Non-technical summary for 'Can We Use High-frequency Yield Data to Better Understand the Effects of Monetary Policy and Its Communication? Yes and No!'

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To set monetary policy appropriately, it is important for the central bank to understand how monetary policy affects the economy. However, assessing this can be difficult.

One reason is that central banks set rates based on expected future economic outcomes. For instance, if the central bank expects that inflation and activity will increase, it will tend to raise rates to keep inflation from rising too far away from its target. As such, it could look like inflation is rising in response to higher interest rates, but in fact interest rates are responding to future (expected) inflation.

A second complicating factor is that central banks not only affect the economy by changing the short-term policy interest rate, but also by communicating about future policy. For example, the central bank may indicate that it expects the economy to remain weak and for interest rates to remain low, and people may respond. However, quantifying the nature and effect of such communication is difficult. Similarly, 'unconventional' policies, such as yield curve targeting and bond purchase programs, work by affecting longer-term interest rates and expectations – not just current short-term interest rates. As such, approaches used to assess the effects of conventional policy that focus on changes to the short-term policy rate can't be used to assess the effects of unconventional policy.

In this paper, we take a new approach to assessing the effects of policy to get around these issues by using data on interest rates of different maturities. This lets us separately examine how RBA decisions and communication affect the economy by influencing: the current policy rate; people's expectations for future policy; and risk or uncertainty (and so the premia people require when investing).

Key findings

The approach is very useful in understanding how the RBA's policy and communication shape people's expectations. For example, it shows that:

- Speeches, the Board minutes and the *Statement on Monetary Policy* affect people's expectations about future interest rates. However, on average, they have a much smaller effect compared with policy announcements.
- When the RBA highlighted housing risks in the 2010s, people increased their expectations for future policy rates, which in turn may have affected economic activity.
- Financial markets appear to systematically misunderstand how the RBA will respond to data, highlighting the importance of clear communication.
- COVID-19-era unconventional monetary policy worked mainly by affecting the premia people require to take on risk, rather than expectations for future policy rates. This is in contrast to pre-COVID-19 policy.

The results also confirm our existing understanding of the effects of policy on the economy. Increases in the current policy rate weaken economic activity, but changes in people's expectations for policy, or regarding risk and uncertainty, don't appear to have an affect (at least that we can find using this approach).