NAB MONETARY POLICY VIEW: JANUARY 2021

QE TO CONTINUE, RBA TO GRAPPLE WITH ENDING YCC

- **The RBA's 6-month $100bn quantitative easing (QE) program currently will cease at the end of April. As such, the RBA will need to provide guidance early this year for its plans for QE, with an announcement likely in March.**
- **NAB expects the RBA to extend QE, with Governor Lowe to signal this as early as February. While the outlook has improved, the pandemic has still been a large hit to the economy such that exceptionally easy policy is warranted. We think an extension in the ballpark of an additional $50bn over another 6 months is likely, broadly in line with our estimate that $143bn worth of purchases would be required to get the unemployment rate down to 5%.**
- **A more significant issue is the yield curve control (YCC) program, where the RBA has tied its 3-year target explicitly to its expectation that the cash rate will not increase for "at least 3 years". At some stage the RBA is likely to become unable to maintain this position as the recovery unfolds– we think the RBA will reach that point around mid-2021. Further, we note that at the current rate, under YCC the RBA will own nearly all April 2024 government bonds by mid 2021, which will interfere with the 3-year yield as a market benchmark.**
- **As such, we expect the RBA will outline an exit strategy by mid 2021, while being mindful that ending YCC is likely to see yields rise across the curve as the market interprets the RBA's shift as a signal for higher rates in the future. In our view, the RBA should name a bond line which YCC will not extend beyond, i.e. Apr 2024, and use its ongoing QE program to help smooth out any sharp rise in yields in response to its exit strategy.**
- **To be clear we see the cash rate on hold until at least mid-2024, in line with RBA guidance. However, note the trajectory of our forecasts point to some risk of a gradual normalization of the cash rate beginning shortly after.**
- **Finally, the RBA is likely to let the term funding facility (TFF) end at its scheduled date of June 2021. The program has provided significant liquidity to banks, supporting credit. Borrowing costs remain extraordinarily low, such that the RBA is unlikely to see an extension to the TFF as necessary.**

The RBA should keep its options on the table and extend QE, despite a stronger-than-expected start to the economic recovery.

Since the RBA's November forecast update, data on the Australian economy has generally been better than the RBA expected. The pace of recovery remains strong, with spending continuing to rebound and employment recovering around 85% of the loss in early 2020. The unemployment rate has declined to 6.8%, suggesting the peak in unemployment has already passed – with forward looking indicators pointing to ongoing growth in the demand for labour. Further, the virus is largely contained in Australia, albeit with some small outbreaks.

These factors will see the RBA upgrade its near-term outlook in February as it starts the year on an optimistic note. Also in February, the RBA has its first meeting for the year and Governor Lowe will also testify before parliament and deliver a speech on the year ahead. Lowe will likely use these opportunities to highlight the remarkable rebound to date and the large and ongoing support from fiscal and monetary stimulus.

However, the RBA is likely to caution that a full recovery is some time away and remains highly uncertain. In our view, while the economic recovery so far resembles a best-case scenario, we still expect unemployment to remain above 5% and inflation to remain near historical lows at the end of 2022. This outlook clearly warrants ongoing QE and the cash rate to stay at a record low 0.1%. Further, the outlook remains highly uncertain, particularly as the global health and economic outlook continues to fluctuate.

As such, the RBA should signal a tapered extension to the QE program in February. In March, we tentatively expect the RBA to announce an extension of $50bn over 6 months. This is supported by:

- Another $50bn is broadly in line with our earlier estimates that $143bn would be needed to reduce the unemployment rate to 5% in three years.
- Bond issuance is slowing and the funding tasks of federal and state governments may be lower than expected if better than expected economic conditions lead to a less severe deterioration in 'automatic stabilisers'.
- Keeping QE on the table allows the RBA to remain flexible amid an uncertain outlook.

Note, on the government/semi-government split of bond purchases under QE, we think the RBA will keep the 80:20 split unchanged. While state government debt issuance will outpace federal government issuance in the near term, the 80:20 split remains sufficient to keep rates low in both government and semi-government markets.

Going forward, the QE program will depend on economic and market conditions. We expect the RBA will maintain a QE program until unemployment and inflation are making clear and sustained progress towards the RBA's targets of full employment and 2-3% inflation. We also expect the RBA to take into account the global economic and financial environment. In our view, it is unlikely the RBA will end QE at a time where other central banks are easing (via their own QE programs) and major economies continue to face headwinds from the pandemic – doing so would risk much higher rates and an appreciation in the Australian dollar that would be headwinds to the Australian economy.

Exiting yield curve control (YCC) is the more significant issue for the RBA as the economic recovery continues

Since its inception, the RBA's YCC program has been tied to the RBA's forward guidance. In the RBA's words, its YCC program targeted the 3-year yield to equal the cash rate

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because the RBA reasonably expected that the cash rate would not rise for "at least 3 years".

Nearly a year has passed since YCC began, such that in order to target the 3-year yield the RBA has (since early November last year) been purchasing Australian Commonwealth government bonds (ACGB) that mature in April 2024. This suggests the RBA expects the cash rate to be on hold until 2024, four years since the beginning of the pandemic. By May/June the RBA will need to turn its focus to the ACGB Nov 24 bond to maintain the target.

The RBA is likely to outline an exit plan for YCC by mid-2021, where we think it should stop buying bonds beyond April 2024 as the simplest exit strategy.

As the economic outlook continues to improve, the RBA will become increasingly uncomfortable with the implication of unchanged rates by rolling forward its YCC program. Based on our forecasts (and likely RBA staff forecast upgrades), we think this will happen around the middle of the year such that the RBA will need to outline its exit plan. It faces a significant challenge in doing so, effectively switching from time based forward guidance for the cash rate to conditional guidance. It would be the first central bank to do so – the Bank of Japan is the only other central bank to have implemented YCC and it has never stopped the program.

In our view, the RBA should end YCC by choosing to stop buying bonds through the program beyond April 2024 – with the term of yield control effectively shrinking as time progresses. This allows a smoother transition than simply ending YCC, where the RBA may also use its ongoing QE program to smooth out any sharp market reactions to ending YCC. In our view, this approach is simplest given the challenges YCC faces. Namely:

1. Any changes in YCC would be seen as a signal on rates, given the RBA has explicitly tied YCC to its forward guidance. The market is likely to take the end of YCC as an implicit signal from the RBA that it expects rates to rise – prompting a rise in yields. We see this issue as the most important for the RBA. As such, any changes to YCC will need to be very carefully communicated if the RBA is not ready to see rates rise across the curve.
2. There is limited bond issuance at April and November 2024 maturities, such that if the YCC continues the RBA is likely to own all the bonds in those lines – interfering with the role of the 3-year yield as a market benchmark. The RBA currently owns around 44% of the ACGB Apr 24 bonds. By the latter part of last year, the RBA was purchasing around 4-5bn of bonds a month to maintain its YCC target. If this pace continues into 2021 then the RBA will own close to all of the ACGB Apr 24 bonds by mid-year and around 70-80% of ACGB Nov 24 bonds by year end.

We acknowledge that the RBA has a range of options available to end YCC – and the decision made will likely depend on economic and market conditions.

While we believe our preferred option of ending YCC through fixing its end date is the simplest approach to the challenges YCC faces, we note the RBA has a range of other options available, which could also be used in combination. The RBA could:

1. Disentangle YCC from its forward guidance. Initially 3-year target was chosen with two elements in mind – the guidance around the cash rate target as well as the fact the 3-year tenor is a key pricing benchmark for other rates. Disentangling YCC from forward guidance would be difficult but as a minimum, mean a shift to conditional forward guidance, such that rates are not tied to a time-based guidance but rather economic conditions. We see this option as unlikely as it undermines the RBA's work in 2020 linking the YCC and rates together.
2. Gradually lift the 3-year target rate, separate to the cash rate. Doing so would begin to normalize the slope of the yield curve but would require significant communication about two separate targets – and would be required to set expectations for two targets. It would also face challenges in deciding the appropriate yield target is as inflation and yields rise with the recovery. This approach, which allows for some normalisation of the yield curve, will still need to be abandoned at some point.
3. Alter its current QE program from bond purchases with 5 to 10-year maturity to include the whole curve out to 10 year which would help keep yields low. This is another benefit of keeping the QE program in play. The RBA will still need to couple this with careful communication.
4. Allow yields to move, but commit to purchasing bonds if the market becomes dysfunctional. This could work to temper any taper-tantrum style rise in yields as unconventional policy begins to be unwound. However, it would then face a challenge communicating its cash rate expectations where the RBA would unlikely envision any moves in the near term – as has been extensively reinforced by the governor.

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