RBA’s inflation target

Inflation of 2–3 per cent on average over business cycle

• Since 1993, formalised 1996
• Monetary policy obligations are laid out in Reserve Bank Act (1959)
The Reserve Bank Act

a) the stability of the currency of Australia
b) the maintenance of full employment in Australia
c) the economic prosperity and welfare of the people of Australia
RBA’s inflation target

Inflation of 2–3 per cent on average over business cycle

• Not a hard-edged band
RBA’s inflation target

- Inflation of 2–3 per cent on average over business cycle

  • Not a hard-edged band
  • Target is CPI inflation but underlying inflation measures help discern trends
Underlying Inflation
Year-ended

CPI excl. volatile items

Trimmed mean**

Weighted median**

1993 1995 1997 1999 2001 2003 2005
Volatility of Real Effective Exchange Rates
Standard deviation of monthly log changes, 1990-2004

Sources: JP Morgan, RBA
Real Exchange Rate and Terms of Trade

Post float average = 100

Real TWI*

Terms of trade**
Medium-term target allows flexibility to respond to shocks
Real Effective Exchange Rates

June quarter 1997 = 100

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Australia

Chile

New Zealand

Sources: RBA; Thomson Financial
Nominal Policy Rates

Sources: RBA; RBNZ; Thomson Financial
Real GDP
Year-ended percentage change

Sources: RBA; Thomson Financial

Asian financial crisis

Australia

New Zealand

Chile

Sources: RBA; Thomson Financial
Pass-through: exchange rate to inflation

• First stage: $\Delta er \rightarrow \Delta pm$
  – rapid and complete
Import Prices and the Exchange Rate

Year-ended percentage change

Sources: ABS; RBA

Import prices 'at the docks'

Exchange rate (import-weighted index, inverted)
Pass-through: exchange rate to inflation

• First stage: $\Delta er \rightarrow \Delta pm$
  – rapid and complete

• Second stage: $\Delta pm \rightarrow \Delta cpi$
  – slower
CPI Tradable and Import Prices
Year-ended percentage change

CPI tradables
(excl. tax)

Import prices
'at the docks'

Sources: ABS; RBA
Pass-through: exchange rate to inflation

- First stage: $\Delta er \rightarrow \Delta pm$
  - rapid and complete

- Second stage: $\Delta pm \rightarrow \Delta cpi$
  - slower
  - has declined
Effects of a 10 per cent Increase in Import Prices

Year-ended inflation – pre-1990 sample

Year-ended inflation – post-1990 sample
Inflation and Expectations

Indexed bond measure*

CPI** (year-ended)
RBA Intervention

- AUD floated in 1983
- RBA does not target exchange rate level
- Can intervene to avoid large overshooting or disorderly market
- RBA intervention is effective (Kearns and Rigobon 2005 JIE) and profitable (Becker and Sinclair 2004)
RBA Foreign Exchange Operations

Cycle 1 | Cycle 2 | Cycle 3
--- | --- | ---
Cumulative foreign exchange position

US$ per A$

Australian Dollar and Average RBA Transaction Rates

- Average rate at which RBA bought A$
- Average rate at which RBA sold A$
- Exchange rate of A$ against US$

Graph showing the exchange rate of Australian Dollar against US dollar from 1986 to 2004.
Nominal Exchange Rates

Monthly

Index

US$ per A$ (RHS)

TWI (LHS)

Source: RBA
Effects of a 10 per cent Increase in Import Prices

Phillips curve model

Year-ended inflation – pre-1990 sample

Year-ended inflation – post-1990 sample
Inflation and the Terms of Trade

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Mar 50 = 100  Mar 72 = 100  Mar 85 = 100  Mar 98 = 100
I  II  III  IV

% 30 25 20 15 10 5 0 -5

51 53 55 73 75 77 85 87 89 91 93 98 00 02 04

Inflation (RHS)
Terms of Trade (LHS)

Sources: ABS; RBA