NAB CHANGE IN POLICY VIEW 22 SEPTEMBER 2020

RBA'S DEBELLE REINFORCES BOARD CONSIDERING FURTHER MONETARY EASING; NAB NOW SEES SIGNIFICANT RISK OF CUT TO THE CASH RATE, 3 YEAR YIELD TARGET AND TFF TO 10BPS AND QE TARGETED AT LONGER-DATED YIELDS

NAB Economics

The RBA continues to signal further monetary easing is likely. Deputy Governor Debelle in a speech titled The Australian Economy and Monetary Policy, "outline[d] [the] possibilities for further monetary policy action should the Reserve Bank Board decide that is warranted" and concluded that "the [RBA] Board will continue to assess the merits of the range of monetary options to best support the economic recovery". NAB now sees significant risk of the RBA easing policy further by cutting the cash rate, 3-year yield target and TFF rate by 15bps to 0.10% (from 0.25%). The remuneration on ES balances which is already at 0.10% is likely to be either unchanged, or cut slightly, so as to remain positive. We also expect the RBA to announce outright QE purchases in the 5-10 year area of the curve, so as to lower longer-dated rates to provide stimulus via the portfolio rebalance effect/a lower $A. Different to YCC, this would likely require a nominated quantum of bond purchases per period to be announced.

NAB expects these further easing measures to be announced at either the October or November Board meetings, noting that the October Board meeting is the same day as the Budget, while the November SMP after the November Board could be an avenue to communicate its messaging to a wider audience. While NAB remains of the view that further monetary easing will have only marginal impact on the economy, the RBA continues to signal that it will do what it can to support the recovery: "given the outlook for inflation and employment is not consistent with the Bank's objectives over the period ahead, the Board continues to assess other policy options". Fiscal policy also continues to be well-placed to support the recovery and further measures are expected to be announced on this front in the Budget on October 6.

It is also worth emphasising the RBA continues to rule out negative rates ("empirical evidence on negative rates is mixed") and the Bank is very reluctant to intervene in the exchange rate ("AUD broadly aligned with its fundamentals"), citing the experience of the Swiss National Bank in today's speech.

- Deputy Governor Debelle today gave a speech on The Australian Economy and Monetary Policy. In the lead up to the speech, there was some speculation that Dr Debelle could use the speech to guide markets into what else the RBA could do to support the recovery. The speech did not disappoint with the speech focused on again outlining the possibilities for further monetary easing "should the Reserve Bank Board decide that is warranted", quite likely an explicit signal that further monetary easing could well be imminent. The timing of the speech comes after the September Board Meeting where the RBA expanded the TFF and also inserted dovish language into the concluding paragraph that suggested the Board is considering further easing measures. Several media articles subsequent to that meeting also suggest the RBA felt the need to communicate its easing bias more explicitly (e.g. see AFR).

- The key reasons for further easing are twofold as hinted in the speech:

    1. "Given the outlook for inflation and employment is not consistent with the Bank's objectives over the period ahead, the Board continues to assess other policy options". The RBA's current forecasts from the August SoMP for the economy do not see core inflation back within the band over the forecast horizon (only at 1.5%), while the unemployment rate only falls to 7% by the end of the forecast horizon after peaking at 10%. The Victorian lockdown also affected the near-term outlook for growth, while the Bank continues to expect a protracted/slow and bumpy recovery.
    2. The recent exchange rate appreciation has probably blunted some of the policy impact from the RBA's existing policy package, albeit border closures are also playing a role. Dr Debelle noted that "a lower exchange rate would definitely be beneficial for the Australian economy, so we are continuing to watch developments in the foreign exchange market carefully". A recent RBA Research paper (The Economic Effects of Low Interest Rates and Unconventional Monetary Policy) also reinforce this notion, illustrating that a key transmission channel of lower bond yields is via the real exchange rate, which in that framework saw net exports account for around half of the effect of lower government bond yields on the level of GDP. Notwithstanding that implication, the RBA remains very reluctant to directly intervene in the currency, noting that "the AUD broadly aligns with its fundamentals". It is also unclear to what

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extent cutting the cash rate and undertaking QE would have on the AUD if other central banks are also set to ease policy further – the BoE and RBNZ have both signalled the possibility of taking rates into negative territory in 2021.

- As for potential easing options, Dr Debelle largely repeated the policy options that Governor Lowe mentioned back in July should further monetary easing be warranted. Our assessment of those options based on Dr Debelle's commentary today suggests the RBA is most likely to lower the cash rate to 10bps (which flows through to the term structure, the 3-year yield target and TFF rate) as well as undertaking some outright QE, most likely in the 5-10 year area. Different to YCC, this would likely include a nominated quantum of bond purchases per period. The latter would be anticipated to have portfolio balance impacts as well as lowering longer-term yields. The possible options were:

    1. Lowering the cash rate without going into negative territory ("it is possible to further reduce these interest rates"). This would most likely entail cutting the cash rate to 0.10% from 0.25% which would then flow through to the term structure of rates, the 3-year YCC target and to the TFF. An open question remains on how the RBA interest rate corridor would be structured given the remuneration on ES balances is currently 10bps. It is possible this rate could be maintained or lowered so it is still above 0.

    2. Outright QE supplementing the existing 3-year YCC target. This would entail the RBA buying bonds further out the curve which could be stimulatory via the portfolio rebalance channel and by lowering longer-term rates. Dr Debelle notes that while "very few financial instruments in Australia price off these [longer-term] yields", bond purchases "have a portfolio balance effect in addition to the interest rate effect….[though] it is difficult to separate the portfolio balance effect from the effect of lower government bond yields empirically".

    3. Negative rates are again argued against. Dr Debelle noted that there was mixed empirical evidence on negative rates. "In the short-term they can contribute to a lower exchange rate. In the medium term, their effectiveness can wane including through the effect on the financial system. Negative rates can also encourage more saving…".

    4. FX intervention, again was suggested as being highly unlikely. The AUD was still assessed to be "broadly aligned with its fundamentals" and intervention would be unlikely to be effective in the current environment. Nevertheless, the RBA continues to try to jawbone the currency lower, noting that "a lower exchange rate would definitely be beneficial for the Australian economy, so we are continuing to watch developments in the foreign exchange market carefully". As noted above, recent RBA research suggests the exchange rate is a key transmission channel for unconventional policy with around 50% of the impact of lower bond yields on the economy coming from net exports.

As for the RBA's assessment of the economy, the RBA notes the sharp contraction in Q2 GDP, while household cash flows have been supported because of government stimulus payments. The RBA continues to assess the recovery will be "uneven" and "protracted" and they "still expect the unemployment rate to rise from here". Inflation is also expected to remain low, with Dr Debelle not seeing "any risk of a sustained rise in inflation while there remains considerable spare capacity in the economy". Wages will be a major factor keeping inflation low, while low rents are "also likely to persist and will also restrain inflation".

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