NAB MONETARY POLICY VIEW: JUNE 2021

YCC TO END AT APR-24 AND QE TO BE TAPERED TO $75BN

- **Bottom line: NAB re-confirms its monetary policy call of the RBA moderately tapering its QE program, penciling in a further $75bn program (over six months) once the current $100bn tranche of buying ends in September. We also expect the RBA will not roll forward its YCC target of 0.1% to the Nov-24 bond, limiting purchases to the April-24 bond.**
- **Following the release of yesterday's GDP numbers and ahead of the looming RBA announcement on its unconventional policy measures at the July meeting we have firmed up our views on policy. As foreshadowed over the last month, we expect the RBA will moderately taper its QE program by announcing a further $75bn program (over six months) once the current $100bn tranche of buying ends in September.**
- **As we have for some time, we continue to expect that the RBA will not roll forward the YCC target of 0.1% to the Nov-24 bond. The better than expected recovery to date means that the RBA cannot credibly commit to unchanged interest rates for the next three years on a rolling basis. Rather the bank will prefer a shift to conditional forward guidance.**
- **Indeed, the bank has emphasised the path of the cash rate – it's most important policy tool - will be based on actual economic outcomes and will not be lifted until full employment has been achieved and inflation is sustainably at target. The latter requires an acceleration in wages growth to above 3%. The RBA and NAB do not see these conditions occurring until 2024, though the risks are now more balanced than previously.**
- **Both economic activity and the labour market have rebounded much more quickly than expected with both employment and GDP now above pre-COVID levels. With forward indicators pointing to ongoing strength in the near-term – absenting the effects of the renewed and hopefully short-lived Melbourne lockdown - it appears that the economy is entering a new phase of growth. That said, unemployment remains a little above pre-pandemic levels, and is notably above the level consistent with full employment.**
- **Therefore, a degree of spare capacity will persist for some time and see underlying wage growth and inflation remain soft – though it is likely that we will see a transitory boost to both wages and inflation in the near term due to continuing pandemic-induced dislocations including border closures and some labour shortages.**

We expect monetary policy settings to remain exceptionally easy – with the cash rate to remain unchanged until 2024 with below-target wages growth and inflation persisting until further spare capacity is eroded.

The national accounts released yesterday confirm that the economy has recovered its pre-COVID level of activity and while the recovery has been uneven, the areas that have lagged – particularly services consumption - saw further improvement in the quarter. Higher frequency labour market data also show that the level of employment has now risen above pre-COVID levels (as has hours worked). While the unemployment rate remains around 0.4ppt above its pre-COVID level, leading indicators of labour demand (job ads, vacancies and the NAB Survey) suggest there will be further gains in the near term. We forecast that the unemployment rate will continue to decline over the next couple of years, reaching around 5% by end 2021 and 4.7% by end 2022. By end 2023, the end of our forecast period, we see unemployment at 4.4%.

However, despite the better than expected rebound to date, the unemployment rate at 5.5% is estimated to be around 1-1.5ppt above a level consistent with full employment. It is unlikely that wage growth will sustainably lift to above 3% until further spare capacity is eroded. How quickly wage pressure builds will likely depend on the point at which the economy hits full employment, how quickly it approaches this level and how far it goes beyond the current estimates of 4-4.5%. We expect wage growth to have risen to just below 3% by end 2023.

Consequently, our outlook for underlying inflation is a rise to just over 2% by end 2023. Ongoing disruptions to supply chains and the impact of weaker migration on the labour market may see a transitory bout of inflationary and wages pressure in the near term, but both will likely not sustainably return to desired levels until at least late 2023 or 2024.

Despite the optimism on the activity side, which will continue to be supported by both fiscal and monetary policy, outcomes for inflation remain uncertain.

To the downside, the level of full employment is highly uncertain and recent experience internationally suggests this figure is substantially below real time estimates. The ability of businesses to pass on emerging cost pressures rather than absorb pressures through lower margins is also unclear.

To the upside, the recovery to date has occurred at a much faster rate than expected and forward indicators point to further gains in coming months. This suggests the risk on the labour market is more titled to a faster rather than slower recovery. There is also some risk that some of the transitory inflationary pressure becomes ingrained via a lift in inflation expectations and hence stronger wage demands.

On policy, the RBA has signalled it will announce its plans at the July meeting for the next phase of the QE program as well as a decision on whether to roll the YCC program to the Nov-24 bond.

While the RBA has firmly conditioned expectations for the cash rate to be linked to actual economic outcomes (rather than forecast outcomes) the unconventional policy components still need to be set in a forward-looking manner – in part because of the forward guidance component. While the outlook for inflation remains weak the economic rebound has unfolded more quickly than expected and the risks around inflation outcomes have become more balanced in our view. The high degree of

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uncertainty around forecasts at that forecast horizon means the RBA will be unlikely to commit to unchanged rates to the end of 2024 or into 2025.

Consequently, we continue to expect that the RBA will not roll the YCC target of 0.1% to the Nov-24 bond, effectively allowing its implicit forward guidance of unchanged rates for the next three years to decay over time.

Paring back the YCC target will begin the exit strategy from the time-based forward guidance of this program and allow yields to begin to normalise as the target rolls off. It is important to remember that this policy will still see short rates firmly anchored at 0.1% for the next couple of years and the TFF continues to provide cheap 3-year cash until mid-2024.The RBA is also still able to shape expectations around the cash rate using outcomes-based forward guidance and continue the QE program as it deems necessary. That could open up the possibility of rate hikes earlier than the current 2024 guidance, which markets are pricing, though is not NAB's view.

Changes to the QE program represent the more significant uncertainty in our view – including some additional uncertainty generated by the renewed virus outbreak and associated lockdown in Melbourne. But assuming the outbreak and lockdown do not extend significantly, NAB still expects to see the beginnings of a moderate tapering in the third round of QE to $75bn.

The QE program will continue to be shaped by 3 key forces:

1) Economic and labour market conditions
2) The exchange rate (financial conditions) and actions of international central banks.
3) The functioning of the bond market.

Recent communication from the RBA suggests they see the overall stock of purchases (and hence the impact on yields) as the key measure of 'easing'. The bank's own projections see the RBA owning around 30% of the stock of AGS by the end of the second round of QE and notes that they have accumulated this stock of holdings at a faster pace than international peers. NAB estimates a further full round of $100bn of QE purchases would see the government own around 39% of outstanding AGS while a smaller $50bn round would lift its share of ownership to around 33%.

The RBA's assessment is that the impact of QE has been the equivalent of a full rate cut (30bps) on 10-year yields and has kept the exchange rate around 1-2% below the counterfactual – at a time where commodity prices have strengthened. The exchange rate is around 10% higher than the time of the QE announcement in October but has tracked broadly sideways this year. The RBA's positive assessment of the effects of QE make it unlikely that a very significant tapering would occur.

However, the RBA also notes that the rate of purchases as a share of outstanding issuance has occurred at a significantly faster rate than other central banks – that is, the pace of easing has been more significant. Looking forward, the better-than-expected federal budget deficit implies an even faster pace of easing that previously expected if the current pace of purchases was maintained. Further, expectations for a tapering by other major central banks over the next year continue to strengthen, with a number already having announced tapering.

While the economy is likely to require ongoing support for some time, the better than expected recovery to date alongside very easy conventional monetary and fiscal policy will allow the RBA to pull back slightly on the rate of bond purchases to prevent potential impacts on bond market functioning, while still providing additional stimulus and allowing for further programs should conditions warrant.

The change in shape of QE is likely to see an alteration to either the rate or size of overall purchases for the 3rd round – we do not see the pace of purchases lifted nor do we see QE completely abandoned. Instead we see key options as:

1) Tapering the purchases over the next 6-month period by announcing a smaller overall volume.
2) Tapering by announcing a further $100bn but spread over a longer time frame.
3) Moving to an open-ended weekly program of purchases allowing the RBA to match issuance flows as well as assess developments on yields and market functioning.

While option 3 would allow the greatest degree of flexibility in setting policy, it represents a communication challenge for the RBA which wishes to set expectations for the overall size of the QE program and would likely be reluctant to generate further speculation in markets based on week-to-week variations in purchases.

Instead we expect the Bank to announce Option 1 – a smaller purchase volume over 6 months. This would allow the RBA more flexibility in further adjustments as the recovery progresses in 2022 and see a slower rate of weekly purchases alongside the government's reduced issuance task. We also expect that there will likely be at least one further round of QE on top of an announced extension in July – which will be shaped by economic conditions and the final size of purchases in the next round once completed. The Bank will likely stress that slowing the rate of purchases is not a tightening of policy – it's a reduction in the amount of new policy support being provided. This is consistent with recent communications highlighting the overall stock of purchases as the measure of easing, as well as the ongoing support until RBA holdings of these bonds mature.

Contacts:

Alan Oster, Chief Economist

Gareth Spence, Senior Economist

Ivan Colhoun, Global Head of Research

Tapas Strickland, Director, Economics, Markets

Contact Details

Group Economics

Australian Economics

Alan Oster
Group Chief Economist
+(61 0) 414 444 652
alan.oster@nab.com.au

Gareth Spence
Senior Economist
+(61 0) 436 606 175
gareth.spence@nab.com.au

Tony Kelly
Senior Economist
+(61 0) 477 746 237
antony.kelly@nab.com.au

Global Markets Research

Market Economics

Ivan Colhoun
Global Head of Research
+(61 2) 9237 1836
ivan.colhoun@nab.com.au

Tapas Strickland
Director, Economics, Markets
+(61 2) 9237 1986
tapas.strickland@nab.com.au

Taylor Nugent
Economist, Markets
+(61) 452 671 752
taylor.nugent@nab.com.au

Rates Strategy

Skye Masters
Head of Rates Strategy
+(61 2) 9293 7168
skye.masters@nab.com.au

Ken Crompton
Senior Interest Rates Strategist
+(61) 439 471 709
kenneth.crompton@nab.com.au