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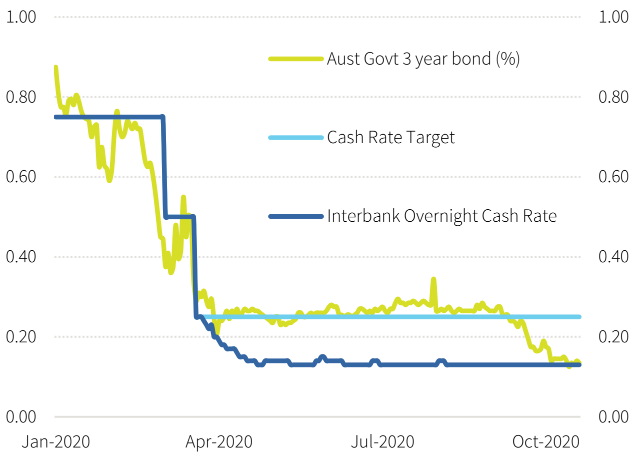
Lower rates out longer along the curve as RBA appears set to go shopping for more bonds

Andrew Mayes
Director, Credit Research
+61 3 8668 8829
andrew.mayes@fiig.com.au

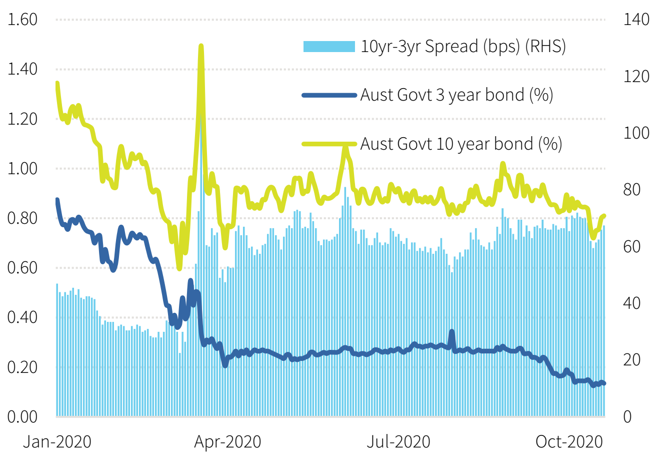
The Reserve Bank of Australia's (RBA's) November board meeting appears set to round out a year of the unconventional. Through the use various policy measures (explored here), the RBA has substantially eased financing conditions in Australia (see Figure 1 and 2). And while the recovery in Australia is arguably stronger than many had anticipated, the recovery is likely to be uneven for some time.

Figure 1: Australian interest rates



Source: RBA

Figure 2: Australian Government bond spreads (bps)



Source: RBA

In recent communications, the RBA has provided a great deal of insight into possible policy options as it seeks to further ease financial conditions, particularly those options aimed toward reducing the targets for the cash rate and the 3-year yield towards zero (without going negative) and buying government bonds further along the yield curve. Much attention has been given to overseas developments, where intervention has been arguably more pronounced, and its relative impact here in Australia (particularly on the currency). These more recent public deliberations from the RBA have pushed Australian yields below their US equivalents and sent the Australian dollar lower.

To date, the RBA has purchased ~AUD52bn in Australian Commonwealth Government Bonds (ACGBs) (along with a smaller amount of semi-government (state) bonds), with a weighted average maturity of ~5.0 years (see Figure 3) through the use of yield curve control. Yield curve control involves the central bank buying and selling bonds as necessary to achieve its short-term interest rate target (i.e., controlling yields at certain point(s) along the government yield curve, hence the term "yield curve control"). Yield curve control is also more closely modelled on conventional monetary policy; the central bank simply transacts in the bond market to keep yields consistent with its target, as it does for overnight rates.

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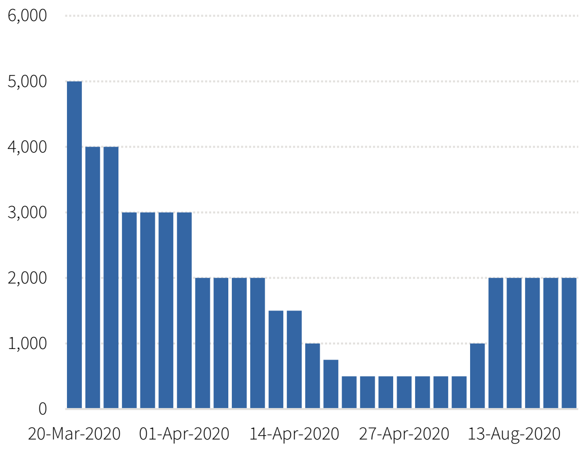
This is in contrast to quantitative easing, which many in the market have interpreted as the next phase in the RBA's asset purchasing program. Quantitative easing, which has been deployed extensively around the world, involves the purchase of a quantity of bonds (hence the term, "quantitative"), increasing the stock of money in the economy.

In simple terms then, yield curve control is concerned with the price of bonds; quantitative easing is concerned with the quantity of bonds.

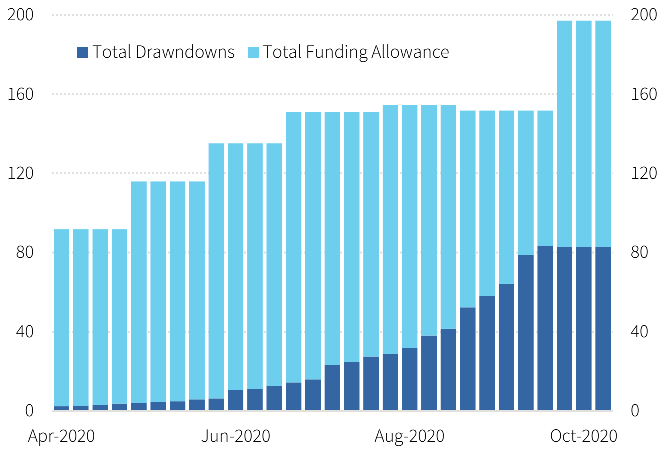
Together with the substantially larger Term Funding Facility (which has so far been drawn to less than half its total allowance of ~AUD200bn, see Figure 4), the RBA's expansion of its balance sheet has provided considerable monetary easing at the shorter-end of the curve (yields out to five years are now less than 30 basis points). We explored the effectiveness of these measures, particularly in relation to Australia's household sector, here. The effective cash rate (actual overnight rates) has been trading closer to 10 basis points since mid-April (a function of substantial financial market liquidity), so it would be reasonable to expect the RBA to simply shift the target cash rate to around that level, and reduce its 3-year yield target rate accordingly. These moves are already effectively priced-in.

Figure 3: RBA purchases of Australian govt. bonds (AUDm)



Source: RBA

Figure 4: Term funding facility (AUDbn)



Source: RBA

By opting for yield curve control initially, the RBA arguably could be seen to be doing more (see Figure 5 and 6), notwithstanding the success of existing measures (recall the overwhelming majority of borrowing in Australia is undertaken on floating or short-dated fixed terms, which explains initial prioritisation of the front-end of the curve). Most estimates have the quantity of bonds to be purchased under an expected quantitative easing program at between AUD80bn and AUD100bn. We would expect much of this to occur at terms between five and ten years, and across both ACGBs and semi-governments. While this appears sizeable in isolation, relative to other developed countries, the size of the RBAs balance sheet would still be toward the lower end.

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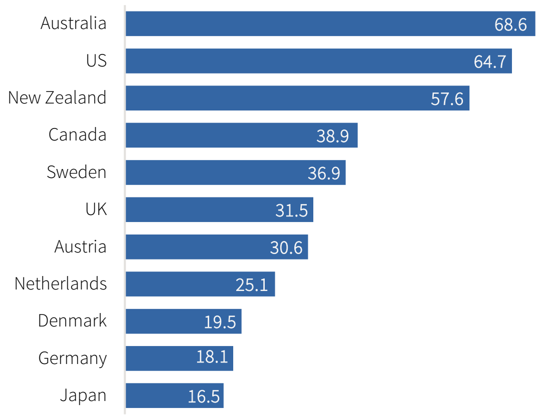
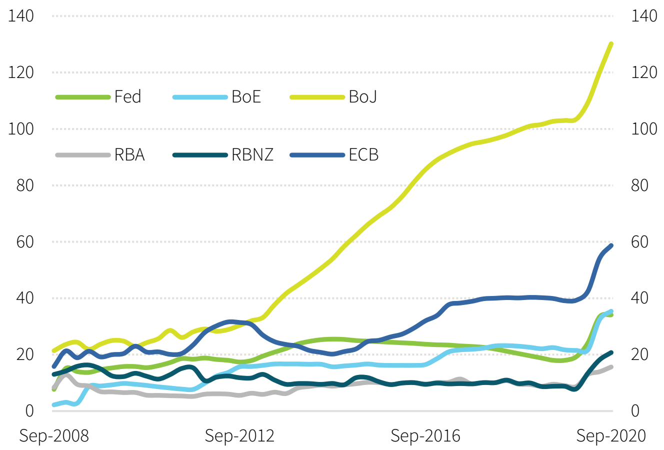
Figure 5: Yield curve steepness among major economies (bps)*



*Source: Bloomberg. *As measured by the 10yr/2yr spread*

Figure 6: Central Bank balance sheets (% of GDP)



Source: Bloomberg.

Although we believe more needs to be done by fiscal authorities, by purchasing government bonds further out the curve, government funding--particularly semi-government--should be one of the main beneficiaries of the RBA's quantitative easing program. This in-turn should support their respective ability to fund their various response programs. We note that despite a fleeting spike in semi-government spreads back in mid-March, they have remained largely on-trend relative to ACGBs.

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