Perspectives from a Consumer of Central Bank Communication

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Good morning, and thank you for having me at the conference this year.

When I was asked to speak at this year's RBA conference, I was told that I was asked on the basis that I have been a "long-time consumer" of RBA communication and that it would be good to have my perspectives as a user, rather than a producer. So please take the comments that follow in this spirit.

Reflecting on the topic, it also occurred to me that central bank communication encompasses a lot. It's everything from explaining to the public what the Bank does, why it exists and why it matters through to communicating the nuances of monetary policy with financial markets. I will keep my comments to the latter, given my experience.

I've been lucky in my career to have listened to four RBA Governors. I started when Ian Macfarlane was pretty much halfway through his tenure as Governor, and then of course have lasted through the Governorships of Glen Stevens, Phil Lowe and now Michele. I'm not sure whether I'll last long enough to see another! But, it goes without saying that they have all had their quite unique and individual styles, which of course add to the mix of factors determining how well or otherwise a central bank communicates.

Governor Macfarlane, at least from my perspective as a fresh-faced graduate who knew nothing about the art of central banking, had a style of communication which pretty much told you how it was. His successor, Governor Stevens, was notable for his parsimony of words and pretty much zero tolerance for silly questions from the audience in his public speeches. I felt he was firmly in the camp of "the less I say, the more you'll listen". Governor Lowe came to the role with a clear intent to communicate more, and to a broader audience, but faced into challenges unlike any of his predecessors. And as for Governor Bullock, I will have more to say on that later!

For most of my career, the clients I have interacted with were financial market participants for whom the RBA mattered a lot. In my current role, many of the clients I speak to are not or have never been financial market participants in their careers. They are either successful high net worth individuals who built wealth in industries outside finance, people from family offices, or representatives from our for-purpose clients. It has been interesting to hear their perspectives on the central bank and how they differ from the perspectives of those who consume RBA communication as a necessary part of their day job. It has certainly given me an appreciation of the complexity of central bank communication beyond the daily ups and downs of 3Y bond futures or the shape of OIS curves.

What's changed? A lot

When I think about my experience of central bank communication over my career, I think there are some important factors that have changed.

The first is the broader context. Central bank communication has gone from simply being the way the Bank's views and reason for being were communicated to becoming a policy tool in itself.

The second is the technological context. Not only have methods of communication changed, but the rate at which communication transmits is much faster. It seems almost ridiculous to remember that in my first job as a graduate, my boss would expect me be in the foyer of the RBA at 11.30am to get a physical copy of the quarterly statement on monetary policy and to run it back to the dealing room as soon as possible. Never have I been more grateful for the fact that it is all downhill from Martin Place to Circular Quay!

Methods of communication has changed but so have societies. Central banks in most Western economies now ply their trade in a society that is more divided than we have seen in the recent past. And so when a central bank moves the overnight cash rate, which in itself is a relative price, then those divisions manifest pretty quickly. Winners and losers are no longer just identified as borrowers and savers, but also according to their generational, geographic, income and wealth characteristics.

By definition, this adds even more pressure to the central bank to not only justify - but also communicate clearly – what it has announced. And in some ways, central banks have been the victim of their own success – perhaps, if they hadn't been so successful keeping inflation low in the period in between the financial crisis and the pandemic, then maybe the communication challenge around the need to act forcefully to bring inflation lower may not have felt so difficult at times.

The advent of social media means that anyone's reflections on anything the central bank says are immediately in the public domain. Social media was meant to democratise access to information but it doesn't really feel it has turned out that way, given the abundance of conspiracy theories and misinformation that lurks online. All else being equal, this makes it more challenging for the central bank to be a trusted source of information.

There has also been an increased demand for transparency by the public from their institutions. This is not such a bad thing, and I think a necessary expectation that should accompany operational independence of central banks.

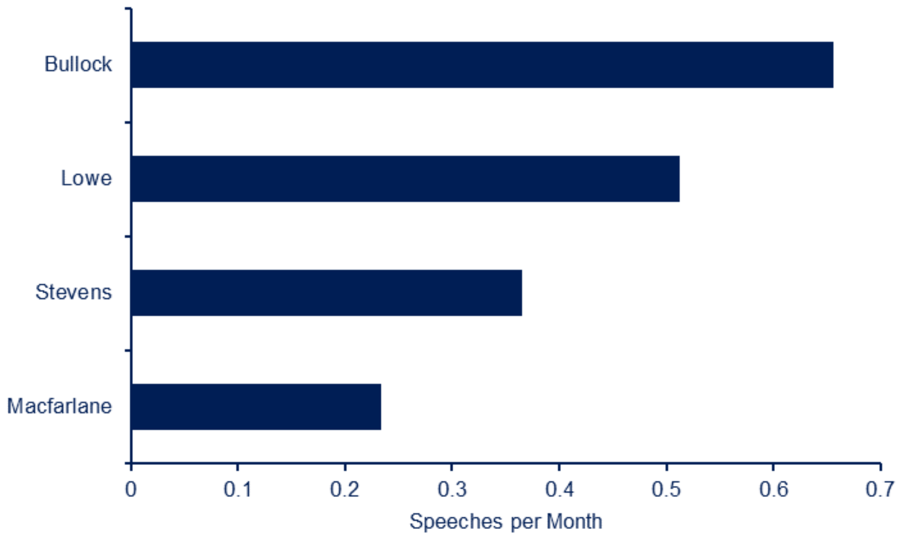
More recently in Australia, we have had the unfortunate incidence of unhelpful commentary on domestic monetary policy settings from politicians who should know better. I'm hopeful that this is a short-term aberration driven by the political cycle, but it sets a less than ideal precedent in the context of what is already a very different and more challenging backdrop for central bank communication.

So, in summary, it is clear that a lot has changed when we think about the broader political and societal environment in which a central bank communicates today.

And it is fair to say that those changes have happened in sync with the move towards more central bank communication than less. When I first started in my career, it was a time when the RBA didn't publish a statement unless the Board actually decided to change rates, let alone publish minutes of the meeting or hold a press conference right after.

Now, governors give more speeches; Chart 1 shows the number of speeches – as per the RBA website – that each Governor averaged over their tenure. Since Macfarlane's tenure to today, the frequency of public appearances has tripled.

Chart 1: RBA Governor speeches, number per month over the Governor’s tenure



Source: RBA and JBWere.

Articulation of the reaction function

But while many things have changed, I’d argue some things have not. From my perspective, a clear reaction function has always been the bedrock of central bank communication. When the public and financial markets have a clear understanding of what the central bank's goals are, how the central bank thinks the economy works and how it is likely to respond to various developments, then it is up to the market to work out how to price the range of policy rate outcomes given that reaction function and the data at hand.

In this framework, central bank credibility and central bank communication are inextricably linked. In simple terms, the central banks says what it is likely going to do, and then largely does what it says.

If a central bank is able to execute in this manner, then this brings well known advantages. Going forward, it should allow the central bank to benefit from the shift in economic agents’ expectations when it communicates. This is because in such an environment, what a central bank says, as much as what it does, will affect those expectations.

As a practitioner, I have always been of the view that in the end, the data will determine what the central bank does. I know that is not a revolutionary view, but I have in my career been surprised by the number of people who will argue that point to the contrary for various reasons.

From my perspective, it has often been useful to pay relatively more attention to the data than to what central bankers are saying. I don’t say this to discount the value of what our central bank officials say, the efforts they put into their communication or the forecasting processes central banks undertake, but more as a reminder to my profession that doing your own analysis usually adds more value to your clients than spending hours dissecting and regurgitating the latest speech from an RBA official. However, this strategy only works if you have confidence in the reaction function of the central bank.

Generally, I think the RBA has been pretty good at this over the last 20 or so years, and it is one of the reasons the Bank has been so well regarded globally by investors and other financial market participants.

There have been some occasional exceptions to this stellar record, in my view. One such episode that comes to mind was the time the notion of a "triple mandate central bank" was introduced into the RBA's commentary. At the time, it was a way of justifying why rates wouldn't be lowered, despite the labour market not being at full employment and inflation tracking below target. The argument was that cutting rates would risk another leg higher in house prices, which wouldn't be in the interests of the welfare of the Australian people over the longer term as it might induce them to borrow excessively.

On one level, I thought this was a step into somewhat dangerous territory, given that we usually regard what is in the best interests of the Australian people as a decision to be made by elected officials. I do know that "the welfare of the Australian people" is one of the three legislated mandates for the Bank. But introducing this into the public discussion left market participants with a less clear understanding of the central bank reaction function, which was unhelpful. I don't by any means have a perfect memory, but I think it was the first time I'd ever heard that part of the mandate invoked to justify a policy stance. And so it wasn't surprising to me that this period was identified in the *Review of the Reserve Bank of Australia*[i] as one in which communication of the considerations driving policy decisions was unclear.

The exit from the RBA's Yield Curve Control policy was also one of the more problematic episodes for communication in recent years. As the *Review* tells us, there were more than just communication issues involved in this episode. But it reinforces the point that while we might like to think of central bank communication as a stand-alone issue, it can sometimes be the consequence of sub-optimal arrangements within the institution. And, as we know in this particular instance, the consequences weren't trivial at the time.

We can talk also about the Bank's use of calendar forward guidance on rates through the pandemic. We in this room all knew it was never a promise to keep rates unchanged for three years, but rather, a conditional statement. Nonetheless, it was this episode that really emphasised for many the importance of communication beyond financial markets to the wider public. And when it is the general public who give legitimacy to the notion of an independent central bank in a democracy, this importance cannot be understated. It also highlighted the importance of political support for the central bank through challenging times for the economy. But I don't intend to dwell on that.

So while we can raise some periods in the RBA's recent history when communication outcomes may not have been as good as we all might have wanted, I think we can also make some observations about those who consume or use RBA communication.

Looking back over the past decade or so, I do sometimes worry we have spurned a generation of financial market participants who have not learnt to think independently of central bank narratives. In some respects, it isn't their fault – the use of forward guidance as a policy tool by many central banks has lured some market participants into a false sense of security – both about the central banks' ability to see into the future, and the market's willingness to accept the central banks' word as gospel. But I don't think that state of affairs does anyone any good in the long run, whether they be traders, economists or central bank officials. The RBA Deputy Governor recently delivered a speech[ii] exactly on this issue, noting that the art of central bank communication is often striking the right balance between leaning against overconfidence without falling into the opposite trap of saying nothing at all.

Michele's approach to communication for most of this year – not ruling anything in or ruling anything out – may have been frustrating to a new generation of traders and analysts used to more explicit guidance from their central bank, but to me, it felt like a much-needed return to the days where a little more uncertainty and volatility in front end rates is not necessarily a bad thing. And while we are on this point, I think Bank officials have done a commendable job in explaining some of the trade-offs that are facing policy makers at present, and the alternatives that we face under different paths for the policy rate.

Data dependence should be the name of the game for central banks, unless we are in exceptional circumstances. And we should never forget that the role of the market is to price risk appropriately – and while we might agree that a lower uncertainty premium is a good thing in order to facilitate the effectiveness of monetary policy and financial markets more broadly, as analysts we should never confuse that with a false sense of certainty.

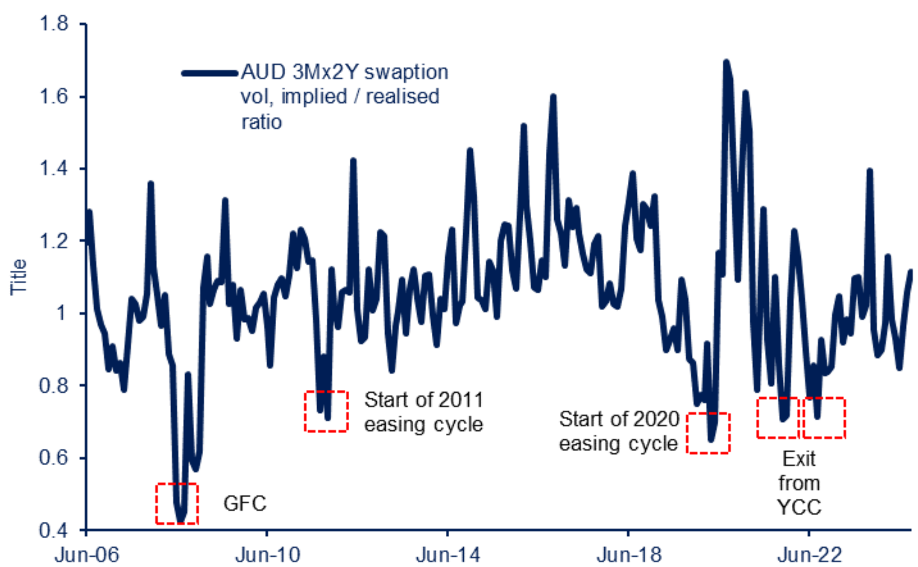
What does the market say?

In my final section, I wanted to talk a little bit about whether we can see the impact of central bank communication on financial markets in any sustained fashion. I've chosen to look at this through the lens of the ratio of implied to realised volatility at the front end of the yield curve. If this ratio is low, then it means the market has been surprised, because actual (or realised) volatility in short-end rates was greater than the market was pricing (or implying) at the time. There are both advantages and disadvantages to this approach but it does I think, provide a simple framework for looking at the issue in the Australian context.

Chart 2 shows this ratio for the AUD 2Y swap rate, using option volatility with a 3-month tenor. Going back to the middle of 2006, we can see there are five distinct occasions when the ratio dipped noticeably. The first and self-evident episode was the Global Financial Crisis.

The second and third incidences of a sharp drop in the ratio were the beginning of the 2011 and 2020 easing cycles. The first of these reflected the impact of the end of the 2000s commodity price boom in Australia, while the second was clearly the pandemic. Moving to the next episode on the chart, we see the ratio drop at the time the Bank exited from YCC, and the last – the largest 6-month increase in 2Y swap rates in over 2 decades – was a consequence of YCC exit.

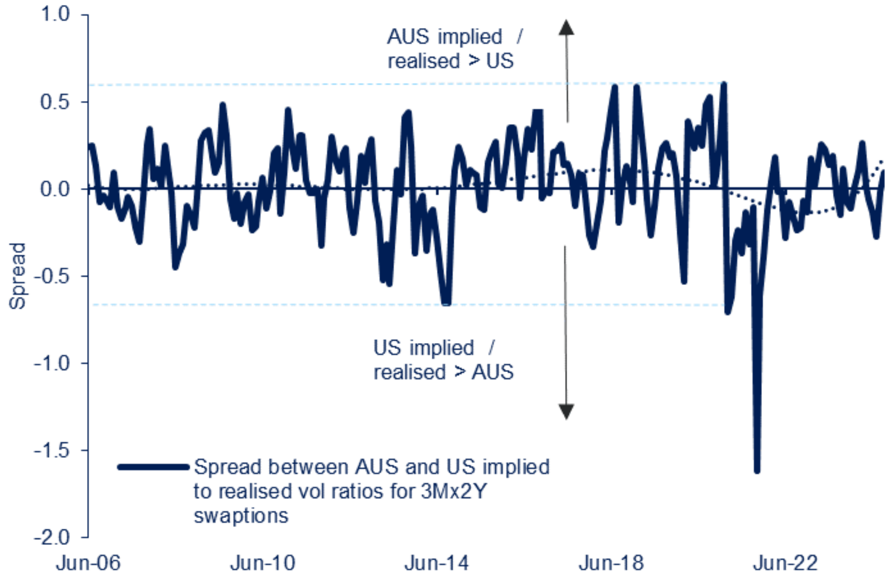
Chart 2: As measured by volatility, there have been 5 big surprises in the last couple of decades



Source: Citigroup Global Markets and JBWere.

So the chart shows us that hiccups in central bank communication can almost be as impactful as exogenous shocks like the GFC or reasonably rapid changes in underlying economic conditions.

Chart 3: AUS implied / realised vol less US implied / realised vol (3Mx2Y swaption vol)

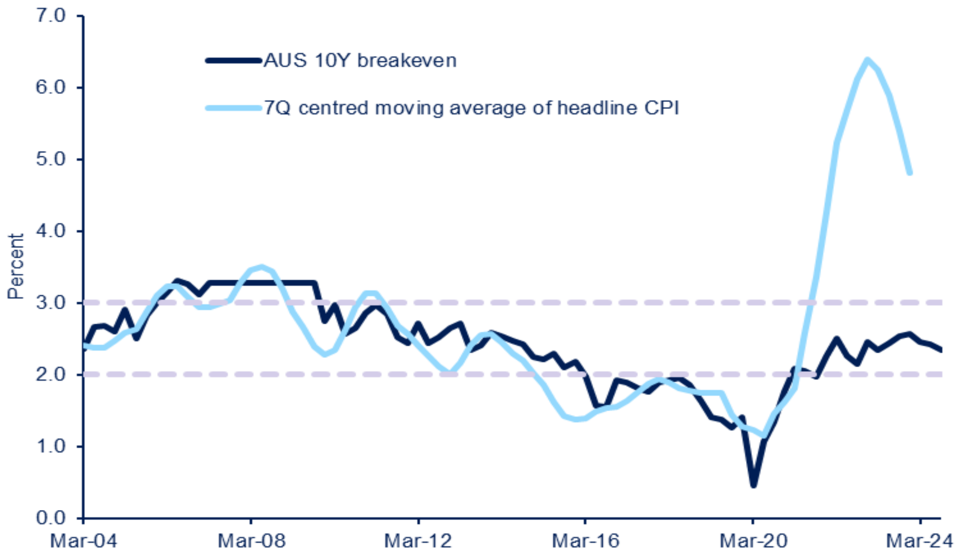


Source: Citigroup Global Markets and JBWere.

And if we look at the ratio as a spread to the US (Chart 3), to try to account for global influences, there is no real trend. As the chart shows, the series is pretty range bound until late 2021, which reflects the volatility in the local bond market due to the YCC exit. So we could conclude that aside from that incident, the signal to noise ratio in central bank communications in Australia hasn't been a driver of excessive front end rate volatility for much for the past two decades.

One simple and quite commonly used measure of central bank credibility and communication is inflation expectations. Chart 4 sums it up – it shows, using quarterly data, the 10Y breakeven rate for Australia and a 7-quarter centred moving average of headline CPI. As the chart makes clear, they have moved together over the past 20 years. But it is the last 3 years that speak volumes about the credibility of the RBA and its communications strategy – despite a protracted period of above target inflation, breakevens have remained resolutely within the target band and if anything, have declined somewhat of late.

Chart 4: AUS 10Y breakeven rate and headline CPI



Source: Bloomberg and JBWere.

Of course, the chart comes with the usual caveats around exactly how much signal we can take from market-based inflation measures, but that this has occurred when we have had a change of leadership at the Bank, a couple of sub-optimal communication outcomes and the highest rates of inflation that most of the population has ever seen in their working lives suggests that the RBA is doing a lot right with its communications, in my view.

Conclusion

And now, the conclusion. Over my career, I think we have been lucky in Australia to have had a succession of RBA Governors who have been, on the whole, very good communicators. Clearly there have been periods where better outcomes could have been achieved – the experience around the exit from Yield Curve Control and the choice of calendar forward guidance as we moved through the pandemic were two such episodes. In both cases, the important nexus between central bank credibility and communication was made clear.

But the chart shows that these aberrations, while not great in the short-run, appear to have done nothing to dislodge long-run inflation expectations in Australia. That sort of credibility is built over decades, and perhaps importantly, shows that while there is much effort and attention paid to the frequency, content and method of central bank communication, in the end I think this success comes down to three things: first, adherence to the inflation targeting framework; second, articulation of the Bank's reaction function; and finally, a willingness to acknowledge uncertainty and to let markets price risk accordingly. From my perspective as a long-time consumer of central bank communication, these are solid foundations.

Of course, it helps to have a governor who *The Australian* newspaper recently described as – and I quote – "…*authentic, confident in the territory, measured, direct and clear*" and who has "…*established herself as a person of authority and is trusted, even as she continues to deny the hungry multitude a cut in interest rates*."[iii]

On that positive note, I will conclude my remarks. Thank you for listening and I look forward to hearing Jens' perspectives on my observations.

[i] rbareview.gov.au
[ii] Beware False Prophets | Speeches | RBA
[iii] Michele Bullock: How Reserve Bank boss became economy's dominant player | The Australian