

Central banking in the age of oil and robots



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In this note we make the case why the RBA is likely at the top of its hiking cycle, assess implications for the RBA of a very different regime under a Warsh-led Federal Reserve and wonder out loud whether a new era is now upon us for central banking: an age of robots.

There is something almost nostalgic in assessing monetary policy responses to an oil price shock. Yet as oil dependency declines and technology shifts, it is difficult to escape the feeling that this may be the last great oil price shock for the planet.

The world wasn't short oil going into the crisis and as OPEC frays and demand for non-combustion engines spikes, it is likely that oil markets will eventually lurch back into oversupplied mode. In the interim, the same playbook of anticipating weaker economic growth and guarding against higher inflation expectations is again playing out.

It's uncomfortable but familiar territory for central bankers.

Australia is likely well advanced in its policy response, and arguably complete, absent upside growth and inflation surprises. Post each major shock the economic and policy parameters tend to evolve and a new era begins. This time, an old-school oil shock is playing out simultaneously with one of the largest technological advancements in modern history. If it's a battle between AI and oil to shape the path of long run inflation expectations, my money is on AI.

Navigating the peak in interest rates

There were several conclusions to be drawn from the RBA decision to raise interest rates on Tuesday.

Firstly, the RBA now acknowledges that financial conditions have tightened and are now likely restrictive. This is a point we have been making for months, suggesting that the RBA is more likely to pause in this rate hiking cycle and assess several months of incoming growth and inflation data. The RBA also published an update of comparisons to other central banks 'neutral' rates revealing that Australia has made more progress in returning policy to the top of the neutral range relative to its peers.

Secondly, the downgrades to the RBA's new forecasts for economic growth and 2027-28 inflation also suggest that policy is more likely to remain on hold. This is particularly post the Governor's insistence on Tuesday that there is nothing that the RBA can do to influence high expected inflation over the next six-month period. The RBA's economic growth forecast remains below its estimate of 'potential' throughout the forecast period: the unemployment rate rises gradually to be above the RBA's estimate of NAIRU, and inflation returns to the mid-point of the target by mid-2027 and remains there in 2028.



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Note, our growth views remain lower and unemployment forecasts higher than the RBA's revised forecast path, however, even if the RBA's new forecasts prove more accurate it is hard to posit that further rate hikes are required absent upside surprises to growth and inflation.

Thirdly, the RBA is currently looking through the sharp declines in business and consumer confidence, at least for now. The RBA is correct in its assessment that confidence is not a great forecaster of demand growth. However, we would point out that large movements in confidence are indicative of shifts in saving and spending patterns that can forewarn of emerging recessionary conditions and as such should be carefully monitored.

Fourthly, the RBA has retained optionality to continue to hike, conditional on evidence that the rise in short term inflation expectations transitions into longer term inflation expectations and if wage growth reaccelerates materially in response to the energy shock. Both are possible, and if any further policy adjustments are likely in the period ahead it will be the evolution of these two forces that will likely be the determining factors.

Fifthly, the RBA published two alternative adverse scenarios related to the oil price shock which suggested the RBA policy rate would be unchanged under more extreme oil price and commodity pressures. The inference is that the RBA believes they have likely done enough to contain the spillovers of second round inflation effects and additional oil price increase would be demand destructive.

The main conclusion we draw is that the RBA is likely on hold until the August meeting and, absent upside to inflation and growth outcomes, we are also likely at the peak of the interest rate cycle, particularly if our more conservative economic views come to pass. Obviously, a protracted Iran conflict presents more difficult choices for policy makers, firms, and households alike, but the Statement of Monetary Policy suggests that under that scenario further rate hikes are not a fait-accompli.

Whether we are at the peak of the rate cycle is clearly an important question for financial market participants. Policy making in this environment is, of course, difficult. We are all dealing with heightened complexity and uncertainty. In such times information and clear communication is at a premium. However, we wonder whether the changes made since the RBA review of 2023 have led to improved outcomes and whether a new era of central banking is coming with the incoming new Fed Chairman.

Three years on from the RBA Review – Is this really a better model?

We are now a little over three years after the "Review of the Reserve Bank of Australia. An RBA Fit for the Future" was released in March 2023. It was well intentioned and an obvious reflex to the poor outcomes from 'time specific forward guidance,' a haphazard yield curve control exit strategy and a perplexing late cycle bout of QE in Australia that ultimately undermined the RBA's balance sheet for uncertain economic gain.

The source of discontent that led to the review came mainly from misadventure down the path of unconventional policy tools rather than complaints over the institutional structure, talent, or communication strategy of the Reserve Bank. There may also have been some political mischief at play at the time, however, there is nothing wrong with commissioning regular reviews into the functioning of important institutions in the economy from time-to-time, and the RBA is no exception to the rule.

There were many recommendations made and although not all were implemented, sufficient change and distance has now passed to make some observations on the success or otherwise of the changes. More importantly, the winds of change are blowing at the most important central bank on the planet, and it is worth contemplating what those changes might mean for the way that monetary policy operates in Australia.

Our initial observations at the time of the 2023 report are largely unchanged. We believed the existing system had, on balance, served Australia very well. We thought that having fewer RBA meetings was a retrograde step which would make decision making less able to adapt in times of crisis, that having press conferences was more likely to confuse the core message than illuminate, and that the shift to a separate Monetary Policy Board merely

opened up the opportunity to make long term appointments to philosophically aligned to the Government which in time could dim the true independence of the RBA.

To be fair, there were plenty of recommendations that were hard to disagree with, including ensuring more debate and engagement with staff on policy matters. However, on the substantive matters of when, how, who and why policy changes are made, we didn't see how most recommended changes represented a step forward.

Fast forward to the present, we believe the recommendations have led to:

1. A central bank that eschews forward guidance in any form (state based, calendar based or any other form);
2. A Board with nine equal voting members, of which the Reserve Bank only has two formal votes, leaving open the possibility the Board could overrule the formal recommendations of RBA staff;
3. RBA meetings have been reduced from 11 to just eight meeting per year. In our opinion the move to two-day meetings is likely a good development, but reducing the number of meetings merely cedes flexibility and reduces the ability to control the policy narrative; and
4. Press conferences are held after each meeting, yet we believe press conferences are a poor substitute for speeches by the Governor on key economic and policy themes. While there is an admirable aim of education and communicating directly to households from these press conferences, too often they devolve into the Governor being repeatedly asked to sympathise with borrower pain rather than for details underpinning the RBA's strategy. Press conferences also have a cost. Formal speeches from the RBA Governor can be counted on one hand since the end of 2024, and there have yet to be any speeches from non-RBA Board members since the 2023 report.

To be clear, we are not advocating for more RBA communication. Quite the contrary.

However, it is perhaps time to pause and reassess whether the way Monetary Policy in Australia has evolved over the past three years is optimal. It is doubtful that anyone wants: (i) less insight into the next steps of policy makers, (ii) a less predictable Board, (iii) less flexibility in decision making, or (iv) the potential for more disparate voices going forward. The better question is what changes are possible and what trends are occurring offshore that may influence Australia?

The winds of change are blowing at the Federal Reserve

Having watched the confirmation hearing of Kevin Warsh and his speeches over many years, it's clear that the Fed is set for a major overhaul in coming months.

Warsh seems to be advocating for a smaller, more efficiently run Fed. A Fed which communicates with one voice rather than elevating the voices of individual Governors and their own economic forecasts. A Fed that communicates less often and talks to a narrow frame of issues with inflation as its central focus. A Fed that not only believes in reducing the size of the Fed's balance sheet but a Fed that can no longer unilaterally implement QE or other unconventional policy tools without agreement from the Treasury. A Fed which believes that AI will deliver a low inflation, high productivity, high growth US economy.

Interestingly, Warsh also indicated that he believes inflation is being incorrectly measured and that alternative measures of inflation should be prioritised. There was a nod to preferencing trimmed mean inflation, where the RBA was sensibly an early leader, however, we believe Warsh was also referencing elevating the importance of real time measures of inflation such as *Truflation* or *PriceStats* which have been showing materially lower core inflation readings recently. If the Fed takes a dovish turn in 2026 under Warsh's leadership, it is more likely to be the elevation of real-time inflation measures rather than near term AI benefits that drive the push.

What does all this mean for the RBA?

The RBA obviously doesn't have to do anything. However, history suggests the RBA is a relatively early adopter of sensible change. We draw four main conclusions on how the RBA may adopt to changes under a Warsh led Fed.

1. A shift to narrower, concise, and consistent communication

The main conclusion is that after 20 years of central banks leaning into more communication, transparency and experimenting with alternative monetary tools, the pendulum looks set to start to swing back in the other direction. Warsh appears intent to tone down the scope, frequency, and media attention that Fed commentary has had in recent years. In some ways that might prove to be a relief. Warsh is not even committed to doing press conferences post Fed meetings, and one suspects the RBA doesn't particularly enjoy the way our own press conferences have evolved. Press conferences bring an elevated risk that the core message is diluted or an answer taken out of context, and frankly there is a repetition in questioning that is tedious for all involved. If the Fed removes Q&A press conferences, then the RBA should also consider following suit. If the aim of press conferences were to enhance community understanding of monetary policy, then advancements in technology may be a better option moving forward.

2. AI's role in central banking

The second conclusion is that a revolution is coming to central banking via AI and real time datasets. Could the RBA's communication objectives be better met with an AI Chatbot conversant not only in every piece of RBA research, speech and testimony but also tweaked to accurately convey the exact intentions of the Board? Maybe not 12 months ago, but today it is certainly possible and arguably preferable.

The public would have better access to how and why decisions are made, the wealth of information hidden on the RBA's website would come to life and the RBA would also likely gain new insights into what consumers, businesses and researchers are focused upon.

The RBA preferred models and datasets could have a more real time and interactive dimension and showcase how real time data sets can inform decision making. It would certainly be preferable to the current situation of market participants imprecisely replicating RBA models and giving their own assessments of what this means for policy.

More importantly, it would give businesses and consumers tools to make better decisions, which can only lead to better economic outcomes. The fact that the RBA still preferences quarterly inflation and GDP data to make policy inferences will seem positively antiquated in the near future. It seems to us that a Warsh Fed looks set to lean into that future.

We are not suggesting AI should determine monetary policy, although that day may come. We are suggesting AI will likely serve a vital role in education and communication that can free up the RBA resources.

3. A more prominent Governor

The third conclusion is that the RBA Governor could be returned as the central voice of policy. An evolving body of research suggests over communication from central bank staff and policy voting members can lead to inefficiencies and confusion in financial markets. Recent comments from the Deputy Governor certainly moved markets ahead of the RBA March meeting, regardless of his intention. Markets might have misinterpreted, but the Governor was clearly left in an uncomfortable position.

If Australia goes down the path of allowing Board members to give frequent speeches on policy matters, it will likely just magnify volatility and likely dilute the core message. Central bankers were never designed to be entertainers and to engage in long format banter to questions outside of their immediate remit. The answers might be interesting, but they are unlikely to be helpful for policy. If the RBA follows Warsh's lead, it would be the RBA Governor who gives all the key speeches on the economy and implications for policy.

4. A more active Fed

The final observation is that Warsh believes inflation is a 'choice.' He believes high inflation can always be contained quickly if central bankers are prepared to do what is necessary. This provides a clear warning to financial markets. Warsh may be prepared to champion the outlook for the US economy in general and AI in particular, but he believes in decisive action if inflation becomes entrenched. There is no quarter given to supply side shocks, excess fiscal policy, or exogenous forces. High inflation will generate higher US rates compared to life under Greenspan, Yellen or Powell, and we will likely get there quicker. We don't agree with Warsh's premise, particularly for a small open economy like Australia, and it is a perspective that directly runs against the RBA's narrative of seeking to preserve labour market gains. Nevertheless, the message is to expect a more active Fed in the future.

If you thought central bankers had reformed their image of being stiff and pre-programmed, then we have news for you. The age of robots is coming for central banking. Fewer words, universal messaging, real-time data sets, narrow purpose driven objective, and harder edges appears the way of the future.



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The age of robots is coming for central banking.

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