Bank of Melbourne

Thursday, 19 March 2020

RBA Policy Decisions

RBA Breaks New Ground

- **The Reserve Bank (RBA) has come out swinging against the impact of the virus with 5 key measures today and promised to do “whatever is necessary” with “nothing…off the table”.**
- **First, it cut the cash rate by 25 basis points, taking the cash rate to a new record low of 0.25%. This level represents the effective lower bound for the cash rate.**
- **Second, the RBA issued forward guidance on the cash rate. RBA Governor Lowe in a speech said it is “quite likely” the cash rate could be at this level for “three years”.**
- **Third, the RBA broke new ground, launching a quantitative easing (QE) program for the first time ever. It involves targeting the Australian 3-year bond yield at “around” 0.25% rather than buying a specified quantity of bonds. There are some advantages to this “yield-curve-control” approach.**
- **The RBA Governor said he plans to remove the yield target before the cash rate is increased.**
- **Fourth, the RBA will provide term funding for banks to access cheaper credit from the RBA in order to support small and medium-sized businesses.**
- **The RBA has highlighted small and medium-sized businesses as a priority. Many of these businesses are going to find the coming months very difficult, as demand for many goods and services dries up. The RBA wants to help these otherwise viable businesses survive.**
- **Finally, the RBA will be renumerating exchange-settlement balances held at the RBA at 10 basis points instead of zero.**
- **The RBA will continue to provide liquidity to financial markets through its repo operations.**
- **In addition, the Treasurer’s Office has announced that the Australian Office of Financial Management will be provided with an investment capacity of $15 billion to invest in wholesale funding markets used by small ADIs and non-ADI lenders.**
- **The various elements of this package reinforce one another and will help to lower funding costs across the economy and support the provision of credit, especially to businesses.**
- **It’s unlikely that even in the short term the latest stimulus package will put an end to volatility in financial markets and uncertainty in the economy. A decline in the daily run rate of new global infections is needed first.**
- **However, this package is welcomed in trying to support the Australian financial system during extraordinary and challenging times. The virus has major health ramifications, as well as significant economic impacts.**
- **The RBA expects the Australian economy to recover once the virus passes. And when the recovery comes, these measures announced today will give the recovery support and help create a bridge from now until then.**

The number of daily new cases of the coronavirus continues to ramp up around the world, leading many governments to restrict people's movements and implement social distancing measures.

These measures and the fear from the virus are causing disruptions to economic activity, leading to sharp declines in demand and economic output. The virus is also causing heightened uncertainty, harming business and consumer confidence, and causing ructions in financial markets around the world.

Central banks and governments around the world are taking action. However, central banks and governments cannot offset the fall in demand that is associated with widespread shutdowns. But they can help soften the impact of the virus on the economy and support jobs, incomes and businesses, so that when the crisis recedes, the country is better placed to recover.

During the virus's outbreak, helping otherwise viable businesses survive is a core strategy, especially as many businesses are facing pressures on cash flows. Many sole traders and small businesses, in particular, will be strapped for cash.

Against this backdrop, the Reserve Bank (RBA) has come out fighting against the impact of the virus with 5 measures.

First, the **RBA cut the cash rate today by 25 basis points, taking the cash rate to a new record low of 0.25%.** This level represents the effective lower bound for the cash rate. That is, the cash rate cannot be taken lower than this due to the structure of our financial markets and economy.

It is the first rate cut made by the RBA outside of a regularly scheduled meeting since 1997. Today, the RBA Governor later confirmed that there was all the RBA could do with the cash rate.

Second, the **RBA has issued forward guidance to say the cash rate will not be raised "until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2-3 per cent target band".** We anticipate the current unemployment rate is set to rise to over 7% this year, due to the crisis. We also anticipate the underlying inflation rate will decline this year and will not make progress towards the band for some time. The cash rate will remain low for a longer period. Indeed, the RBA Governor in a speech after this announcement said **it is "quite likely" the cash rate could be at this level for "three years".**

Third, the RBA broke new ground, **launching a quantitative easing (QE) program** for the first time ever. We have been flagging the possibility of QE for some time, but prior to the outbreak of the virus, thought it was more likely to come around the middle of this year.

It plans to target the Australian 3-year bond yield at "around" 0.25% by buying Commonwealth government and semi-government bonds in the secondary market. This is also known as "yield-curve control". This starts tomorrow.

Other QE programmes around the world have typically involved buying a specified quantity of bonds. Using a yield-curve control measure means the RBA has no limit on the volume of bonds it will buy. It has signalled it will buy or sell however many bonds it takes across the yield curve to keep the interest rate on government bonds at its target level.

The emphasis is not on the quantities – that is, the RBA is not setting objectives for the quantity and timing of bonds that it will buy. How much the RBA needs to purchase, and when it needs to enter the market, depends upon market conditions and prices.

The Australian 3-year bond yield has fallen from a high of 0.60% before the RBA's announcement to 0.34% at the time of writing and it has averaged 0.45% in recent weeks. The Australian 10-year bond yield has gyrated more wildly. It spiked from 1.52% before the announcement to a high of 2.50% just after the announcement, before retreating to 1.43% currently. These wild swings might have reflected some market participants anticipating the RBA would target the 10-year rather than the 3-year bond yield.

The Australian 3-year bond yield is seen as an important benchmark for bond raisings in the Australian financial markets.

If the RBA is able to get the Australian 3-year yield to its objective, then that will also drag yields on the longer-end of the yield curve lower.

The RBA in a speech this afternoon also added that it is not planning to have the Australian 3-year bond yield at exactly 0.25% exactly each day. Further, the RBA plans to remove the yield target before the cash rate is increased.

It is worth considering why the **RBA might prefer yield-curve control** over a more commonly used approachto quantitative easing that has been used in much of the world during and since the GFC. Yield-curve control's approach of targeting specific interest rate is more similar to conventional monetary policy. The RBA is experienced in setting and publishing the cash rate and measuring the impact on the economy. Indeed, the RBA Governor in his speech said that it is an extension of and complimentary to targeting the cash rate.

The RBA might also prefer yield-curve control as it could need to buy less than it would have to achieve lower interest rates, if the RBA's stated target is seen as credible.

Fourth, **term funding has been made available for banks to access cheaper credit from the RBA in order to support small and medium-sized businesses.** Under this new facility, authorised deposit-taking institutions (ADIs) in total will have access to at least $90 billion in funding. ADIs will be able to borrow from the Reserve Bank an amount equivalent to 3 per cent of their existing outstanding credit to Australian businesses and households. ADIs will be able to draw on these funds up until the end of September this year.

Lenders will also have access to additional funding if they increase lending to business. For every extra dollar lent to large business, lenders will have access to an additional dollar of funding from the Reserve Bank. For every extra dollar of loans to small and medium-sized businesses they will have access to an additional five dollars. These funds can be drawn upon up until the end of March next year. There is no extra borrowing allowance for additional housing loans.

The funding from the Reserve Bank will be for three years at a fixed interest rate of 0.25 per cent, which is substantially below lenders' current funding costs. Institutions accessing this scheme will need to provide the usual collateral to the Reserve Bank, with haircuts applying. The first drawings under this facility will be possible no later than four weeks from today.

The objective is to support small and medium-sized businesses (SMEs), which was noted as a priority for the central bank. Many small businesses are going to find the coming months very difficult, as demand for many goods and services in the economy declines. The RBA wants to help these otherwise viable businesses survive.

ADIs will still be required to take on the credit risk associated with these facilities, but may consider switching more expensive facilities for existing borrowers into these facilities, providing a cash flow boost to small and medium sized businesses.

Finally, **exchange settlement balances at the RBA will be renumerated at 10 basis points, rather than zero** as would have been the case under previous arrangements. This is in recognition that exchange settlement balances are likely to increase significantly as a result of this policy package.

The RBA will also continue to provide liquidity to Australian financial markets by conducting one-month and three-month repo operations in its daily market operations until further notice. In addition, the RBA will conduct longer-term repo operations of six-month maturity or longer at least weekly, as long as market conditions warrant.

In addition to these initiatives announced by the RBA, **the Treasurer's Office has announced a program of support for the non-bank financial sector, small lenders and the securitisation market**, which will be implemented by the Australian Office of Financial Management (AOFM). The AOFM will have a capacity of $15 billion to invest in wholesale funding markets used by small ADIs and non-ADI lenders. This initiative parallels a similar initiative by the AOFM during the GFC. It will be of particular support to issuers of mortgage-backed securities (MBS).

Overall, we are pleased with the package delivered today. Indeed, the various elements of this package reinforce one another and will help to lower funding costs across the economy and support the provision of credit, especially to small and medium-sized businesses.

It's unlikely that even in the short term the latest stimulus package will put an end to volatility in financial markets and uncertainty in the economy. A decline in the daily run rate of new global infections is needed first. However, **this package is welcomed in trying to support the Australian financial system during extraordinary and challenging times.** The virus has major health ramifications, as well as significant economic impacts.

The RBA is expecting a recovery once the virus passes and these measures announced today will help support the recovery and create a bridge from now until then.

To conclude, the RBA Governor was asked what other measures might the Governor consider if more stimulus is yet needed. Governor Lowe responded that at the moment he feels the RBA has done enough. But he "will do whatever is necessary" and "nothing is off the table".

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