Flash Note - Incoming RBA Governor Philip Lowe's 8 September 2016 speech

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Comments from incoming RBA Governor Philip Lowe at a speech this morning referred to the considerable research being conducted within the RBA and other monetary policy bodies around the world into the efficacy of the inflation targeting mandates, which suggest that more careful management of inflation risk within investor portfolios may be required in years ahead.

Dr Lowe's comments are heavily couched in terms of "research-in-progress", and are reproduced below:

A related research question is how policy should respond to a systematic weakening of balance sheets. This question is the subject of a lot of research at present, much of it prompted by work at the Bank for International Settlements (BIS). The work at the BIS, though it has focused heavily on aggregate credit as the indicator, has advanced the hypothesis that, in some circumstances, ***the build-up of financial imbalances may be a better guide to the sustainability of growth in the economy than is the current rate of inflation.*** *Clearly, this hypothesis needs to be tested. If it were found to be valid, it would have implications for policymakers in a number of spheres, including monetary policy, prudential policy and even fiscal policy.*

The above is extremely interesting as it suggests that for the first time the RBA may be willing to contemplate other policy objectives, and place these at equal or greater priority to its inflation target.

The underlying argument for this is that inflation targeting has been successful in recent decades not because of the delivery of low and stable inflation per se, but because of the positive effects it has had on balance sheet strength. Consequently, if balance sheets can be strengthened and maintained through other policy measures such as prudential ones, then perhaps inflation targeting may become less rigid, with inflation having greater freedom to move around than it has had in the past.

We are not suggesting there will be any immediate changes to the RBA's long-cherished inflation targeting framework, but this type of reasoning would be consistent with greater flexibility around the target going forward, both above and below the 2-3% band. It would also, all other things being equal, require more explicit management of inflation risk, up and down, in investor portfolios.

Again we would emphasise that this is early days still, but an interesting comment such as this one made so close to the commencement of a new Governor's tenure, shouldn't go without notice.

The full speech is available at http://www.rba.gov.au/speeches/2016/sp-dg-2016-09-08.html.