Review of the RBA's Approach to Forward Guidance

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Overview

This review examines the Reserve Bank of Australia's use of forward guidance regarding the cash rate over the COVID-19 pandemic period and discusses the approach going forward.

As was the case for many other central banks during the pandemic, the RBA used forward guidance on the cash rate to strengthen the impact of its other monetary policies. Previously, the Bank had used forward guidance to varying degrees, with the guidance being generally qualitative in nature. During the pandemic, forward guidance was more specific and formed a prominent part of the package of policy responses. Those responses included the cash rate being reduced to the effective lower bound, a three-year yield target, a three-year Term Funding Facility (TFF) and a bond purchase program (BPP).

As part of its forward guidance, the Board indicated that it would not increase the cash rate until progress was being made towards full employment and it was confident that inflation was sustainably within the 2 to 3 per cent target band. At various points, the guidance included a time-based element and a more detailed specification of the economic conditions that would determine a lift in interest rates. Since raising the cash rate earlier this year, the forward guidance has returned from this stronger, more specific form to its earlier, more qualitative form.

The key points of this review are:

- Together with other policy measures, the RBA's stronger forward guidance worked to lower funding costs and support the economy early in the pandemic, when the outlook appeared dire. The policy response helped shore up confidence during a period of significant uncertainty and disruption. It also provided insurance against very bad economic outcomes at a time when there was very limited scope to lower the cash rate further.
- The forward guidance was state-based, but at various times included a time-based element. This complicated the Bank's attempts to communicate the state-based nature of its policies and it could have done more to emphasise the conditionality of its statements about the future path of the cash rate.
- The time-based element of the guidance was very prominent in media and market commentary, and came to dominate the interpretation of the forward guidance. The RBA attracted extensive criticism when the cash rate was increased much earlier than implied by the conditional time-based guidance.
- The message about the likely timing of future cash rate increases was complicated by the yield target. The time-based element of guidance and the term for the yield target were mutually reinforcing. Neither were well suited to respond to the unprecedented global events. In particular, if the time-based aspect of the conditional forward guidance had been shortened or removed while the yield target was in place, it would have significantly affected the credibility of the yield target. Also, in retrospect, greater emphasis on upside risks might have led to an earlier decision to modify the time-based aspect of forward guidance. See also 'Review of the Yield Target' (RBA 2022b).
- The Bank sought to explain in some detail the economic conditions that would prompt an increase in interest rates. The Bank had difficulty communicating the state-based conditions, such that they were not well understood. In particular, the Bank emphasised that the outlook for wages was an important indicator for

assessing whether or not inflation was 'sustainably within the target range'. This detail complicated the messaging, with many commentators interpreting the Board as having a wages target.

- The Board recognised the risks involved in stronger forward guidance, and judged that it was appropriate given the unique circumstances of the pandemic and the desire to insure against the worst possible economic outcomes. The forward guidance involved providing information about the key considerations for policy decisions and then combining this with the economic forecasts to draw out the implications for the timing of the next change in interest rates.
- The experience with forward guidance over the pandemic period highlights the challenges in combining state-based and time-based elements in forward guidance, particularly with a yield target. The Board is committed to learning from this experience. Many major advanced economy central banks also provided both state-based and time-based elements in forward guidance during the pandemic and experienced communication challenges. The public is interested in understanding the factors that drive the Board's decisions and this understanding is important to policy effectiveness and accountability.
- In extreme circumstances like those of recent years and when interest rates are at (or close to) the lower bound, a strong form of forward guidance can provide additional stimulus and therefore be an important part of the policy toolkit. The Board has not ruled out using a strong form of forward guidance again.
- The Board places value on being transparent about its view of the economy and how it intends to adjust policy in response to incoming information. In most situations, the preferred approach is to leave the markets and public to draw their own inference about the timing and extent of future interest rate movements using information provided by the Bank and other information more broadly.
- The Board's approach to forward guidance will be guided by the following considerations:
  - Where forward guidance is appropriate, ordinarily it will be qualitative in nature. Given the inherent uncertainty in the world, forward guidance will generally be flexible and conditionality will likely focus on the Board's policy objectives – namely, inflation and unemployment – rather than the drivers of these variables (e.g. wages). It will typically focus on the short term and be narrative in nature.
  - Forward guidance on interest rates will not always be provided, although the Board will continue to outline how monetary policy settings are adjusted in response to evolving economic conditions.
  - The Bank will continue to publish forecasts on a regular basis, along with an assessment of the various risks. The Bank does not intend to publish its own forecasts of the expected policy path.
  - When policy rates are at, or near, the effective lower bound, a stronger form of forward guidance will be considered, taking into account lessons on the benefits of flexibility and using scenarios to prepare for a range of scenarios.

1. Some background on forward guidance

'Forward guidance' refers to a central bank communicating in some way about the future course of monetary policy. It can take a variety of forms. One common form of forward guidance is where the central bank provides a qualitative or general statement about the likely direction or movement in interest rates. A 'stronger', more specific version is where the central bank might commit to hold interest rates on a specified path until specific macroeconomic objectives or conditions are fulfilled or even commit to hold interest rates on that path for a specified period. When effective, forward guidance can influence interest rate expectations and thus interest rates further along the yield curve and, therefore, financial conditions.

Most central banks employ some form of forward guidance, although the details differ. The use of forward guidance has taken on increased importance over the past decade or so, as central banks have sought to provide additional policy stimulus when the policy rate has been constrained at the effective lower bound.[1] This additional stimulus can be achieved by the central bank committing to a path for the policy rate that would not be followed if the central bank was not constrained. In more normal times, forward guidance can be used to reinforce the market's understanding of how the central bank intends to adjust monetary policy in response to incoming information (its 'reaction function').

Forward guidance near the effective lower bound can reduce short- and long-term real interest rates by:

1. lowering expected future nominal interest rates
2. raising inflation expectations and thereby reducing real interest rates, because policy is more stimulatory than otherwise
3. reducing uncertainty about the future path of the policy rate, which reduces term premia.

By lowering real interest rates, forward guidance can therefore boost aggregate demand. The increase in demand can then produce beneficial second-round income effects, which can raise expenditure further. In the empirical literature, most of the effect is attributed to the first and third of these channels, with little effect found for inflation expectations.[2]

Most discussions of forward guidance focus on three main approaches:

- *State-based* – where the forward guidance conditions the path of policy on the state of the economy (e.g. requiring specific thresholds for inflation or the unemployment rate to be met before the next move in the policy rate).
- *Time-based* – where the focus of the communication is on the calendar with, for example, the central bank indicating that it intends to hold the policy rate unchanged for a particular period or until a particular point in time.
- *Qualitative* – where a general statement is provided about the likely direction for interest rates, possibly over a limited or otherwise not too specific time period. Qualitative guidance can be embedded in a narrative about the economy and the central bank's decision-making framework.

All three approaches have been used in practice with different levels of success.[3] Often forward guidance is included as a short description that forms part of the central bank's broader communication about its monetary policy decision. However, it can be provided in a number of different ways. One possibility is to say explicitly that interest rates will not be increased (or will continue to be increased) until a specific condition is met or a date reached. Another possibility is for the central bank to publish its own forecasts of the policy rate. The Federal Reserve (Fed), for example, publishes the so-called 'dot plots', based on the projections of Federal Open Market Committee (FOMC) meeting participants; other central banks publish their expected path for the policy rate. Alternatively, a central bank can make fairly high-level statements about the direction of interest rates.

In adopting specific guidance, on balance academic research favours state-based forward guidance over time-based guidance because it is more resilient to changing economic circumstances and has fewer credibility issues as a result.[4] Even so, time-based forward guidance can be more powerful, especially in extreme circumstances and when the policy rate is close to the lower bound.[5] During the pandemic, many advanced economy central banks provided forward guidance that was primarily state-based but also included some communication around expected timing (see Box A). Some research has found that mixing state-based and time-based guidance runs a high risk of misinterpretation, with a high likelihood that the media and markets focus on the time element.[6] The focus on timing is understandable given that the concept of time is more straightforward than state-based conditionality.

While straightforward messages are more easily understood, they are less likely to be fulfilled if they oversimplify the complexity of the policy decision. For example, if the central bank provides a relatively simple state or time contingency that is easy to communicate, its message might turn out to be 'too simple' and therefore require the central bank to change the guidance. On the other hand, if the central bank lists a multitude of indicators to be

Box A: International use of forward guidance with time-based communication in response to the pandemic

Most advanced economy central banks used forward guidance as part of their policy response to the pandemic. State-based forward guidance was generally preferred but a number of central banks employed some form of time-based communication. For example:

- The Reserve Bank of New Zealand adopted specific time-based forward guidance at the start of the pandemic, committing in March 2020 to hold the official cash rate at 0.25 per cent for at least a year. It then switched to state-based guidance after that.[7]
- The Bank of Canada (BOC) used state-based guidance that maintained the policy rate would remain low until 'economic slack is absorbed so that the 2 per cent inflation target is sustainably achieved'. In October 2020, the BOC indicated that '[in] our current projection, this does not happen until into 2023'. In April 2021, it brought this expectation forward to the second half of 2022.[8]
- The Fed continued to provide information about FOMC meeting participants' assessment about the likely path for policy.[9] From early on in the pandemic, the median FOMC meeting participant did not expect the federal funds rate to rise until after the end of the projection period. In mid-2020, this was not until after 2022, and in early 2021, the first increase was not expected until after 2023. The expected timing of the first increase started to be brought forward after that during 2021.
- The European Central Bank (ECB) added time-based communication to its state-based guidance, which focused on forecast inflation returning to target alongside progress being seen in underlying inflation dynamics. In late 2021, ECB President Christine Lagarde noted that the conditions for a rate lift-off were unlikely to be met in 2022. In March 2022, President Lagarde indicated that, conditional on the medium-term inflation outlook, the net purchases under the Asset Purchase Program would end in the third quarter of 2022 and interest rates would increase 'some time after' that.[10]
- The Swedish Riksbank had published forecasts of its policy rate for some time. After the onset of the pandemic and up until September 2021, the guidance was that rates would remain at zero per cent until the end of the forecast period (roughly three years ahead). From November 2021 and up to February 2022, the guidance was that the first increase in the policy rate was expected sometime in 2024.

considered when making its judgements, communication of the state-based conditions that is accurate and intelligible can be very difficult to achieve. Qualitative guidance is a more flexible form of guidance as it tends to be less specific about the conditions that are determining the policy decisions, although it is usually accompanied by a discussion related to the central bank's policy objectives.

For all approaches, the effectiveness of forward guidance depends on the guidance being credible. If the central bank communicates beyond what is deemed credible, markets and the media will discount the communication and it will have limited effect on financial prices.[11] By damaging the credibility of the central bank (which could be because the central bank decides to renege on the guidance or misses its policy objectives), it could also damage the effectiveness of its communication in the future.[12]

An important issue with all approaches is the degree of flexibility inherent in the forward guidance. Strong guidance, if credible, can have a helpful effect regarding the transmission of policy but is vulnerable to significant unanticipated events. Indeed, central bank observers have questioned whether forward guidance unhelpfully delayed central bank responses to emerging risks for the inflation outlook.[13] As the Governor of the Bank of France has noted, there is 'a trade-off between the benefits of signalling intentions in advance and the constraints this places on both sides' (Villeroy de Galhau 2022). This trade-off can become more difficult at times of heightened uncertainty.

2. The RBA's approach during the pandemic

Prior to the pandemic, the Bank provided some form of forward guidance as part of its communication, which varied in extent over time. The best description of this guidance would be 'qualitative guidance' as it was fairly general in nature and was at times fairly limited, with the focus being on explaining the current situation.

The approach evolved during the exceptional days of the pandemic. As was the case with other central banks, the Board used more extensive forward guidance as part of its policy response. The approach was always state-based, but at various times it included a time element as well.

The general approach was as follows:

- set out the central forecast for the economy and inflation
- explain the broad decision rule that was being used and the conditions in that rule
- draw out the implications of the forecasts and the decision rule for the timing of the first increase in interest rates.

The Board's forward guidance was accompanied by a number of other policy measures. These included the yield target and the TFF. Both of these policies reinforced the time element of the forward guidance, as both had a three-year maturity for much or all of the period of their operation.

The following discussion steps through the evolution of the Board's forward guidance over this period.[14]

Forward Guidance Key Developments[(a)]

(with other time-related policy developments shown in blue italicised text)

19 March 2020	'The Board will not increase the cash rate target until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2–3 per cent target band.' (This statement was made within the announcement of the package of monetary policy measures in response to the pandemic, which included: a cut in the cash rate to 0.25 per cent; a yield target for three-year government bonds; a TFF to provide low cost three-year funding for banks; and bond purchases to address market dislocation.) A speech by the Governor added that the conditions on the cash rate 'means that we are likely to be at this level of interest rates for an extended period'. Regarding the yield target: 'We have chosen the three-year horizon as it influences funding rates across much of the Australian economy and is an important rate in financial markets. It is also consistent with the Board's expectation that the cash rate will remain at its current level for some years, but not forever.'
1 September 2020	*Extension and expansion of the TFF announced: latest maturity of three-year funding available was extended from September 2023 to June 2024.* *Monetary policy meeting Minutes noted that 'the focus of the yield target will increasingly shift [from the April 2023 bond] to the April 2024 bond, which will become the bond with a maturity closest to three years in the second half of October 2020.'*
15 October 2020	In a speech, the Governor communicated the evolution of forward guidance as discussed by the Board in October, placing more weight on actual outcomes than forecasts in assessing whether inflation is sustainably within the target band: '[A]chieving inflation consistent with the target is likely to require a return to a tight labour market. On our current outlook for the economy – which we will update in early November – this is still some years away. So we do not expect to be increasing the cash rate for at least three years.'
3 November 2020	'For its part, the Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. For this to occur, wages growth will have to be materially higher than it is currently. This will require significant gains in employment and a return to a tight labour market. Given the outlook, the Board is not expecting to increase the cash rate for at least three years.'

	Package of additional monetary policy measures announced, including: cuts to the cash rate target, the three-year yield target and the TFF rate to 0.1 per cent; and the establishment of a BPP of $100 billion at a pace of $5 billion per week.
2 February 2021	'The Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. For this to occur, wages growth will have to be materially higher than it is currently. This will require significant gains in employment and a return to a tight labour market. The Board does not expect these conditions to be met until 2024 at the earliest.'
10 March 2021	Amid the rise in yields, a speech by the Governor reiterates support for the yield target on the basis of forward guidance: 'Consistent with the judgement that the condition for an increase in the cash rate is unlikely to be met before 2024, the Bank remains committed to the three-year yield target. We are not considering removing the target or changing the target from 10 basis points.' The speech also provided more detail on the sustainable inflation condition: 'For inflation to be sustainably within the 2 to 3 per cent range, it is likely that wage growth will need to be sustainably above 3 per cent.'
4 May 2021	'The Board is committed to maintaining highly supportive monetary conditions to support a return to full employment in Australia and inflation consistent with the target. It will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. For this to occur, the labour market will need to be tight enough to generate wages growth that is materially higher than it is currently. This is unlikely to be until 2024 at the earliest.'
6 July 2021	'[The Board] will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. The Bank's central scenario for the economy is that this condition will not be met before 2024. Meeting it will require the labour market to be tight enough to generate wages growth that is materially higher than it is currently.' *Yield target of 0.1 per cent maintained for the April 2024 bond but not extended to the November 2024 bond.*
2 November 2021	*Board announced that the yield target is discontinued after stronger-than-expected Australian CPI and April 2024 bond yield rises through target amid rise in global yields.* 'The Board is prepared to be patient.' A speech by the Governor added: 'There is genuine uncertainty as to the timing of future adjustments in the cash rate … it is still entirely possible that the cash rate will remain at its current level until 2024. But it is also possible that an earlier move will be appropriate.' The Minutes from the November meeting stated: '[T]he Board agreed … to discontinue the yield target altogether. In making this decision, members highlighted the importance of continuing to communicate clearly that future decisions about the cash rate would be based on the state of the economy and not particular dates on the calendar. Given the latest data and forecasts, the central scenario for the economy continued to be consistent with the cash rate remaining at its current level until 2024.'
7 December 2021	'The Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. This will require the labour market to be tight enough to generate wages growth that is materially higher than it is currently. This is likely to take some time and the Board is prepared to be patient.'
1 February 2022	'As the Board has stated previously, it will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. While inflation has picked up, it is too early to conclude that it is sustainably within the target band. There are uncertainties about how persistent the pick-up in inflation will be as supply-side problems are resolved. Wages growth also remains modest and it is likely to be some time yet before aggregate wages growth is at a rate consistent with inflation being sustainably at target. The Board is prepared to be patient as it monitors how the various factors affecting inflation in Australia evolve.' *Board announced decision to cease further purchases under the BPP (final purchases on 10 February) following a review of the actions of other central banks, the functioning of Australia's bond market and the progress towards the goals of full employment and inflation consistent with target.*
1 March 2022	'The Board is prepared to be patient as it monitors how the various factors affecting inflation in Australia evolve.'

5 April 2022	'The Board has wanted to see actual evidence that inflation is sustainably within the 2 to 3 per cent target range before it increases interest rates. Inflation has picked up and a further increase is expected, but growth in labour costs has been below rates that are likely to be consistent with inflation being sustainably at target. Over coming months, important additional evidence will be available to the Board on both inflation and the evolution of labour costs. The Board will assess this and other incoming information as it sets policy to support full employment in Australia and inflation outcomes consistent with the target.'
3 May 2022	Cash rate target increased by 25 basis points. 'The Board is committed to doing what is necessary to ensure that inflation in Australia returns to target over time. This will require a further lift in interest rates over the period ahead. The Board will continue to closely monitor the incoming information and evolving balance of risks as it determines the timing and extent of future interest rate increases.'
7 June 2022	Cash rate target increased by 50 basis points. 'The Board expects to take further steps in the process of normalising monetary conditions in Australia over the months ahead. The size and timing of future interest rate increases will be guided by the incoming data and the Board's assessment of the outlook for inflation and the labour market. The Board is committed to doing what is necessary to ensure that inflation in Australia returns to target over time.'
4 October 2022	Cash rate target increased by 25 basis points. 'The Board expects to increase interest rates further over the period ahead. It is closely monitoring the global economy, household spending and wage and price-setting behaviour. The size and timing of future interest rate increases will continue to be determined by the incoming data and the Board's assessment of the outlook for inflation and the labour market. The Board remains resolute in its determination to return inflation to target and will do what is necessary to achieve that.'

(a) Unless otherwise stated, these quotes are taken from the Monetary Policy Decision statements that follow the monthly Board meetings.

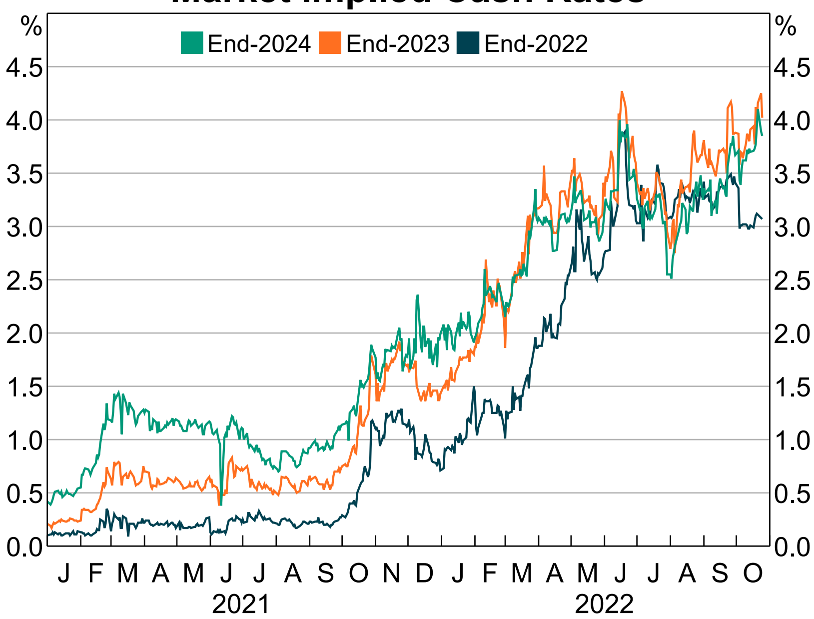
In March 2020, with the cash rate near the effective lower bound, the Board sought to strengthen the effect of its reduction in the cash rate. The forward guidance set out the broad conditions for the first increase in the cash rate, and indicated that to meet those conditions the cash rate was likely to be at its current level for years but not forever.

In October/November 2020, forward guidance language became more specific about the conditions for an increase in the cash rate and the timeframe considered likely to meet the conditions. The Board announced that it would place more weight on actual inflation outcomes than forecasts in assessing whether inflation was sustainably within the target band.[15] It also said that this would require materially higher wages and the return to a tight labour market. Given the outlook at that time for these conditions to be met, the Board was not expecting to increase the cash rate for at least three years.

Through 2021, more detail was provided on the conditions for an increase in the cash rate and the time-based communication was modified in line with the yield target.

- In **February 2021,** the time-based communication was amended to state that the Board was not expecting the conditions for a cash rate increase to be met 'until 2024 at the earliest', from 'at least three years' previously. This focus on 2024 reinforced the link between the forward guidance and the yield target. This occurred around the time when overnight indexed swap markets started pricing some expectation of rate rises before 2024, and communication around the yield target had become more committed, with less discussion of exit.[16]

Market Implied Cash Rates



Sources: Bloomberg; RBA

- In a speech in **March 2021**, the Governor emphasised the existing message – that for inflation to be sustainably within the 2 to 3 per cent target range, wages growth needed to be materially higher than it was currently (Lowe 2021a). At the time, growth in the Wage Price Index was at its lowest in the history of the series. Expanding on that, the Governor stated that 'for inflation to be sustainably within the 2 to 3 per cent range, it is likely that wages growth will need to be sustainably above 3 per cent'. Though couched in highly conditional language, the '3 per cent' came to be viewed by some as an integral part of the state-based criteria for a cash rate increase.
- In **July 2021**, language around when conditions for a rise in the cash rate might be met changed from 'until 2024 at the earliest' to 'the Bank's central scenario for the economy is that this condition will not be met before 2024'. The more qualified tone was consistent with deliberations on the yield target around this time. At the July 2021 meeting, the Board decided to retain the April 2024 bond as the target bond, rather than extend the target to the bond with a maturity date of November 2024, which was soon to become the bond closest to a three-year maturity.

Following cessation of the yield target in November 2021, time-based communication in the forward guidance became less specific.

- In **November 2021**, conditions for a rise in the cash rate were explained as 'likely to take some time. The Board is prepared to be patient'. The Board's central scenario was still that the cash rate would not rise before 2024, but it was acknowledged that it was possible that rates could rise earlier.
- In **April 2022**, the Board's communication no longer included the statement that it was 'prepared to be patient' and noted that, while inflation had picked up, 'labour costs has been below rates that are likely to be consistent with inflation being sustainably at target'. The Minutes of the April Board meeting noted that the Board would assess evidence on inflation and the evolution of labour costs 'over coming months'. The Minutes also noted that recent developments in relation to inflation had brought forward the likely timing of the first increase in interest rates. This included Russia's invasion of Ukraine in late February, which had led to a surge in energy and other commodity prices and had created some additional disruption in global supply chains, both of which were likely to lead to higher global inflation in the near term.

- In **May 2022**, the Board considered that the conditions of the forward guidance had been met, which was assessed as 'actual inflation to be sustainably within the 2 to 3 per cent target range, which was likely to require a faster rate of wages growth than had been experienced over the preceding years'. The Minutes noted that inflation was above target and likely to persist, and evidence on wages and business surveys clearly pointed to labour costs rising at a faster pace and this was expected to continue given tight labour market conditions. The Board raised the cash rate by 0.25 percentage points and noted that it 'is committed to doing what is necessary to ensure that inflation in Australia returns to target over time'. The Board indicated that a further lift in interest rates would be required, though the timing and extent would be assessed based on the 'evolving balance of risks'. At a media and markets briefing after the meeting, the Governor noted that the Board 'is not on a pre-set path'. That language was included in the media release following the monetary policy decision in August.

Following the first cash rate increase, forward guidance has evolved further. Subsequent forward guidance through 2022 has been more flexible, focused on the near term and emphasising the straightforward condition of returning inflation to the target. Three key messages have been reiterated:

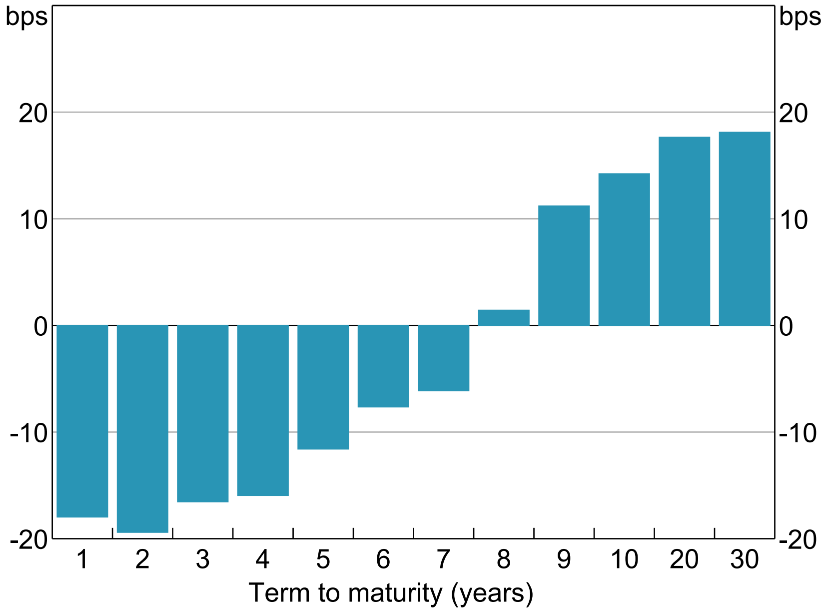
1. The Board expects to increase interest rates further in the period ahead.
2. The size and timing of future interest rate increases will be guided by the incoming data and the Board's assessment of the outlook for inflation and the labour market.
3. The Board is committed to doing what is necessary to ensure that inflation in Australia returns to target over time.

3. Some observations from this experience

Forward guidance (together with other measures) worked in lowering funding costs

Forward guidance worked alongside other monetary policy measures implemented during the pandemic to lower funding costs and reduce financial market volatility. The announcement of the package of policy measures on 19 March 2020, including forward guidance, the yield target and the TFF – which were all mutually reinforcing measures relevant for funding costs out to the three-year maturity – had an immediate and substantial effect on yields on intermediate maturities. The three-year yield fell by 24 basis points to 34 basis points between the time of the announcement and the market close that day. As these measures worked in combination, it is not possible to estimate their individual effects.

Change in AGS Yields
Over 19 March 2020

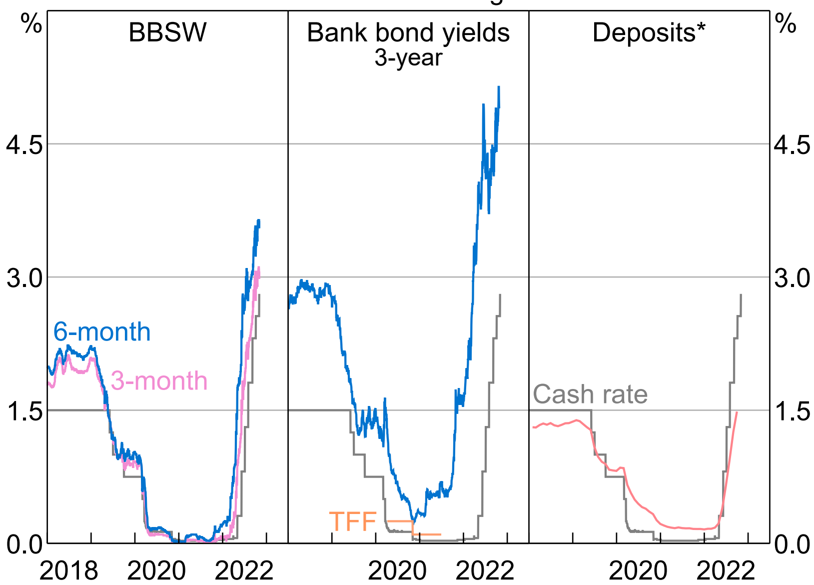


Sources: Bloomberg; RBA

During the pandemic, the overall package of policy measures reduced funding costs across the economy to very low levels. As outlined in the 'Review of the Yield Target' (RBA 2022b), yields fell to historical lows across all debt-funding securities and deposits. In turn, rates on new and outstanding loans declined substantially for both housing and business lending. This supported the Bank's goals by lowering interest payments for existing borrowers and encouraging new borrowing at low rates. In particular, the fall in lending rates was pronounced for fixed-rate loans, with banks lowering fixed housing rates to well below the new variable rate for the first time. Fixed housing rates fell even further below variable rates from late 2020, consistent with the additional TFF funding announced in September, the strengthening of forward guidance in October 2020, and the cut in the yield target to 0.10 per cent and other policy measures introduced in November 2020.

Major Banks' Funding Costs

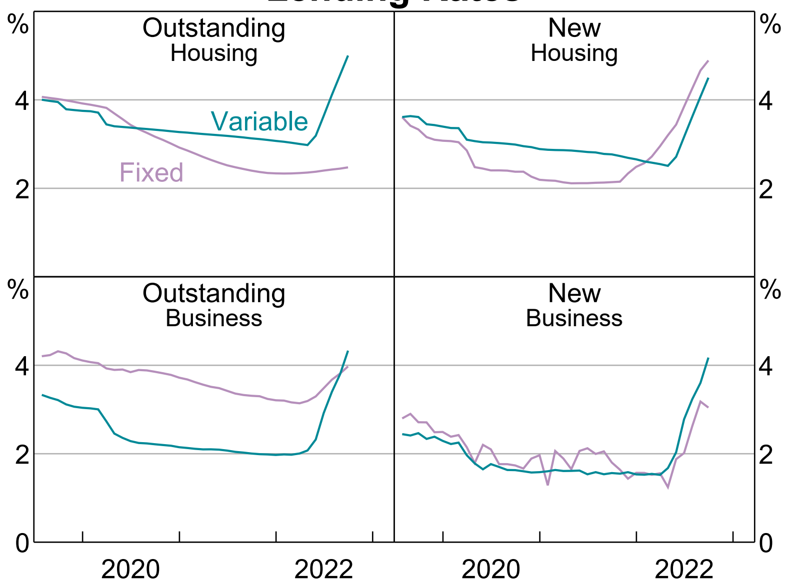
For new funding



* RBA estimates; excludes deposits in housing loan offset accounts.

Sources: AFMA; APRA; ASX; Bloomberg; major banks' websites; RBA; Refinitiv

Lending Rates

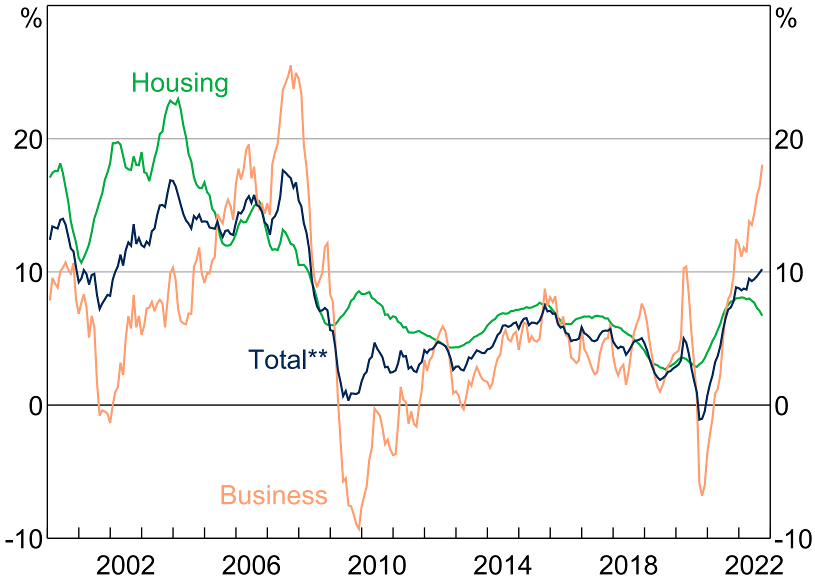


Sources: APRA; RBA

Low funding costs supported the availability of credit to the economy. Total credit growth increased, reflecting strong growth in both housing and business credit. Growth in fixed-rate housing loans was particularly rapid, as borrowers were attracted by the historically large discount on fixed rates relative to variable rates. The sharp rise in the share of new housing loan commitments at fixed rates unwound sharply with the rise in swap rates in late 2021. By March 2022, fixed rates were well above variable rates and the fixed-rate share of new housing lending had fallen to around 20 per cent from its peak of close to 45 per cent in November 2021.

Credit Growth by Sector*

Six-month-ended annualised

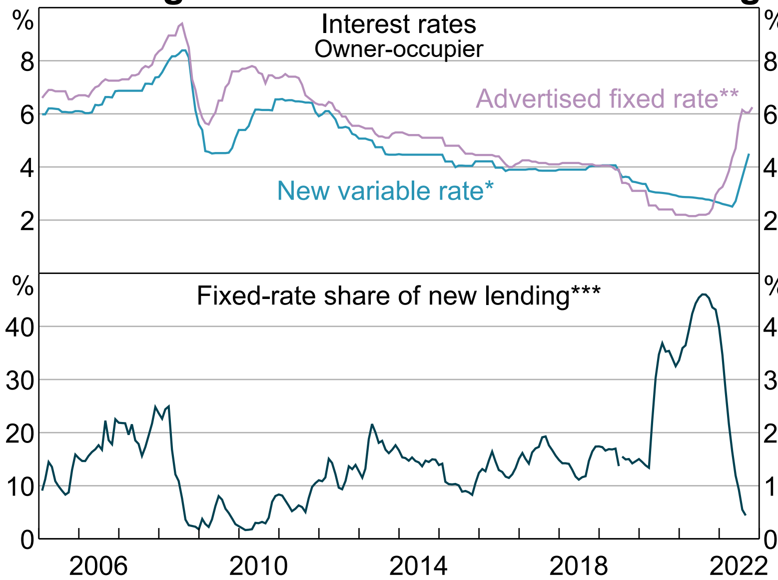


* Seasonally adjusted and break-adjusted; including securitisation.

** Includes housing, personal and business credit.

Sources: ABS; APRA; RBA

Housing Interest Rates and New Lending



* Perpetual data to 2013; advertised package rate to July 2019; thereafter, data based on the EFS collection. Break-adjusted.

** Three-year term to maturity; large lenders only.

*** Estimated owner-occupier share up to July 2019; thereafter total housing loan commitments to residents funded in the month.

Sources: ABS; APRA; Banks' websites; CANSTAR; Perpetual

Communication regarding the conditionality of the forward guidance could have been clearer

During the pandemic, the Board stated that it would not increase the cash rate until certain economic conditions had been met. But these conditions were not sufficiently clear and were not well understood. At times, the communication was overly complex. The time aspect of the Board's communication came to dominate the messaging, with many people focusing on the time aspect rather than the economic conditions.

The Board has sought to be transparent about how it responds to incoming information and how it would be likely to respond in the future. In the unique circumstances of the pandemic and the fact that interest rates had reached the effective lower bound, the Board saw value in drawing out the implications of its economic forecasts and its decision-making framework for the expected timing of the first increase in the cash rate.

Drawing out the implications in this way was a deviation from the previous approach, as was the medium-term nature of the communication. While the Board recognised the risks, it judged that in the unique circumstances of the pandemic it was appropriate to make this change. It was expected that this would reinforce the message that the Board would do what was necessary to support the recovery from the pandemic and provide important insurance against catastrophic outcomes. In any case, an estimate of when the conditions for the first cash rate increase would occur could be arrived at using published information about the Board's state-based forward guidance and the economic forecasts.

A somewhat similar approach was taken by a number of other central banks during this time, with many major advanced economy central banks providing state-based guidance as well as some guidance about the expected timing of the first rate increase (see Box A). Like the Bank, in early 2021 many major advanced central banks did not anticipate a rise in their policy rates until late in or after the end of the forecast period, which implied the first rate rise would be in 2023 or 2024. Similar to the Bank's approach, the state-based guidance emphasised the conditions required for the first increase, in recognition of the considerable uncertainty regarding the outlook for the economy.

In late 2020 and for much of 2021, the Board indicated that the first interest rate increase was not expected for 'at least three years', and then not until '2024 or later'; these statements covered the central scenario or any downside risk that would suggest a later timing for the first rate rise. There was no public commentary of what would occur if the upside risks were realised; during this period, the Board was focused on insuring against the worst possible outcomes. As outlined in the 'Review of the Yield Target' (RBA 2022b), in retrospect more attention could have been given to upside scenarios when making decisions through this period.

It is now clear that the time element of these statements dominated the messaging about conditionality.[17] It was more straightforward for people to understand and recall a certain time than a set of statements about conditionality. The repetition of '2024' in the Bank's communication served to create a strong anchor point, which held considerable sway in the public discussion of the Bank's intention for the timing of the first cash rate increase, even if financial market participants became increasingly sceptical about this timeframe. It was often interpreted that the RBA had promised that interest rates would not increase until 2024, with the statements about conditionality being downplayed. The specification of the yield target served to support the interpretation that interest rates would be unchanged until 2024.

During this period, the Board considered providing a fuller description of the uncertainties involved, but was concerned that this might 'muddy' the message that the Board would provide the support that the economy needed and could also weaken the effectiveness of the policies. An additional complication was that, for the yield target to remain credible, it was desirable that the forward guidance for the cash rate was consistent with the fixed date relevant to the yield target. In other words, the yield target benefited from the time element of the Board's forward guidance, although this was not the main consideration in the framing of the guidance.

The fact that many people interpreted the forward guidance as 'a promise' that there would be no rate raises until 2024 led to considerable reputational damage to the Bank. When the cash rate was increased in May 2022, many people saw the Bank as having broken 'its promise'.

In hindsight, and focusing only on forward guidance, a less specific timeframe, or one covering a shorter horizon, would have been preferable. Given the outlook was highly uncertain, the Board could have given more consideration to potential upside scenarios, including scenarios that could warrant the Board raising the cash rate earlier than anticipated. These observations with the benefit of hindsight are consistent with those made for the yield target in the 'Review of the Yield Target' (RBA 2022b).

At a number of points during the pandemic, the Board considered ways to explain more fully the details of the state-based forward guidance – in particular, what it meant for inflation to be 'sustainably' within the target range. As part of this, the Board regularly referred to the outlook for wages as an important indicator for assessing whether or not inflation would be 'sustainably in the target range'. Over time, it became incorporated into the Board's state-based forward guidance and was a key criterion discussed in the decision to raise rates in May 2022.

This further complicated the messaging, with many commentators interpreting the Board as having a wages target. A specific number for wages growth (3 per cent) served as an anchor point and there was some confusion among commentators over what wages data were being considered. In the end, there was some perception that the Board moved later than it should have as it waited for evidence on wages growth before raising rates. This focus on wages could have also down-weighted other important factors that can drive inflation. Some criticised the Board for relying on liaison data on wages rather than more conventional indicators.

A more straightforward approach, and one with less risk of being subject to misinterpretation, would have been to focus only on inflation conditions, not wages as a driver of inflation. Fewer conditions could also have been placed on the guidance for inflation. For example, the commitment could have avoided use of 'sustainably' and been simply to not raise the cash rate until inflation was within the 2 to 3 per cent target range. Such wording would not have obligated the Board to raise rates when that condition was satisfied if it judged that low rates were still warranted for other reasons.

This experience highlights some of the complexities of communication. The public rightly wishes to understand the factors driving the Board's decisions and this understanding is important to policy effectiveness and accountability. The economic environment is inherently complicated and often highly uncertain, making straightforward messaging difficult. But the more detail provided, the more complicated the messaging can become and the greater the risk of misinterpretation. The question remains, how much to say?

With the cash rate having moved above the effective lower bound, forward guidance has returned to the limited and more flexible form used prior to the pandemic

Following the first increase in the cash rate in May 2022, forward guidance has reverted to the type of guidance that was provided from time to time in the years prior to the pandemic. That guidance is expected to be more resilient to changing economic circumstances and to also have a more limited role in influencing financial conditions. With that in mind, it allows for a more flexible approach in providing guidance from time to time. Three key messages have been reiterated of late:

1. The Board expects to increase interest rates further in the months or the period ahead.
2. The size and timing of future interest rate increases will be guided by the incoming data and the Board's assessment of the outlook for inflation and the labour market.
3. The Board is committed to doing what is necessary to ensure that inflation in Australia returns to target over time.

These messages have generally been understood and are subject to a lower risk of misinterpretation. Markets have generally anticipated forthcoming cash rate movements fairly well, consistent with a reasonable understanding of the Board's objectives and key considerations for policy.

In a similar vein, the use of short-term and flexible guidance worked well for communications about the BPP. The fairly short timeframes of each of the various phases of the BPP to which the Board committed facilitated a timely and relatively smooth end to bond purchases (RBA 2022a). The Board communicated the key considerations that would influence decisions on the BPP prior to the decision points, which were themselves before the implementation dates.

This helped to guide the markets' thinking on the likely course of purchases while still providing the Board with necessary flexibility. Ultimately, this approach enabled a smooth adjustment by markets as bond purchases were wound down.

Assessment summary

The Board's forward guidance on the cash rate helped achieve its policy goals in the early phases of the pandemic. In those extraordinary times and with interest rates at the effective lower bound, the forward guidance and the inclusion of a time-based element reinforced the effectiveness of the Board's other policy measures.

At the time, the Board judged that it would be very likely that its goals for inflation and full employment would not be achieved for a long time. The Board assessed that the dire circumstances warranted policy actions that would not be called for in normal times.

The Board's forward guidance was an important part of a mutually reinforcing package of policy measures to provide support to the economy and insure against the real possibility of very bad economic outcomes. The package successfully met this objective, by helping to lower funding costs across the economy and providing some confidence in a period of significant uncertainty and disruption; however, like the yield target, the effectiveness of forward guidance as a monetary policy tool waned as market participants reassessed their views of the outlook for the cash rate.

The Board's forward guidance – both in terms of the conditions for an increase in the cash rate and the expected timing – was not well understood, particularly as time progressed. The Board was seeking to be fully transparent about its decision-making and the implications of its decision-making framework for its expected path of the cash rate. But in seeking to be transparent, it overly complicated the communication, was misinterpreted and the time-based communication ultimately proved incorrect. .

There are benefits in a central bank being transparent about how it intends to adjust policy in response to incoming information and the economic outlook. And from time to time, there can be benefits to providing some guidance about the likely path of policy rates. However, given the inherent uncertainty about the economic outlook, there are risks to communicating complicated messages, imposing a high level of conditionality and providing guidance on the likely path of policy rates over a long horizon.

Taking on the lessons of recent experience, the Board now favours a less specific approach than that used during the pandemic. This is discussed in the next section.

4. Future approach

Outside of periods of extreme stress, the Board prefers to return to the approach used prior to the pandemic. This involves providing some guidance about future interest rates where it is appropriate to do so, and over a fairly short period. The focus will continue to be on explaining the decision-making framework. It is unlikely that the Bank will draw out in detail the implications of that framework for the timing of future interest rate changes, although it does not rule out doing so. Most of the time, the better approach is to leave it to the market to work out expected timing by combining forecasts of the economy with the Board's decision-making framework.

As explained by the Governor in February 2019:

> *I want to emphasise that we don't have a crystal ball that allows us to see the future with certainty. … The reality, though, is that the future is uncertain. None of us can say with certainty what will happen. What the RBA can do, though, is highlight the issues that are likely to shape the future, explain how we are thinking about those issues, and discuss how they fit into our decision-making framework. (Lowe 2019)*

In the years prior to the pandemic, the Board provided some guidance about the likely direction of the next move in the cash rate with language that varied according to the circumstances. For example, guidance through 2018 was that the next move in the cash rate was more likely to be up than down. By early 2019, with changing economic circumstances, that guidance shifted to the probabilities being more evenly balanced between up and down.

The use of forward guidance in response to the pandemic underscores the attraction of guidance that has fewer conditions, is short term and more clearly flexible. The conditionality of the guidance used during this period could have been communicated more clearly by the Bank. The time-based element attracted criticism when the central forecast that it was based on did not eventuate and so the cash rate was raised earlier than previously expected. A number of other central banks had a similar experience with their own forward guidance during this period.

Another factor supporting a shorter term focus for forward guidance is the structure of the Australian financial system. The bulk of financing activity in Australia is through borrowing linked to short-term rates and, in turn, lending is also primarily linked to short-term interest rates. Indeed, the share of housing lending in Australia that is at variable rates is among the highest in advanced economies. Therefore, by adjusting the cash rate, and occasionally influencing expectations for the cash rate in the near term, the Board can have a strong influence over financial conditions applicable to a large share of funding in the economy. By contrast, for economies where the bulk of financing activity is done at longer terms, the benefits of guiding expectations over longer terms can be greater.

The following summarises the Board's preferred approach to forward guidance, building on some current practices and recognising the lessons from recent experience.

- **Given inherent uncertainty in the world, forward guidance should be flexible and is not always required. This approach is best described as qualitative guidance.** In times when the policy rate is not at the effective lower bound, forward guidance can be used to help inform the public and markets, but it is best to avoid being too prescriptive. A flexible approach will allow communication to adjust to the evolving economic situation. There are circumstances in which specific forward guidance is unlikely to be of use and there is no presumption that guidance about future interest rates will always be provided. Ordinarily, any guidance about future interest rates would be over a relatively near-term horizon and would not be time-specific.
- **Communication should be straightforward and easy to understand.** In most situations, conditionality is likely to focus on the Board's policy objectives – namely, inflation and unemployment – rather than the drivers of these policy variables.

- **The Board will continue to outline how monetary policy settings are being adjusted in response to evolving economic conditions**. This type of communication can help to improve the effectiveness of monetary policy, including by reducing uncertainty about how policy is likely to respond to key news affecting the economic outlook. This can reduce financial market volatility, as well as enhance transparency and public accountability, thereby increasing trust between the Bank and both financial markets and the general public.
- **The Bank will continue to regularly publish economic forecasts and emphasise the various associated risks.** The publication of economic forecasts together with information about the Board's key considerations for monetary policy decisions allows the public and the markets to form their own views about the likely course of monetary policy. However, because forecasting is difficult and the outlook is uncertain, including details about the main risks to the outlook is important. The Board does not intend to publish forecasts of the expected cash rate path (or 'dot plots'). However, the assumed path of the cash rate included in the forecasts will continue to be made explicit.
- **When policy rates are at the effective lower bound, the Board will consider adopting a stronger form of forward guidance.** The Board would consider this approach if it were seeking to deliver additional monetary policy stimulus in very adverse economic circumstances. In doing so, the guidance would be straightforward and focus on the Board's core policy objectives and would avoid including other complicating conditions. State-based guidance would be preferred and the Board would be cautious about any time-based guidance. However, if a timeframe was to be provided, it is likely to be kept to a fairly short time period. As concluded in the 'Review of the Yield Target' (RBA 2022b) and the 'Review of the Bond Purchase Program' (RBA 2022a), the Board has agreed to strengthen the way it considers the full range of scenarios when making policy decisions, especially when they involve unconventional policy measures. The scenario analysis if strong guidance was being considered would include the likely benefits and costs, including the flexibility of the policy to respond to changing circumstances and the associated communication challenges.

Endnotes

[1] Notably, many major advanced economy central banks used forward guidance with this objective as part of their response to the global financial crisis.

[2] See, for example, Hubert and Labondance (2018), Altavilla *et al* (2019), Coibion *et al* (2020), Swanson (2021) and Hofmann and Xia (2022) for the effect of forward guidance on expected future nominal interest rates; and Coenen *et al* (2017), Ehrmann *et al* (2019) and Bauer *et al* (2022) for the effect of forward guidance on interest rate uncertainty. See de la Barrera *et al* (2017) and Coibion *et al* (2020) for evidence of forward guidance on inflation expectations of financial market participants and households, respectively.

[3] See, for example, Swanson and Williams (2014) and Ehrmann *et al* (2019).

[4] See, for example, Blinder *et al* (2017) and Ehrmann *et al* (2022).

[5] See, for example, Eusepi *et al* (2022).

[6] See Feroli *et al* (2017); Broadbent (2022). Coibion *et al* (2020) also found that forward guidance about interest rates has longer lasting effects on household expectations than guidance about economic outcomes.

[7] See Kengmana (2021).

[8] See Bank of Canada (2020; 2021).

[9] The Fed did not publish 'dot plots' in March 2020, but resumed publishing these in June 2020.

[10] See Lagarde (2021); Lagarde and de Guindos (2022).

[11] Altavilla *et al* (2019), Swanson (2021) and Hofmann and Xia (2022) found that forward guidance generally has larger effects on near- to medium-term yields than longer term yields, indicating the limits of central bank credibility to affect rates through forward guidance.

[12] Whether it is optimal to renege on forward guidance depends on the consequent cost to credibility, and the expected frequency/severity of future contractionary shocks (Nakata 2018).

[13] See, for example, remarks by Bowman (2022) regarding the Fed's recent experience with forward guidance.

[14] Events leading up to a number of these decisions are covered in detail in the 'Review of the Yield Target' (RBA 2022b).

[15] A number of central banks strengthened their forward guidance around the conditions for a policy rate increase around this time. In particular, in September 2020 the Fed also moved to focus on actual inflation rather than forecast inflation.

[16] When initiated, and subsequently, the Board noted that the yield target would be removed before any increase in the cash rate. While this remained the strategy, by February 2021, with some signs of pressure emerging on the target, the Bank's communication emphasised options of either extending the target or maintaining it. In March 2021, the Board reiterated the commitment to the yield target, with that commitment subsequently elaborated in the Minutes of the March meeting and a speech by the Governor on 10 March 2021 (Lowe 2021a).

[17] In addition to the Monetary Policy Decision statements, conditionality was explained in speeches and public testimony. For example, in February 2021, in response to the media question 'Is a 3 to 4 year pledge too good to be true?', the Governor replied, 'Can I just take an issue with the word pledge? I haven't pledged anything' (Lowe 2021b). Also, in May 2021, the Deputy Governor said: 'The Bank has provided a possible timeframe alongside its description of the state of the economy required before considering a rise in the cash rate … But I would highlight that it is the state of the economy that is the key determinant of policy settings, not the calendar' (Debelle 2021).

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