill into the federal parliament to create a Central Reserve Bank (CRB) along the lines that had been proposed earlier by Sir Ernest Harvey. (Theodore 1930: 123, 1334, 1335) The new institution was to be achieved by removing the central banking functions from the Commonwealth Bank and transferring them to the new central bank. Theodore announced that the CRB would 'operate for the maintenance of the stability and security of Australia's monetary and credit system.' There was 'no sinister purpose behind the proposal', he informed the parliament. 'We are merely following a course that has been adopted in many other countries'. He dismissed the view, advanced by private bankers, that the Commonwealth Bank itself should become the central bank by jettisoning its commercial banking functions, arguing that 'the Commonwealth Bank was established by its founders, and was carried on for a number of years, with an objective quite different from that desired in the establishment of a central reserve bank. The Commonwealth Bank was intended to be a trading institution, and to operate freely in competition with the private trading banks.' While it was true that in 1924 'an attempt was made to enable it to develop into a central reserve bank', Theodore argued that 'it has not succeeded in fulfilling the functions of such an institution, and cannot be regarded as a central reserve bank.' 'The principal obstacle in the way of such a development', he said, 'was the attitude towards the Central Bank of the private trading banks.' For the banks had 'declined to deposit any considerable portion of their reserves with it [the Commonwealth Bank], because they realized that such reserves might be used to further its active competition with them.' This concern, Theodore considered, was perfectly understandable: 'One cannot blame the managers and controllers of the private institutions for that attitude. They realized that in the Commonwealth Bank they had a competitor of tremendous power; and it was unreasonable to expect them to strengthen that competitor by handing over to it large proportions of their reserves.' With remarkable foresight, Theodore had put his finger on the central issue that was to lead thirty years later to the separation of the central banking functions of the Commonwealth Bank from its commercial operations and to the establishment of the RBA, namely the resentment of the private banks to one of its competitors having responsibility for holding a significant proportion of their reserves in compulsory Special Accounts.

Theodore's bill to establish a separate central bank passed through the House of Representatives without fundamental objection. But it was defeated in the Senate, which was controlled by the Opposition with a large majority. For Theodore's bill clearly had another purpose, which frightened those who feared that credit creation was tantamount to inflation, no matter what the current state of economic activity. 'There is', Theodore said, 'a generally held opinion among economists, bankers and financiers generally that our existing banks and financial system has proved defective, and that that has been partly responsible for the difficulties which Australia has encountered in the last year or two. The lack of the means for the mobilization of our credit resources has been a serious defect in our monetary system within recent months'. The board of the Commonwealth Bank, led by its powerful and dominant chairman, Sir Robert Gibson, had placed strict limits upon the availability of central bank credit for the purpose of funding employment-creating public works and assisting industries facing acute hardship. During the four years 1929-33 the Bank had discounted Treasury bills amounting to nearly £55 m. for the purpose of funding federal and state expenditure, but most of it was provided after the adoption of the Premiers' Plan in 1931; indeed, most of it was provided in 1932 and 1933, well after the peak of the depression had passed. The CRB would require a new board which, the government hoped, would be more accommodating to the government's policy of Commonwealth Bank-funded public works programs than the board of the Bank had been. Moreover, the legislation provided for the compulsory lodging of banks' reserve deposits with the CRB. It was felt by many – including the Opposition in the Senate – that these deposits would be used by the new central bank to fund profligate public works programs.

Gibson and the Royal Commission on the Monetary and Banking Systems in Australia

Sir Robert Gibson, a Melbourne businessman, who had chaired at the end of the war the Royal Commission 'to consider and report upon the public expenditure of the Commonwealth of Australia with a view to effecting economies', was a member of the original Commonwealth Bank Board appointed in 1924. When Garvan resigned in 1926 due to ill-health, Gibson replaced him as chairman. According to Giblin, 'Sir Robert had a clear and confident but somewhat imperfect vision of central banking problems in Australia; his assurance and dominance tended to reduce everyone else concerned on the staff or Board to the status of a rubber stamp.' (Giblin, 1951: 353) During the depression, Gibson opposed devaluation, rejected deficit financing and fought against Theodore's attempt to establish a separate central bank.

At the federal election in 1934 the Labor and Country Parties campaigned for an inquiry into the Australian monetary and banking systems. They were highly critical of the role played by the banking system before and during the depression and were especially critical of the performance of the Commonwealth Bank as a central bank, asserting that over-investment in Australia in the nineteen-twenties had helped to promote the depression and that the contraction of credit during the depression had exaggerated its extent and delayed recovery. Rather than adopting measures to initiate recovery, the Bank had attempted to maintain an overvalued exchange rate, and had withheld funds for the provision of government relief works and assistance to farmers. During the election, the government of J.A. Lyons rejected these calls for a review of the financial system. But the government lost its majority at the election and was forced into a coalition with the Country Party. The new government, again led by Lyons, agreed to establish a Royal Commission to review the Australian monetary and banking systems. Chaired by Justice John Mellis Napier of the South Australian Supreme Court, the Royal Commission included a future Prime Minister (J.B. Chifley) and one of Australia's leading economists (Professor R.C. Mills, Dean of the Faculty of Economics at the University of Sydney); its economic adviser (J.G. Phillips) later became Governor of the RBA. It took submissions from 318 persons, including bankers, financiers, public officials and virtually all of the country's leading economists. Its report contained thirty recommendations and was highly influential in setting the agenda for much of the debate on central banking over the succeeding twenty years. In many ways the Royal Commission was the equal of the next major review of the Australian financial system, the Inquiry into the Australian Financial System (the Campbell Inquiry), which reported in 1981. (Australia 1937)

The Royal Commission called for the creation of a strong central bank, one equipped with adequate policy instruments to regulate economic activity and stabilize the banking system. It spent considerable time examining the nature and causes of the depression and the role of monetary policy, concluding that 'No action by the monetary and banking system of Australia could have avoided some depression, although the system together with governments, and indeed, the community as a whole, must share some responsibility for the extent of the depression. The development of boom conditions could have been checked, and the depth of the depression could have been lessened. Monetary measures alone did not produce recovery, but their effects would have been greater had they been taken earlier.' (Australia 1937: 209)

Focusing specifically on monetary policy, the Royal Commission judged that: 'Two of the most important monetary measures taken during the depression were the expansion of central bank credit by means of treasury-bills in 1931 and 1932, and the movement in the exchange rate in January 1931. In each case, in our opinion, the depression would have been lightened, and some of its worst effects avoided, if these measures had been taken earlier.' (Australia 1937: 211) The Commission argued strongly for greater control and regulation of the Australian monetary and banking systems, recommending that the banks should operate upon the authority of a licence, which could be withdrawn if a bank failed to follow government policy. The banks should be compelled to hold at the central bank an undefined percentage of their deposits, which might be varied according to the requirements of monetary policy. Further, the policy of the Commonwealth Bank should be subordinate to the government, and the Bank should conduct its policy with a view to stabilizing the business cycle rather than aiming at price stability or a fixed exchange rate. The Commission believed there were benefits to be gained by the central bank retaining its commercial banking functions, proposing that the Bank's trading and savings activities should be used to expand or contract the amount of credit in the economy as a whole.

One of the Royal Commission's major conclusions was that the Commonwealth Bank lacked the policy instruments required to achieve its objectives. It noted that the Bank had rarely, if ever, engaged in discounting bills, other than government bonds that were about to mature. The Bank's spokesmen informed the Commission that the Bank's failure to undertake market operations was because the secondary market for government securities was narrow and extensive operations would significantly affect the price of government paper and hence interest rates. The Commission, however, doubted that the secondary market for Treasury bills was inadequate for the purpose of conducting open market operations. It had no doubt that the market was indeed somewhat thin, 'but its extent depends upon so many circumstances that no estimate can safely be made of the amount of securities which could be sold at any time without seriously affecting their price.'

(Australia 1937: 226) The Commission proposed that the authorities should act to create an open market for government securities, which would be offered to the public on a regular basis through public tender at rates determined by the tenders that were received. It admitted that such a market would have to be established gradually, and that its success would depend on the coordination of fiscal and monetary policy.

The Commonwealth Bank argued before the Commission that the banks should be compelled to lodge with the Bank a fixed minimum percentage of their deposit liabilities and, further, that the Bank should possess the authority to draw upon the banks' overseas reserves. These powers would allow the Bank to buy securities in Australia and foreign exchange in London, thereby permitting it to control both domestic credit expansion and the exchange rate. As the report of the Royal Commission explained: 'the necessity to maintain not less than a certain fixed percentage of their liabilities to the public with the Commonwealth Bank would force the banks to borrow occasionally from the Commonwealth Bank and thus strengthen the Commonwealth Bank's control of their credit policy.' (Australia 1937: 227) But as they had done on earlier occasions, the trading banks opposed the idea of mandatory reserve deposits lodged at the central bank, claiming that they would have to hold more of their assets in cash if part of their reserves were surrendered to the Bank; this, in turn, would induce higher interest rates. Additionally, if there were a fixed minimum of deposits that the banks would have to lodge at the Bank, as the Commonwealth Bank proposed, difficulties would inevitably arise when seasonal conditions were tight.

The Royal Commission recommended that the regulation of credit by the Bank should be conducted primarily by the Bank establishing close co-operation with the trading banks – what, at a later time, was referred to as 'suasion'. Believing, however, that the necessary co-operation with the trading banks might not always be obtainable, the Commission further recommended that the banks should be compelled to keep an unspecified minimum proportion of their deposits with the Commonwealth Bank, the actual proportion to be determined by the Bank, with the consent of the Treasurer, for a period that could not exceed six months without obtaining further authority from the Treasurer. The percentage could be varied according to monetary conditions: increased when monetary conditions needed to be tightened, and reduced when conditions could be eased. The same percentage was to apply to all the banks, regardless of their particular circumstances. Attempts, however, in the late 1930s by the Treasurer, R.G. Casey, to introduce legislation compelling banks to lodge a minimum of 7½ per cent (earlier drafts had mentioned a ratio of 10 per cent) of their deposit liabilities at the Bank failed as a result of intense pressure brought to bear on the government by the banks, which lobbied furiously to have the draft legislation shelved. A somewhat different system was introduced on a voluntary basis by the Fadden government in 1941 and made compulsory under the National Security (Defence) Regulations shortly after the Curtin government came to power in October 1941. In the event, no effort was made before the war to sell government securities by public tender, though it is probable that attempts were made by the Bank to apply suasion in the hope that the banks would adhere to monetary policy.

Melville and the Creation of a New Monetary Framework

Virtually nothing is known of the consultations undertaken by Sir Ernest Harvey with the board of the Commonwealth Bank in 1927, though it is probable that Harvey drew the Bank's attention to its lack of technical expertise. When Sir Otto Niemeyer and Professor T.E. Gregory visited Australia from the Bank of England in 1930 they appear to have advised the Commonwealth Bank to appoint an economist to its staff. The following year the Bank appointed Professor Leslie Melville of the University of Adelaide as its first Economist (later Economic Adviser). Melville quickly established the Economist's Department in the Bank and recruited professional economists to it; in 1935 he appointed Dr H.C. Coombs to be his assistant. (Cornish 1993)

When Melville was appointed to the Commonwealth Bank, perhaps on the recommendation of Niemeyer, and certainly with the approval of Gibson, he was regarded as the most conservative of Australia's senior economists. As early as 1927 he predicted that Australia was heading toward major economic trouble, and by 1929/30 he was arguing that the depression constituted a real decline in output and that this had to be accepted by cutting real wages and government expenditure. (Cornish 1999; Macfarlane 2002) Yet Melville also supported devaluation, which he considered was necessary to boost the incomes of farmers and enable local production to compete in international markets. He conceded that, in the short run at least, some central bank funding of government expenditure was necessary through the issue of Treasury bills, though he argued that the issue should be limited and funded at the earliest opportunity.

By the mid-1930s Melville was expressing concern about the pace of recovery and proposed that Treasury bills should now be funded, for in the hands of commercial banks they would be treated as liquid assets, thereby providing the basis for further credit expansion. This matter was the subject of considerable debate among Australian economists at the time. The majority tended to dismiss Melville's concerns, contending that as unemployment remained high there was little possibility of inflation arising from unfunded Treasury bills. On the question of returning to some sort of gold standard or gold exchange standard, an aim that Gibson supported, Melville was totally opposed to the idea; while he supported exchange stability in the short term, he believed that a gold standard arrangement, by which external adjustment was obtained through domestic deflation, was altogether too inflexible. He was keen for the central bank to play a decisive role in the formulation of monetary policy, not just in its execution, and he supported the development of open market operations by the Bank through the buying and selling of government securities with the object of stabilizing prices and economic activity. An attempt in 1936 by the Commonwealth Bank to sell securities on the open market for the purpose of moderating activity failed, however, when the Bank of New South Wales decided to circumvent the policy by raising interest rates on its fixed deposits.

Melville's approach to domestic monetary and exchange rate policy was elaborated at length in his Statement and testimony to the Royal Commission in 1936. (Melville 1936: 1117-30) The Commonwealth Bank's decision at the end of 1931 to control the exchange rate, and its policy to preserve a fixed rate of exchange with sterling, constituted an important step toward the operation of central banking in Australia. To maintain a fixed rate of exchange, the Bank extended its agreement with the banks, negotiated during the depression, to mobilize their London reserves for the purpose of meeting government debt obligations in London. Maintaining a fixed rate of exchange with sterling also meant that the Bank had to set domestic monetary policy in such a way that exchange stability could be preserved. From late 1931 until the early 1970s, the authorities in Australia adhered to a monetary framework that centered on maintaining a stable – though not an absolutely fixed - exchange rate in terms of sterling. There was only one occasion when this policy failed to be observed: sterling was devalued in 1967 but the Australian dollar was not.

The exchange rate with sterling was preserved after 1931 as a result of monetary and fiscal policy being applied to manage the level of aggregate domestic demand. In the short term, the level of Australia's foreign reserves – augmented by foreign borrowing – was allowed to fluctuate, reflecting excessive or deficient domestic demand and other forces operating on the balance of payments. But sooner or later the stance of monetary, and perhaps more especially fiscal policy, was altered for the purpose of easing pressures on the exchange rate. Though this new sterling-exchange standard was not strictly a gold standard, since the exchange rate was not immutably fixed to gold, it served to provide a nominal anchor for the Australian monetary system, since to maintain exchange stability, the authorities were obliged to formulate and implement domestic monetary and fiscal policy aimed at retaining the fixed rate with sterling.

The elements of this monetary framework were carefully articulated by Melville in his Statement to the Royal Commission. Because of the intrinsic complexity of the economic policy process, Melville argued that there was a need to simplify it by adopting simple rules. It was necessary, he said, to 'select one factor in the economy and attempt to fix it, at the same time endeavouring, as far as possible, to make every other factor in the economy adapt itself to the fixed factor.' But what should be the fixed factor? 'Having regard to the necessity for Australia to trade on friendly terms with other countries, her need for overseas capital, and the convenience of traders and financiers', Melville concluded that 'it seems best in her case to fix the exchange rate and adapt the economy to that fixed rate.' In these circumstances, domestic policy would be guided in large measure by the level of the foreign reserves; monetary policy would be eased when the reserves rose, and tightened when the reserves fell. This did not mean that policy settings should be altered immediately the level of reserves changed. 'Were ample funds available', he said, ' 'we should watch the progress of a fall, or rise, for some time, and test it by examining other statistics in order to decide whether it was only a temporary movement, or whether we must expect it to continue indefinitely. In the former case no action need be taken to adapt the internal economy to the altered conditions. We should wait until London funds [Australian banks' reserves held in London] were in due course restored to their original level. In the second case there would need to be a contraction, or expansion, of credit – gentle at first, but applied with increasing severity until the internal economy had been suitably modified.' Given Melville's desire for a relatively stable exchange rate, the rise or fall in the foreign reserves – by placing pressure on the exchange rate – would signal the need for an expansion or contraction of monetary policy. Importantly, Melville admitted that the nexus between the foreign reserves and domestic monetary expansion or contraction should not be left simply to automatic processes, or to the decisions of the trading banks, which had been the case in the past. For there would inevitably be times when the expansion and contraction of credit overshot the mark, 'unless there is a Central Bank waiting, properly equipped, to guide the economy as smoothly as possible.'

While Melville recommended that the exchange rate should provide the anchor – or 'compass', to use his own expression – around which monetary and other policy settings should be adjusted or guided, this did not mean that he was advocating a fixed rate of exchange in all conditions. On the contrary, there would doubtless occur from time to time 'exceptional circumstances' when the exchange rate would have to be altered. In short, there should be short-term stability, but the rate should not be fixed absolutely, as was the case in a gold standard system. This policy framework later came to be known more generally as the Bretton Woods system. Melville himself led the Australian delegation to the Bretton Woods conference in 1944 and was closely associated with Giblin, Coombs and others in the development of Australia's policy toward the Keynes-White plans for the international monetary system following the end of the war. It was no surprise therefore that Melville should become a powerful advocate of Australia's adoption of the Bretton Wood's system, though he much regretted that the more expansive Keynes plan (the Clearing Union) had generally been subverted in the creation of the International Monetary Fund by the more restrictive Stabilization Fund sponsored by the United States Treasury.

Chifley and the Creation of the Regulatory Regime

Many of the recommendations of the Royal Commission were adopted during the Second World War under emergency war-time regulations. They were made permanent subsequently by legislation passed in 1945. In that year, two bank bills were enacted: the Commonwealth Bank Act, which completely rewrote existing legislation relating to the nature and structure of the Commonwealth Bank; and the Banking Act, which contained a comprehensive set of regulations that were to apply to the Australian monetary and banking system. (Chifley 1945: 547, 557). These regulations drew in part upon the recommendations of the Royal Commission, including the mandatory holding of reserve deposits with the central bank. In reality, however, they went far beyond the Commission's proposals, embracing the stronger and deeper control regime that had been adopted during the war.

The controls and regulations contained within the 1945 legislation formed the basis of the Australian financial system from the Second World War until the 1980s, determining its structure and operation. At the centre of the regulatory regime was the Special Accounts system (after 1959, the Statutory Reserve Deposit (SRD) ratio). Unlike the recommendation of the Royal Commission, which had specified a minimum but variable system of reserve deposits based on a proportion of bank deposits or liabilities, the wartime system of Special Accounts allowed the central bank to call up to 100 percent of any increase in bank assets from a nominated date. According to the Banking Act, the private trading banks were to lodge in their Special Account at the Commonwealth Bank each month no more than the wartime accumulation of assets in Special Accounts, plus any increase in the bank's assets from the commencement of the provisions of the Act. The central bank was to notify banks in writing each month the Special Account requirements for each bank. The banks would be paid a nominal rate of interest (less than one per cent a year) on their lodgments, and they were unable to withdraw funds without the authority of the Bank; such withdrawals could attract a penalty rate of interest.

When he introduced the Commonwealth Bank Bill into the parliament in 1945, the Treasurer (and soon to become Prime Minister following the death of John Curtin), J.B. Chifley, highlighted the deflationary circumstances of the depression, the expected postwar slump (depressions had followed the Napoleonic Wars and the First World War), and the likely inflationary pressures that would be experienced immediately after the war as a result of pent-up demand and excessive bank liquidity. (Chifley 1945: 557) He explained that the proposed legislation was 'based on the conviction that the Government must accept responsibility for the economic condition of the nation. The problems of the postwar period – of employment, development and trade, are of such magnitude, and involve such serious consequences, that no other attitude could be maintained. Accordingly', Chifley went on, 'the Government has decided to assume the powers which are necessary over banking policy to assist it in maintaining national economic health and prosperity.' With echoes of Theodore and the Royal Commission, he declared that it was the 'opinion of the Government' that 'the Commonwealth Bank and the banking system should have done more to mitigate the distress of the depression years.' 'The present Government', he said, 'is determined to ensure, so far as it lies within its power, that this will not be repeated.' As to the Banking Bill, which contained the collection of new peacetime measures designed to regulate the banking and monetary systems, Chifley explained that the 'main purposes of the provisions is clear. They are intended to equip the Commonwealth Bank with adequate powers to supervise the banking system…No responsible government could afford to move forward into the post-war period without adequate means at its disposal to cope with inflationary and deflationary movements in the monetary and banking system.'

Shortly after the 1945 legislation was passed a challenge in the High Court of Australia by the Melbourne City Council to Section 48 of the Banking Act – which required certain public authorities to hold accounts with the Commonwealth Bank – raised the possibility that other and more vital provisions of the legislation might be challenged in the courts. In particular, there were fears that the private banks might challenge those sections of the Banking Act that dealt with the Special Accounts procedure, which was expected after the war to be used as the main instrument for the control of bank liquidity. As a member of the Royal Commission in 1936-37, Chifley had written a minority report proposing the abolition of private banking, on the grounds that private banks were more concerned with making profits than promoting the public welfare. (Australia 1937: 262-8) Now, as Treasurer and Prime Minister, he introduced a bill into the parliament in 1947 making it illegal for privately-owned institutions to undertake banking in Australia. As he explained to the Parliament: 'It would be disastrous, from the point of view of the people of Australia and the prospects of economic stability, if sections 18-24 of the Banking Act [those sections providing for the Special Accounts system] were held to be invalid and the consequent loss of control over the banking system led to an inflation of credit, with all the loss and disorder which inflation entails.' (Chifley 1947: 799, 802)

When seeking to justify the government's decision to nationalize banking in Australia, Chifley referred again to the depression of the 1930s, claiming that 'the banks as a whole restricted new lending and called in advances', and the result was 'to accentuate the contraction of business and the unemployment of those years. They helped but little in recovery during the 'thirties, waiting rather for improvement to come from other sources instead of taking the initiative and helping to promote recovery. They followed these courses because it seemed best and safest from the standpoint of their own interests.' The 1945 legislation had sought to control the private banks in the interest of preserving monetary stability. But the possibility of a threat of legal action aimed at the chief mechanism for credit control – the Special Accounts system – rendered it necessary, Chifley asserted, to remove banking from private ownership and place it in public hands. In the event, the attempt to nationalize the private banks failed when first the High Court of Australia, and then the Judicial Committee of the Privy Council in London, declared the enabling legislation to be unconstitutional. Nationalization of banking having failed, the government then reverted to its former course, which was to control the banks through the operation of a powerful central bank and the application of extensive regulatory measures.

Chifley continued to be influenced in his approach to monetary and banking arrangements by his understanding of the Commonwealth Bank's failure to avert economic disaster in the early 1930s. When the newly elected Liberal-Country Party government announced in 1950 that it proposed to reintroduce a board of directors for the Commonwealth Bank, Labor having replaced the board in 1945 by an Advisory Council of Bank and Treasury officials, Chifley, now the Leader of the Opposition, vowed that he would oppose any attempt to re-impose a board of directors upon the Bank along the lines of the board that had existed from 1924 to 1945. Labor would not object to a board composed of 'a number of prominent public servants and economists who have no interest in private enterprise.' (Chifley 1950: 60, 61) But it would have no hesitation in opposing a board comprised of persons who had 'certain social or business affiliations'. He continued to blame the board of the late-1920s-early-1930s for much of the distress that Australia had experienced during the depression. 'I do not suggest that the Commonwealth Bank Board at that time could have prevented the financial and economic depression that occurred in Australia – indeed, it could not have done so'. But he believed 'it could have alleviated the effects by perhaps 75 per cent.' Specifically, he was convinced that 'a great deal of the responsibility for that situation…may be laid at the door of those who were not elected to the Commonwealth Bank Board by the general public or even by the Parliament, but were appointed by the Government of the day.' He could never understand how some of the people were appointed to the Board at that time: 'I can only surmise that they were very pleasant fellows at cocktail parties and similar functions'; 'most of them were definitely associated with private enterprise, and their business was to restrict the operations of the Commonwealth Bank.' The Labor Opposition upheld its leader's threat to block the government's amendments in the

Senate. After a second vote, the Senate rejected the legislation again. The government then invoked section 57 of the Australian Constitution and was granted a double dissolution of Parliament by the Governor-General. At the general election that followed, the government was returned with majorities in both houses of Parliament. The legislation was then reintroduced and was subsequently passed.

Coombs and the Problems of Central Banking

The years immediately preceding and following the 1945 bank legislation saw the high watermark of monetary and banking regulation in Australia. During this time, H.C. Coombs, first as adviser to Chifley, and later as Governor of the central bank, was a powerful influence in the determination of monetary policy. (Coombs 1981; Rowse 2002; Cornish 2007) He generally supported the 1945 legislation as the alternative to bank nationalization, though he disagreed with key provisions of the legislation. He emphatically opposed bank nationalization in 1947. As Governor of the central bank, he allowed the banks greater control over the management of their liquidity, tried to introduce market-based processes of monetary policy when problems associated with the application of direct controls began to be experienced, and warned as early as 1959 of the dangers of stagflation.

At the end of 1948, Coombs was appointed by Chifley to be the next Governor of the Commonwealth Bank. He served in this position until January 1960, when he became the first Governor of the Reserve Bank of Australia, retiring from the post in 1968. At the beginning of the war he had moved from Assistant Economist at the Commonwealth Bank to fill the new position of Economist at the Treasury in Canberra. When Labor came to power in October 1941 and set up an Office of Rationing as part of its New Economic Policy, Coombs was appointed to head the Office. In February 1943 he was appointed Director-General of Chifley's new Department of Postwar Reconstruction, resigning from it to take up the position of Governor of the Commonwealth Bank on 1 January 1949. He is regarded as the principal architect of Australia's postwar policy of full employment and the country's leading adherent of Keynesian policy. Together with Giblin and Melville, Coombs formulated Australia's international economic policy in the 1940s, the so-called 'Positive Approach' or 'Full Employment Approach'. Responding to Article VII of the Mutual Aid Agreement, signed initially between the United States and the United Kingdom, and later between the United States and other countries including Australia, the 'Positive Approach' embodied a defensive policy designed to safeguard employment in Australia when discriminatory trade and payments barriers were dismantled after the war in accordance with Article VII. In essence, the policy was to promote a high level of activity internationally by inserting a commitment to full employment into the charters of the new multilateral institutions that were to operate after the war, among them the IMF/World Bank, the United Nations and the proposed International Trade Organization. (Cornish 1992)

Having dedicated himself to the achievement and preservation of full employment in Australia and elsewhere, it is an irony that the major problem that confronted Coombs throughout his time as Governor of the central bank was over-full employment and inflation. Yet contrary to what might be supposed, he was perhaps the most dedicated anti-inflationist in government service throughout the 1950s and 1960s. Even before he was appointed Governor, he had expressed concern about inflation. In 1948 he presented a paper to the summer school of the New South Wales Branch of the Economic Society of Australia and New Zealand entitled 'Australia's ability to avoid booms and depressions'. In the paper, Coombs was critical of the failure of economic decision-makers (government ministers) and some of their advisers – those in the Treasury in particular – to understand the approach to policy adopted in the Curtin government's white paper on full employment issued in 1945. (Coombs 1948) He pointed out that the framework of the white paper, like that of Keynes's *General Theory*, provided for circumstances both of under-full employment and over-full employment (Cornish 1981). In 1948 there was clearly excess demand in Australia; inflation had reached an annual rate approaching ten per cent, and the government ought to have been pursuing policies directed at easing pressures in labour markets. Above all, there should have been fiscal and monetary restraint. In 1949, as Governor of the Bank, Coombs argued that Australia should not follow sterling and devalue against the $US by the full 30 per cent proposed by Britain; rather it should devalue by something less than that. In this way the £A would depreciate against the $US, but would appreciate against sterling and the rest of the Sterling Area. However, the government rejected Coombs's advice and devalued by the full 30%, at a time when unfilled vacancies for labour exceeded the numbers registered as unemployed.

Throughout the 1950s and into the 1960s, Coombs sought to achieve two objectives: to draw attention to the dangers of inflation, and to make monetary policy more effective. His advice in 1949 regarding the exchange rate was based on his concern about the inflationary consequences of an excessive devaluation. (Coombs 1981: 149-50; Cornish 1993).Again in 1950, when the effects of the 1949 devaluation, and the even greater inflationary impulses unleashed by the Korean war, were beginning to be felt, he advised the government to revalue the £A, tighten monetary policy by calling up additional bank assets to the Special Accounts and lifting interest rates, and strengthen fiscal policies by raising taxes and cutting government expenditure. These proposals were at first opposed by the Treasury and rejected by the government. Some of them were finally introduced in the 'Horror Budget' of 1951, but by then it was too late, the Korean War boom having broken. As the economy began to slide into recession, and with unemployment appearing for the first time since the war, Coombs was then required to formulate a reflationary program.

By the mid-1950s it had become clear to Coombs that the chief monetary instrument that had been devised to combat inflation – the Special Accounts system – was defective. For a start, the Australian trading banks, unlike their counterparts in many other countries, did not adhere to a common liquidity standard; some banks adopted lower liquidity ratios than others. As a result, an increase in the call to Special Accounts aimed at tightening the availability of credit was often circumvented by banks with high liquidity conventions simply reducing their liquidity ratios. Even those banks with low liquidity standards acted to reduce their liquidity levels still further. To obviate this problem, Coombs secured agreement with the banks for a minimum liquidity convention – the so-called LGS (liquid assets and government securities) convention. An increase in the call to Special Accounts (after 1959, Special Reserve Deposits or SRD's) would put pressure on the LGS convention; if a bank's liquidity ratio fell below the LGS convention, it was obliged to borrow from the central bank, possibly at a penal rate. (Coombs 1971: 27-43)

With one problem solved, another soon appeared. Coombs realized that the SRD/LGS system and other bank regulations (including qualitative and quantitative lending directives, and interest rate and maturity controls on loans and deposits) were inhibiting the opportunity of banks to compete against non-banking financial institutions (NBFI's), which were not regulated by the central bank. Finance companies, hire purchase companies, building societies, short-term money market operators and merchant banks expanded rapidly from the early 1950s. In part, this was the natural outcome of new consumer demands and the growing diversification of the nation's economic base. But part of the growth of NBFI's arose because the banks were constrained by regulations such as ceilings on the rates of interest they could offer to depositors and charge on loans; maturity controls; central bank advice that restricted loans to designated activities; and the compulsory absorption of assets/deposits in Special Accounts and LGS assets. Whatever the reason for the growth of NBFI's, their activities eroded the effectiveness of the Bank's monetary policies. This was because the Australian Constitution gave the Commonwealth – of which the central bank was a part – authority over banks but not over NBFI's. Soon the banks themselves acquired NBFI affiliates, to which they directed their customers; they also devised new financial instruments, such as bank endorsed and accepted commercial bills, which, because they were not included on banks' balance sheets, were not subjected to direct controls. Further, disintermediation grew as a strong inter-company market developed as a result of the restrictions on the activities of banks. Finally, limitations on bank lending encouraged borrowers to look increasingly overseas for funds, particularly in the new Euro-dollar markets that were opening up.

Coombs was extremely sensitive to these developments and their consequences for the operation of monetary policy. (Coombs 1971: 27-43, 44-56) To circumvent the diminishing impact of monetary policy as the NBFIs expanded more rapidly than the banks, Coombs favoured the application of market procedures, such as open market operations. The decision by the Bank in 1959 to encourage the development of an official short-term money market by extending lender of last resort and other central bank privileges to a number of authorized discount houses was an important step in this direction; so was the Bank's support for a more diverse supply of short-dated government securities. However government and Treasury policy aimed at keeping interest rates below market clearing levels limited the effectiveness of open market operations. Frequently, the Bank was required to purchase government securities for the purpose of shoring up the price of government paper. The result was that, at times when the monetary authorities should have been draining the financial system of liquidity, they were actually adding to liquidity. As Coombs explained in his R.C. Mills Memorial Lecture in 1958: the Bank in 1950/51 and 1951/52, at the height of the Korean War inflation, was obliged to purchase government securities on the open market to prevent a decline in the price of bonds; instead of deflating activity, the Bank was stimulating it. (Coombs 1971: 31, 32) 'It would be pleasant to be able to record', he said, 'that when the problem [of inflation] recurred in 1954/55 the Bank was able promptly to resolve the issue and to avoid adding to the money supply – limiting its purchases on the market and accepting the higher level of yields which this implied…In fact, however, while the character of the dilemma was recognized from an early stage, the claims of low interest rates and stability of prices of government securities were difficult to resist. The process of resolving the dilemma was slow – indeed resembling what in another context has been called "an agonizing re-appraisal", and it was not until early in 1956 that Central Bank support for the market was reduced to normal amounts.' His conclusion was that 'Effective open market operations by the Central Bank in the restraint of inflation are…unlikely unless we adopt more flexible attitudes towards interest rates.' Invariably it was Coombs who put the case to the government for greater flexibility in the setting of rates on government securities. But he was frequently opposed by the Treasury and the government; without such flexibility, it was impossible to apply open-market operations systematically.

Of the growth of NBFI's, Coombs explained in a series of public lectures that their expansion had increased the velocity of circulation of money; the considerable rise in aggregate expenditure in recent years, he argued, 'was largely financed by a more frequent use of the existing money supply rather than from an increase in the volume of money itself'. (Coombs 1971: 40) He pointed to statistics that showed a persistent decline in the ratio of money to nominal income, suggesting that NBFI's had been instrumental in increasing the turnover or velocity of money. 'Expressed in general terms this has meant', he said, that 'the banking system has been becoming a less significant element in the financing of the economy. This is not necessarily a bad thing…But it does mean that to the extent that monetary policy relies primarily upon action through the banking system it is operating in a steadily contracting field.' In his Sir James Morris Memorial Lecture in 1962, Coombs asked the question: 'Why has the post-war period seen such a proliferation of new financial institutions?' Responding to the question, Coombs replied that 'It is sometimes argued that the emergence and growth of this multiplicity of financial agencies reflects the rigidity of official banking policy; that the strict limitations on the freedom of bank lending has caused the banks to confine their loans more and more to the narrow provision of working capital on overdraft and to contract out of more adventurous and particularly longer-term classes of business: that limitations on the freedom of banks to pay interest on fixed deposits have left depositors with too limited opportunities to earn a return on surplus funds and have encouraged them to turn elsewhere. Correspondingly, business enterprises faced by unresponsive bankers and concerned at the periodical intensification of restrictive credit policy have sought other channels of access to other people's money they need for their businesses.' (Coombs 1971: 49-50) Coombs supported this interpretation of events, concluding that the application of direct controls 'no doubt…encouraged this tremendous expansion of other financial institutions and that every stage in that expansion limits the area to which official monetary policy directly applies.'

Having identified by the late-1950s (and even earlier in some cases) the central problems facing monetary policy in Australia, and having fought a long battle to render the adoption of open market operations more effective, Coombs then began to focus on the nature and consequences of inflation. He drew attention to the problem in 'A Matter of Prices', his Presidential Address to the Australian and New Zealand Association for the Advancement of Science (ANZAAS) conference held in Perth in 1959. (Coombs 1971: 117, 118, 120, 128) There he pointed out that inflation seemed to have settled at about 3 per cent a year. That might not seem a great problem in itself. But what was of decidedly greater concern to him was that 'a significant new factor appears to have entered the situation', namely 'a widespread acceptance of price increases of this order as natural and inevitable.' 'An important reason for believing that this trend of prices does in fact represent a significant and continuing element in our economic climate', he said, 'is the experience of the United States during the recent business recession when, despite the fact that almost every indicator of economic activity turned downwards, consumer prices continued to rise.' Between August 1957 and April 1958, the index of industrial production in the United States fell by 13 per cent, retail sales fell by 5 per cent and unemployment almost doubled, but the consumer price index and wages rose by almost 3 per cent. The coincidence of falling activity and rising prices, Coombs explained, was something new, for in 'the past, periods of declining economic activity have almost invariably brought falling prices.' This deeply worried him, for, as he put it, 'If this change in the relationship of price movements to other indicators is due to continuing factors, it would bring about a vital change in people's attitudes towards prices – a change which could have profound economic effects'. As he continued: 'Previously, even if people felt that the long-term trend would be upwards, they had to take into account that there would be times when prices would fall. This probability introduced some uncertainty into any assessment they were making. In other words, while the long-term trend of prices might be upwards, any judgment relating to a particular period had always to allow for the possibility of a fall. This prevented people from being able to plan on the assumption of continuously rising prices. Recent experience suggests that this may be no longer true.' Here, Coombs had plainly identified both the problem of stagflation and the concept of inflationary expectations.

Coombs had no immediate solutions to offer. Yet he was adamant that the 'longer prices continue to rise – however slowly – and the more confident become the expectations of further rises, the more people will seek protection and the more expensive it will become. Indeed, it is difficult to conceive an upward trend of prices remaining slow and gradual in a world where everybody is seeking to protect himself against its effects'. For Coombs, the combination of price inflation and recession raised an acute policy dilemma: to which objective – inflation or unemployment – should monetary policy be directed. As he put it, there was now a 'conflict of objectives'. 'The Commonwealth Bank, for example, is required by law to pursue a policy which will best contribute to the maintenance of full employment and to the stability of the currency. These are the basic objectives of monetary policy in practically all democratic countries. If there is a tendency for prices to rise, the monetary authorities may feel obliged to impose a restrictive credit policy even though such a policy may prevent the emergence of full employment.'

So concerned was he about this new dispensation of inflation and unemployment occurring simultaneously that Coombs was convinced that 'we should receive, with grave scepticism, pronouncements which suggest that we do not need to worry about prices. A persistent tendency for prices to rise may, like the housemaid's baby, be very small at first – but once people have got used to it being around, they may well be astonished at how rapidly it will grow.' 'It does matter', he declared, 'if prices continue to rise – the trend is a serious and growing threat to the health of our economy; if it continues uninterrupted there is a grave danger that it will gather momentum from the efforts of people to protect themselves from its effects and cease to be merely a "creeping inflation".' Monetary policy therefore had to become more effective and that meant greater use of open market operations.

From the middle of the 1960s the monetary authorities accepted Coombs's analysis and began to allow greater flexibility in the setting of interest rates, thereby making it possible to rely more heavily than in the past on open market operations. It is possible to trace this development through the speeches of J.G. Phillips, Deputy Governor of the RBA from 1959 to 1968 and Coombs's successor as Governor. In an address to the Australian Society of Accountants (NSW Division) in June 1960, Phillips said that so far as the control of bank credit was concerned, the 'major instrument here, in a quantitative sense, is probably the Statutory Reserve Deposit Accounts, the former Special Accounts…This is probably the major instrument in the hands of the Reserve Bank at present for controlling and influencing the liquidity of the banks.' (Phillips n/d: 10) By October 1964, in his ES&A Bank Lecture at the University of Queensland, Phillips claimed that 'The evolution of monetary policy in recent years in Australia has been towards greater emphasis on the liquidity situation generally, rather than more narrowly on the banks. This has involved greater concern by the monetary authorities with the prices and yields of the wide range of securities now offered to the public, a greater concern with interest rate movements and a readiness to use them more freely as an instrument of policy.' (Phillips n/d: 31) In an interview with *The Banker*, published in December 1969, Phillips explained that as 'a rough rule, and depending on circumstances, we would nowadays tend to look first at the more pervasive instruments of open market operations and interest rates, and then at the direct influence on lending, and direct liquidity controls.' (Phillips 1969: 1289) In his R.C. Mills Memorial Lecture delivered in 1971, Phillips spoke about the

> increasing emphasis we [at the RBA] have been placing on market-oriented policies as against direct controls [which] has come about because of the need to take into account the increasing flexibility and diversity of the Australian financial system, and its growing relationships with the world outside Australia. In these circumstances direct controls have tended to lose their strength, because market forces produce reactions which in time largely offset direct control. Direct restrictions on bank lending tend to promote a shift of lending to other financial intermediaries, which is strengthened if bank deposit rates are not competitive with those of other borrowers…Shifts of this kind induced by direct controls do not necessarily promote the efficiency of the financial system, where the optimum position from an economic point of view is an institutional structure determined by the relative efficiency of the various intermediaries in providing financial services. (Phillips n/d: 71)

On the issue of inflation, the RBA, in its Annual Report for 1970/71, noted that 'In the period since the Second World War most countries have come to regard gradually rising prices as an inevitable accompaniment to the successful pursuit of policies of high employment and economic growth.' (Reserve Bank 1971: 36) It went on: 'Recently, however, without any apparent change in aims regarding either employment levels or economic growth, the rate of inflation has tended to quicken significantly in many of the developed countries of the world.' The United States was mentioned as an example: it 'experienced a prolonged period of excess demand prior to 1969. During this period not only did inflation accelerate but the community appears to have come increasingly to expect that prices would go on rising and to have acted accordingly. This inflationary psychology has been manifest, even after the elimination of excess demand…It seems that once the view that prices are going to continue rising strongly becomes entrenched, fairly drastic measures may be required to modify this expectation.' Twelve years earlier, the then Governor of Australia's central bank was warning of this very problem and the difficulties that it would present in the future for the conduct of macroeconomic policy.

Conclusion

Garvan, Theodore, Gibson, Melville, Chifley and Coombs all made significant contributions to Australian monetary and banking history. Some of them were more effective than others, but all of them left their mark. The immediate results of Garvan's influence on the policies of the Australian Notes Board and the Commonwealth Bank were condemned by business groups and by politicians. He may have held a narrow conception of the relationship between the quantity of money and the price level, but given the government's intention to return to the gold standard at the prewar parity, the policy of systematic contraction of the monetary base in order to influence the price level and, ultimately, the value of the £A, was successful in preparing the way for Australia's return to gold. This policy led to the 1924 Commonwealth Bank Act, the aim of which was to enhance the central banking powers of the Bank. The legislation had two enduring consequences. First, it established a board of directors drawn from industry; its structure and composition, in fact, were almost identical to the RBA's board when it was established in 1959. And second, the 1924 Act forced the banks to open settlement accounts at the Commonwealth Bank. These accounts now lie at the heart of the present cash rate system, the main mechanism for monetary control by the RBA.

Theodore, in promoting a separate central bank without commercial functions, was attempting at once to deal with criticisms that had been levelled in the late 1920s at the composite nature of the Commonwealth Bank and the political problems that the Scullin government faced when trying to fund recovery measures. In 1959 the RBA was established as a separate central bank, as Theodore had intended with the CRB. Gibson, on the other hand, set himself to constrain what he considered to be the financially reckless tendencies of politicians, especially Labor politicians. Adherence to the gold standard, balanced budgets and a central bank run by persons drawn from the world of business were principles to which he subscribed, and he sought to apply these principles during the late 1920s-early 1930s. On balance they probably delayed recovery though it is arguable that, without Gibson, greater instability might have prolonged the recovery process. Whatever Gibson's personal views, the RBA since 1996 has been able to adopt monetary policies free from government interference, as Gibson himself strived to achieve during his time at the central bank.

Melville, for his part, brought economic intelligence to the central bank, creating as he did a research mentality that became highly respected throughout the nation and beyond. His lucid explanation at the Royal Commission of how monetary policy should be conducted foreshadowed the Bretton Woods system that Australia followed in the 1950s and 1960s. His leadership of the Australian delegation to the Bretton Woods conference, and his advice to the government that Australia should join the IMF and World Bank, were equally important for the conduct of economic policy in the immediate post-Second World War decades. Melville defined and promoted a new monetary framework for Australia, but his enduring legacy was to establish a professional approach to central banking in Australia. Coombs thought that Melville had 'made a contribution to central banking that is without equal in the world' (Macfarlane 2002: 15); Macfarlane wrote that 'in the 1930s and 1940s you could be forgiven for thinking that Melville was the central bank'. (Macfarlane 2002: 16)

Chifley, more than any other individual, created the regulatory system of the immediate postwar years, obsessed as he was with the experience of the depression in the 1930s and the policy deficiencies of that time. Coombs, on the other hand, quickly observed the deficiencies of the regulatory system and argued for the adoption of market processes. He tried to warn Australians as early as the 1950s of the dangers of becoming complacent about inflation, identifying as he did the phenomena of stagflation and inflationary expectations and their implications for policy, about a decade before they were highlighted by economists and central bankers in other countries.

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