

Non-technical summary for ‘Perceived Monetary Policy Rules: Evidence from Professional Forecasters in Australia’

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What did we set out to do?

What people expect will happen to interest rates is an important driver of their behaviour. For example, if financial market participants think the cash rate will rise, they will adjust the prices of a range of financial assets, resulting in increases in a range of other interest rates. Central banks, like the Reserve Bank of Australia (RBA), shape these expectations by explaining how they will adjust interest rates when inflation or unemployment changes. This is known as the central bank’s “reaction function”.

However, it can be difficult for a central bank to know whether people understand this reaction function, or how to improve their understanding. For example, do people learn more from what the RBA says, or from what it does?

In this research, we use survey data to study what professional forecasters believe the RBA’s reaction function is. We focus on three key questions:

- What do forecasters think the RBA’s reaction function is on average?
- How do these beliefs change over time, and are they influenced by the RBA’s actions and communication?
- When forecasters disagree about future interest rates, is it because they expect different economic conditions, or because they think the RBA will respond to a given set of economic conditions in different ways?

What are our key findings?

- On average from 2015-2019, based on the estimated simple and more complex Taylor Rule reaction functions, professional forecasters believed the RBA responds less strongly to rising inflation than many economic models assume.
- The RBA’s communication matters. For example, in the mid-2010s, comments about housing-related financial stability risks, such as in some speeches, led forecasters to believe the RBA would be less likely to cut interest rates even if inflation was low.
- Acting by adjusting the cash rate shapes professional forecasters’ view of the reaction function. After COVID, forecasters only became convinced the RBA would lift rates sharply once it actually started doing so. Similar patterns occurred in other countries such as the United States and United Kingdom.
- Most of the disagreement about future interest rates has historically come from different views about the economy, but at times forecasters have also disagreed about how the RBA will respond to a given set of conditions. For example, coming

out of COVID, there appears to have been some disagreement around how sharply the RBA would respond to the pick-up in inflation.

What are the key policy implications of our findings?

It's important for a central bank to have a well-understood reaction function, as it means that people will have a good sense of what is likely to happen to rates in the future as the economy evolves.

Our work shows that the RBA can shape professional forecasters' understanding of its reaction function through its communication, highlighting the importance of clear and deliberate communication.

The research also shows that in addition to communication, the RBA's actions are also important for shaping forecasters' expectations.