Bank of Melbourne

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Reserve Bank Policy Outlook

The RBA Cuts Rates And More

- **As expected, the Reserve Bank (RBA) reduced a range of interest rates following its monthly board meeting. The cash rate was reduced from 0.25% to 0.10%.**
- **In March, the RBA began setting a target for the 3-year government bond yield by buying and selling bonds across the curve (called yield-curve control). The target was set at 'around' 0.25% and was reduced to 0.10% today.**
- **In a new move, the RBA will introduce a separate bond-buying program (i.e. quantitative easing) for maturities beyond three years. It now plans to purchase bonds in the 5 to 10-year range, thus impacting on yields further along the yield curve.**
- **The RBA now has a price target (for the 3-year bond yield) and a quantity target (for its bond buying program for maturities of 5-10 years).**
- **In its effort to support businesses and job creation, the RBA in March also introduced a Term Funding Facility (TFF) whereby lenders could borrow from this fund to on-lend to clients. The borrowing rate from this fund was initially set at 0.25% and today was also reduced to 0.10%.**
- **Today's policy package is designed to work via three channels. Lower lending rates should lift cash flows and so lift spending. There will be downward pressure on the Australian dollar because of lower bond yields. Lower yields and access to credit will put upward pressure on asset prices. This will strengthen personal and business balance sheets allowing more scope for spending.**

As expected, the Reserve Bank (RBA) reduced a range of interest rates following its monthly board meeting. The cash rate was reduced from 0.25% to a new record low of 0.10%.

These days, monetary policy is more than adjusting the cash rate. The RBA also seeks to influence yields across the yield curve. In March, the RBA began setting a target for the 3-year government bond yield by buying and selling bonds across the curve (called yield-curve control). The target was set at 'around' 0.25% and was reduced to 0.10% today.

RBA Governor Lowe, in his accompanying press conference stressed this is the new lower bound and stressed again that negative rates remain "extraordinarily unlikely". He did concede, however, that if other major central banks all have negative rates, then the RBA would have to consider negative rates.

In its effort to support businesses and job creation, the RBA in March also introduced a Term Funding Facility (TFF) whereby lenders could borrow from this fund to on-lend to clients. The

borrowing rate from this fund was initially set at 0.25% and today was also reduced to 0.10%.

Another arm of the RBA's monetary policy is the operation of its Exchange Settlement account. Banks and other authorised deposit institutions (ADIs) hold accounts with the RBA and bank funds can sit there. The rate on those accounts, prior to the RBA board meeting, was 0.10%. Today that rate was reduced to zero. With a zero rate, there is no incentive for banks to hold funds in these accounts. The expectation is that banks will seek out better yielding alternatives. When lent out, these funds can assist business activity.

In a new move, the RBA will introduce a bond-buying program (i.e. quantitative easing) for maturities beyond 3 years. It now plans to purchase bonds in the 5 to 10-year range, thus impacting on yields further along the yield curve.

It announced today that it would purchase $100 million of 5-10-year bonds issued by the Australian government and those of the states and territories for a period of six months. The RBA also said this bond-buying program is separate to the bonds it buys as part of its yield-curve-control program.

The RBA now has a price target (for the 3-year bond yield) and a quantity target (for its bond buying program for maturities of 5-10 years).

The new bond-buying program announced today matches the QE programs of other central banks, which the RBA hopes will bring down yields at the longer end of the Australian yield curve and reduce the demand for the Australian dollar (than otherwise would be the case). A more competitive currency would help bolster the trade sector and economic recovery.

Why is $100 billion the magic number? The Governor explained that international experience suggests 5% of gross domestic product (GDP) is what has a meaningful effect on the currency and bond yields. For Australia that is around $100 billion. The RBA Governor also said that if this amount proves to be wrong, they will adjust the numbers.

The Governor's statement, following the changes to monetary policy, stressed that the RBA intends to play its part in assisting the recovery and creating jobs. The RBA is concerned about the long-lasting effects from the pandemic, especially on jobs, and hopes the delivery of these new stimulus measures will reduce the risk of high unemployment. A sharp bounce back in jobs is unlikely but the priority is clearly on job creation.

Importantly, the Governor stated that the RBA board is prepared to do more if necessary. The Board will keep the size of the bond purchase program under review, particularly in light of the outlook for jobs and inflation.

Today's rate changes, and the forward guidance it has given, reduce the cost and the risk of borrowing. They should also aid recovery via their impact upon business and household balance sheets.

But will they really work? The RBA is of the view that as restrictions across the economy are lifted, so its policies will gain more traction. Recent statistics on home lending, building approvals and consumer sentiment suggest that green shoots are emerging in the economy. Today's announcements will encourage growth.

The Governor's statement acknowledged that recovery was underway. It also acknowledged that some of its early concerns were not met. Accordingly, it now forecasts that the rate of unemployment will peak a little below 8% rather than the 10% expected some months ago. It now also expects the unemployment rate to sit around 6.0% by the end of 2022 (down from 7% previously forecast).

The RBA also upgraded its near-term economic growth forecasts. GDP growth in the year to June

2021 is now anticipated to be 6% compared with 4% previously.

But the Governor made it clear that the economy remains in recession, although the narrow definition of a technical recession won't be met with solid growth in the September quarter expected by the RBA.

Given the slack in the labour market, the RBA notes that wages growth will be weak over the next few years. This is important for its inflation outlook given that wages are a major business cost. With wage growth low, it will take longer for inflation to reach the RBA's 2-3% per annum inflation target. From this flows the remark made by the Governor that "the Board is not expecting to increase the cash rate for at least three years".

The Governor explained in his press conference that there is less certainty beyond three years, but he hopes within the next five years, the economy will begin to show signs of recalibrating and policy will begin to normalise.

Is the RBA out of firepower? The Governor says 'no' and they have additional policy tools if needed.

Today's policy package is designed to work via three channels.

Lower lending rates should lift cash flows and so lift spending.

There will be downward pressure on the Australian dollar because of lower bond yields. This will aid export industries and those receiving income from abroad.

Lower yields and access to credit will put upward pressure on asset prices. This will strengthen personal and business balance sheets allowing more scope for spending.

Together, the RBA policy package and the recent Budget announcements should help create jobs and aid in the recovery of the economy.

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