THE INFLATION WARRANT

The Reserve Bank of Australia (RBA) wants you to believe that increasing the official cash rate (OCR), which is typically passed on to variable interest rate mortgages, will have the effect of reducing increases of inflation, as measured by the consumer price index (CPI).

Making mortgage holders give more money to banks reduces the disposable income of the householder and increase the income of the lender, but cannot induce suppliers of goods and services to cease passing on cost increases contributing to inflation. The spending of households with mortgages is not the only contributor to the pricing decisions of businesses.

This article argues that the RBA does not have a sufficient warrant for its inflation targeting policy. There is insufficient evidence to claim increasing the OCR has a significant influence of prices. Because there is no apparent benefit the pain inflicted on mortgage holders is not warranted.

HOW TO TEST A CLAIM

The early economists were philosophers inquiring about the nature of the economy. One result of Adam Smith's study is the 'invisible hand' (beneficial outcomes arising from self-interested behaviour) which he based on market signals. Later economists developed data-driven and mathematically models based on price as the equilibrium market signal. Economics in popular use has since morphed into a set of politicised policy prescriptions based on price as the only signal of beneficial outcomes.

It is not that economists do not know about the importance of inquiry, they just choose to define economics around one easily observed data point.

The RBA should know data usually comes with some variation, but can be interrogated to determine unequivocal evidence of a model. A model can be tested by three questions intended to produce verifiable and repeatable answers.

1. Direction of change: Is the direction of change consistent with model (positive) or inconsistent with model (negative)?
2. Size of change: Does a change of the independent variable induce a significant change in the dependant variable? (There is, or is not a significant connection between independent and dependent variables.)
3. Strength of connection: Is there a strong and consistent relationship between independent and dependent variables?

These questions can be rephrased for the purpose of public policy: society can ask, 'Are the effects of the policy warranted by the results being achieved?' Is the policy warranted?

INFLATION EXPECTATIONS MAKES DATA REDUNDANT

The RBA does not use a model of independent and dependent variables. Two decision points, inflation expectations and the upper bound of an inflation target, make other data series redundant.

One of these data series is the non-accelerating inflation rate of unemployment (NAIRU). The last sentence of the second paragraph in the section 'The non-accelerating inflation rate of unemployment or NAIRU' of Assessing Full Employment in Australia' in the Bulletin of April 2024 explains.

> *"The models do not mechanically require unemployment above the NAIRU for inflation to fall from a high level back towards target if inflation expectations remain anchored."* (RBA April 2024 Bulletin)

The NAIRU is neither independent or dependent, just not relevant when its implications are contradicted by inflation expectations.

There is an extremely high non-zero probability that the RBA will make statements like, 'Unemployment may need to increase before inflation comes down,' and 'The current level of NAIRU is higher than our current estimate' when the RBA believes inflation is continuing to be above its target rate.

Self-interest behaviour can manifest as inflation expectations. When inflation is continuing to be above the RBA target rate those economic agents standing to benefit from an increase in the official cash rate can justify inflation expectations: high or increasing inflation proves the expectation, an expected beneficial outcome becomes the moral justification for the expectation.

This typical statement by the RBA demonstrates the point, 'some pain now will prevent worse pain later.' The 'pain' mainly refers to the unemployed and mortgage holders. Businesses have the cover of inflation and RBA endorsement of inflation expectations to pass on cost increases or just increase prices with the expectation of cost increases.

The RBA is a bank in charge of a policy that puts banks before others. The self-interest of those most feeling the pain is not represented in RBA decisions to increase the OCR.

RBA Statement Lacks Evidence

At the Commonwealth Bank Global Markets Conference 2026 held in October, RBA Assistant Governor Christopher Kent is reported to have said higher interest rates help support the Australian dollar which helps lower the cost of imports (Micallef 2026). A similar statement was made by the RBA Governor Michele Bullock at the 2026 Fireside Chat at the Committee for Economic Development of Australia (CEDA), saying that one very important way monetary policy works through the system is the exchange rate.

> *"…which impacts prices across the economy and shifts demand between imports and domestic production."* (RBA 2026)

From June quarter 2022 to June quarter 2026 the OCR has increased from 0.37 to 4.27 and the exchange rate ($AUD needed to buy US$1) from 1.4516 to 1.4558, a depreciation of 0.42 cents. From September quarter 2022 to September quarter 2026 the OCR increased from 1.78 to 4.35 and the exchange rate ($AUD needed to buy US$1) down from 1.5380 to 1.4333, an appreciation of 10.47 cents. 1

Applying the three test questions above: the direction of change is not obvious, the size of the change over the period could be significant or not depending on the period chosen, and a strong and consistent relationship does not appear to exist. The suggestion that the economy has "shifted demand from imports to domestic production" is not demonstrated, not proved and might be improbable. For this four-year period there is not enough evidence to support the RBA's claims about how monetary policy operates through the exchange rate.

The Governor's statement is certainly is not currently true and the Governor should have the professionalism to be truthful. It is a specious claim that some change (or level) of the OCR has a particular effect if that effect cannot be revealed by the data.

Australia uses a floating exchange rate. Using mortgage holders as a proxy to indirectly manipulate the exchange rate assumes a degree of influence not in evidence. Mortgage holders are not such a large group they can obviously influence foreign currency transactions. The exchange rate will adjust to prevailing domestic and rest-of-world economic conditions.

One Decision Point

The inflation target range preferred by the RBA is between two and three per cent per annum. If inflation is continuing below one, two or three per cent an increase in the OCR is not justified. Therefore, the lower bound is not critical to an increase in the OCR. The RBA has an inflation target set only by an upper bound.

There are two questions that indicate an increase in the OCR is likely to be justified by the RBA. "Is inflation below three per and increasing such it might exceed three per cent?" and "Is inflation above three per cent and remaining above three per cent?"

The quarterly data for the OCR and trimmed mean version of the CPI suggest that proportionally more increases occur when inflation is above three per cent (around 45%) than when inflation is within the two and three per cent range (about 25%). Intuitively this result is correct: when inflation is not a concern the RBA does not have a compelling argument for increasing the OCR. 2

The pre-eminence of inflation expectations over other data is demonstrated in this statement by the then RBA Governor Dr. Philip Lowe in a speech at the Australian Financial Review Business Summit on 9 March 2022, about the effects of a supply shock that was causing higher [international] prices, especially for commodities.

> *"This new supply shock will extend the period of inflation being above central banks' targets. This runs the risk that the low-inflation psychology that has characterised many advanced economies over the past two decades starts to shift. If so, the higher inflation would be more persistent and broad-based, and require a larger monetary policy response."* (ABC News, 2022)

Dr. Lowe is saying that if higher inflation is expected, higher inflation will result and higher interest rates will be the response. He does not consider the possibility the effects of the supply shock will diminish as producers and consumer adjust to the new supply logistics, price/cost and demand/supply relativities. (Look up 'income effect' and 'price effect' in relation to market dynamics if you are unsure what the previous sentence means.) He does not consider that mortgage holders didn't cause the supply shock.

Three per cent inflation is effectively a decision point that stands in isolation from the real world. But why three per cent? The RBA is not known for transparent, predictable, consistent and clear communication. Three per cent could be the inflation rate at which banks require compensation to be added to their mortgage rates. It could be something else.

Just Doing What the Institution Demands

The RBA has one tool to meet one policy objective: manage inflation with the official cash rate.[1] The RBA knows inflation cannot be managed precisely by changing the OCR. In 2015 at the National RSL Clubs Conference the RBA assistant governor Christopher Kent said.

> *"Monetary policy is certainly playing an important role, but it guides things rather imprecisely, with the relatively blunt tool of the overnight cash rate."* (Mitchell 2015)

Because the future state of economic conditions cannot be accurately determined, the RBA cannot be sure what a 25 or 50 basis point change in the OCR will do, or what effect a particular level of the OCR will have. The RBA can only respond within its institutional constraints: one tool, one objective.

[1] Employment is not a policy objective since a higher interest rate is intended to increase unemployment as one of the mechanisms used to reduce aggregate demand which is meant to result in lower inflation.

At the Fireside Chat at CEDA, The Governor of the RBA said.

> *"AI is the great white hope to improve productivity."* (RBA 2026)

There is no way of knowing now what the actual connection of future inflation will be to current investment in artificial intelligence. The Governor has made a post hoc claim and should know better. In a similar way the RBA validates its inflation targeting policy when inflation falls without any demonstrable evidence.

Professor William Mitchell has noted[2] the racist origins of the term 'great white hope' makes for a poor choice of words. The poor choice of words reveals an outdated awareness.

As an institution the RBA has not been tasked with a methodological study of economic theory and application of results to deciding on socially preferred policy responses to inflation. The RBA was been given one tool and one objective around one number in the 1990s. Since then, the world has changed. Its actions today cannot be anything other than institutional.

And its institutional actions regularly produce pain for a minority of the population.

CONCLUSION

This article is the fifth in a series. The previous four discuss various aspects of inflation. Together they give an overview of the main issues, evidence and contribute to this conclusion.

- Can We Dampen Inflation? *We should be asking better questions*.
- The Inflation Choice. *The RBA's inflation targeting policy fails on performance and social justice grounds.*
- Challenging the Need for Unemployment. *Using unemployment to promote price stability must be challenged*.
- The Inflation Question. *There is sufficient evidence to demonstrate the RBA influence over consumer prices is deficient and can produce socially suboptimal policy outcomes*.

The RBA wants you to believe that increasing the official cash rate reduces inflation, but has never provided any verifiable and repeatable evidence this policy actually works. Because the RBA give pre-eminence to inflation expectations and has one tool and one objective its decisions to increase the official cash rate can only ever be an institutional response. The RBA validates inflation expectations, which in turn can justify price increases.

The RBA knows it has nothing more than an imprecise influence on consumer prices. Because the data does not reveal unequivocal evidence of the effect of higher interest rates, the RBA cannot be ignorant of its policy failing.

Are the effects of the policy warranted by the results being achieved?

No.

There is sufficient evidence to claim that increasing the official cash rate produces socially suboptimal policy outcomes. There is no unequivocal evidence supporting the policy. Because there is no identifiable socially beneficial outcome the pain inflicted on a minority of society is not justified.

[2] https://billmitchell.org/blog/?p=63389

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Endnotes

1. Sources: Reserve Bank of Australia, FIRMMCRT in F1.1 Interest Rates and Yields – Money Market and AUD/USD Exchange Rate in F11 Exchange Rates Retrieved from https://www.rba.gov.au/statistics/tables/.

2. Using data from September quarter 1990 to September quarter 2006 of the ABS series A3604509L, CPI 'Trimmed Mean, Australia, Seasonally Adjusted' and a quarterly average of monthly values from the RBA series FIRMMCRT the values are derived by counting the number of times the OCR increased when inflation was equal or greater to three divided by the number of times inflation was equal or greater to three, repeated for values within the target range (x >= 2 and x < 3).

Use of AI Declaration

AI tools were not used to check spelling, grammar, style or provide content.

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Labels: monetary policy, inflation, consumer price index, modern monetary theory, heterodox economics.