

Questions for the Governor

Reserve Bank of Australia (RBA) Governor, Philip Lowe, testified to a parliamentary committee today following a more dovish statement than expected earlier in the week. This accompanied the RBA's decision to extend QE. Here's what I would have asked him



Reserve Bank of
Australia Governor
Philip Lowe

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Why make date-contingent forward guidance?

The first thing I would have asked the RBA Governor was why he thought it a good idea to add some date-contingent forward guidance (FG) to his statement on 2 February. Here is the passage from the latest statement, and the important bit is emphasized.

"The Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 percent 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***"

As some of you will by now realize, I have strong reservations about forward-guidance of any sort. My last piece on this got some snarky comments on Twitter along the lines of "...It's how central banks communicate their reaction functions dummy!". To which my only response, is, "Yes, but why don't you actually read the note and not simply fire off clever-clever responses to Twitter

titles, as you will see I don't dispute this". (I didn't say that, but I did think it).

But before we return to date-contingent forward guidance, the worst sort of FG in my view, let's ponder for a second on the question of reaction functions of central banks - a nod to the "Twitterati". Typically, central banks prefer higher growth to lower, and they like a bit of inflation and wages growth, just not too much of each, and often, a weaker currency, though not too weak.

On a weekly, monthly, heck, probably on an annual basis, those preferences, and hence that "reaction function" should not change much if at all. And so markets should really only be bothered about central bank comments if they feel it changes their *understanding* of that assumed reaction function. If it does, it should be a fairly marginal, and probably an incremental process unless the central bank is in the habit of making deliberately misleading comments, or is simply incompetent. That is not our view of the RBA. Otherwise, markets responding to these comments suggest they believe the central bank is constantly making minute adjustments to their preferences for growth, employment, inflation, and a whole host of other variables. That is palpable nonsense.

Back to date-contingent forward guidance. The problem with this is a simple one of time-inconsistency. If Governor Lowe says, "not until 2024 at the earliest", and the economy is booming in 2023 and inflation and wages have shot up and the unemployment rate dropped sharply, then he can either brazen it out, ignore the data and sustain an inappropriately easy rate policy (at least until 2024, when he can play catch-up), or he can throw in the towel, admit he got it wrong, and do the right thing. The point is, we know this, which is why today, 10Y Australian government bond yields are continuing to move higher, as they are also in the US, where the Fed has made virtually the exact same date commitment and suffers exactly the same time inconsistency issue over policy. And let's face it, Lowe's choice of 2024 was no fluke. This was probably done to try to keep AUDUSD in check, although recent moves suggest that such "steering" isn't really necessary as the USD seems to have found some strength of its own.

As for state-contingent forward guidance - like a much lower unemployment rate and higher wages - I have far fewer issues with this. But again, if the guidance is clear, we don't need this repeated ad nauseam. And then, yes markets can move in response to unanticipated shifts either towards or away from those targets as economic data is released and delivers a little volatility. But we still don't really need the incessant central bank chatter as the reaction function is clear and unchanging.

The key remarks Governor Lowe made were not on this of course but instead justified the extended QE programme by citing the actions of other central banks, which would have caused an "unwelcome rise in the dollar" in his view without these additional moves. Lowe also hinted at winding down the Term funding facility, which no longer seems to be needed. This could be allowed to lapse in June.

For what its worth, my view is that if US Treasury yields decide to march significantly higher, and I suspect our house view on this that they will is correct (this week's payrolls may also be a near-term excuse for them to go a little higher), then there isn't much Governor Lowe can say or do that will stop the Australian bond market from following suit, no matter how long Australia's QE programme is extended, and no matter how dovish the Governor sounds. The direction of the AUD is far less clear, however. The widely differing efficiency of vaccine rollout's around the world raises a big question mark over synchronous global recovery ideas that were probably buoying the AUD

earlier in the year. It is not clear when this view will return. But is probably more of a 2Q/3Q story than a near term one.

Elsewhere in the world.

It's going to be a fairly dull day today apart from any lingering RBA interest as mentioned earlier, though we have also already had some Australian trade data for December which showed a smaller than expected widening of the trade surplus from AUD5014m to AUD6785m, thanks to slightly weaker than expected export growth (up 3% on the previous month rather than the expected 6%). The AUDUSD rate has jumped a little higher from about 0.7620 to 0.7630, but that may look like noise by the end of the day.

Thai January consumer confidence isn't likely to set markets on fire when it is released later this morning, and in the G-7 it is also fairly quiet after yesterday's stronger than expected US ADP survey. From the US, all we have is factory orders and weekly claims figures to wait for. No Fed speakers today, but Kaplan tomorrow will no doubt be listened to for hints as to possible minute changes of the Fed's reaction function.

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