Australia: Is the RBA heading to QE?

Speculation that the Reserve Bank of Australia may embark on quantitative easing is growing, although we see no crisis to warrant the use of such an unconventional monetary tool. If anything, we would expect an Aussie QE to be limited in size but still trigger some AUD weakness

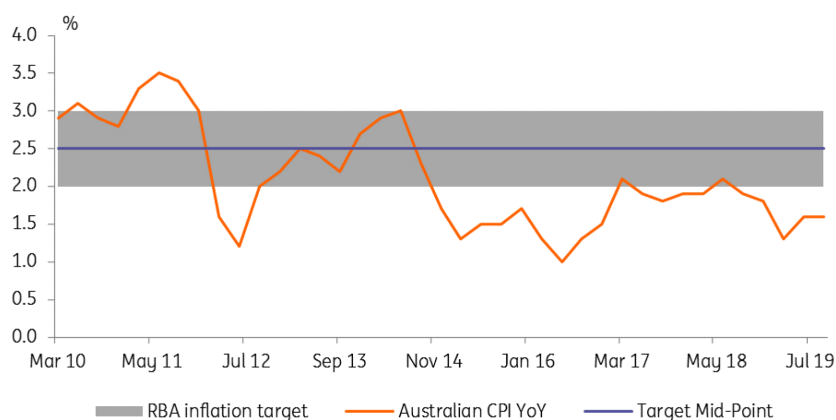
RBA governor, Philip Lowe

Lowe still lacking reasons for QE

The latest rate cut by the RBA on 1 October took the cash rate to just 0.75% and comes after consecutive rate cuts in June and July of this year. The Australian economy has been hit by a combination of stagnation in some of the extraction industries following years of excess investment and capacity increases, and more recently by the impact of the trade war on global demand, notably for commodities, and the slowdown in the housing market.

Decent employment growth has not generated much of an upturn in wages, but has underpinned consumer spending; the economy has held together reasonably well given the headwinds it has faced. More recently, RBA Governor Philip Lowe hinted at a gentle (upward) turning point – an idea supported by what appears to be some bottoming in the housing market. But like many other central banks, the RBA is concerned about missing its inflation target. This is higher than in most OECD countries, with a mid-point of 2.5% for CPI. Currently, inflation stands at only 1.6%YoY (2Q19).

Australian inflation still below target



Source: Bloomberg, ING

Recent research by the RBA also seems to suggest that the unemployment rate needs to fall to 4.5% for wages and prices to start rising. We believe it is this, and small increases in the unemployment rate (August print was at 5.3% from 5.2% in July) that led to the RBA easing aggressively during the middle of the year, and again more recently. Today's release shows unemployment was at 5.2% in September, still far from the RBA target, but improving.

Leaving aside the rights or wrongs of this approach (and we have serious misgivings) some observers are beginning to speculate that the RBA might eventually embark on a quantitative easing programme of its own, like other central banks including the US Federal Reserve, European Central Bank, Bank of England, Bank of Japan and Sweden's Riksbank.

> *Some are beginning to speculate that the RBA might eventually embark on a QE programme*

Certainly, if the RBA is intent on seeing the unemployment rate fall to 4.5 %, then the economy isn't growing nearly fast enough to achieve that, and so this could be one argument for embarking on unorthodox policy measures. We would argue that getting the unemployment rate this low with monetary measures alone, or even with the help of fiscal measures too, would require unrealistic amounts of stimulus. The negative consequences of doing this would likely far outweigh any positive benefits.

But worryingly, central bankers these days seem to be far more sanguine about the effects of such policies, as a recent BIS paper from a committee co-chaired by the RBA's Governor Lowe indicates.

All in all, we suspect that to push the RBA to embark in quantitative easing we would need to see inflation still around 1.5% after two more rate cuts (cash rate at 0.25%) and some uptick in the unemployment rate (around 5.5%).

What's needed to push the RBA to start QE

Factor	Level to justify QE	Current level
RBA Cash Rate	0.25 %	0.75 %
Inflation (CPI YoY)	1.5 %	1.6 %
Unemployment rate	5.5 %	5.2 %

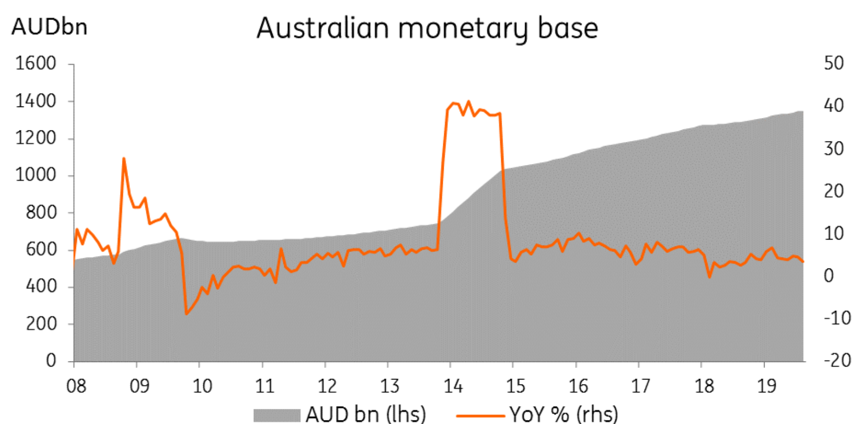
Source: ING

How would an Aussie QE look?

The most obvious approach for the RBA would be to purchase Australian government debt in much the same way as the Federal Reserve was a net buyer of Treasuries from 2009 to 2015. By April 2010, 12 months after commencing outright purchases the year before, the Federal Reserve had increased its holdings of Treasuries by around $1.1tr, at an average pace of $95bn per month.

Purchasing occurred in waves, though successive rounds of QE2 did not match the initial pace of purchase either in terms of the absolute change in outright ownership, or as a proportion of the monetary base. Bear in mind of course that the monetary base was itself swollen rapidly by these procedures.

Australian monetary base



Source: Bloomberg, ING

Different conditions

For Australia, conditions could not be more different. The Australian economy is not imploding, asset prices, real and financial, are steady or rising, and there is frankly no crisis that needs such emergency monetary policy tools.

Bearing these very different backdrops in mind, then If the Fed effectively doubled the monetary

base in the 2009/10 period for QE1, there is no plausible excuse for the RBA doing more than a fraction of that, say a 30% increase of the monetary base. Base money already grows by about 5% per year to keep track with the nominal growth of the economy, so an additional 25% increase would currently entail an annual increase of AUD28bn per year, from today's monetary base of AUD112.6bn. That would be about AUD2-3bn of additional outright asset purchases per month.

FX impact: a notable precedent

Historical evidence suggests that, on a general basis, quantitative easing and the consequent expansion of a central bank balance sheet negatively affect rates (especially on longer maturities) and weakens the domestic currency, other things equal.

In a notable example, the asset purchase programme implemented by the ECB starting from early 2015 is widely recognised as a main driver of the euro weakening. In an ECB research paper, it is estimated that every expansion in the relative ECB-Fed balance sheet by 1.9% caused a 1.1% depreciation of the EUR/USD. According to such estimates, the ECB APP prompted a total 20% EUR/USD depreciation between the announcement of the programme in September 2014 and the end of 2016.

Should the RBA decide to explore quantitative easing in the next quarters, the reasons, size, domestic and international backdrops would only be few of the differences with the post-crisis QE experiences in the US, Eurozone, Japan and United Kingdom. However, it seems reasonable to assume a negative impact on the Australian dollar, given QE's inherent power to dampen interest rates.

Estimated impact on AUD

At this point, the relative size of the RBA vs the Fed's balance sheets does not show a meaningful correlation with the AUD/USD cross. However, this was also the case for EUR/USD and the ECB/Fed balance sheet before 2015.

For EUR/USD, we find that the negative correlations between the assets held by the central bank and the currency became evident only once the asset purchasing started. A similar case was seen in EUR/SEK, with the cross following the dynamics of the ECB/Riksbank relative balance sheets only after QE was introduced in Sweden. We would expect the same trend to occur for AUD/USD, and the correlation between the cross and the balance sheet to pick up only once the RBA starts engaging with or signals asset purchases.

Should (a) the RBA start the QE programme now and deliver AUD 28bn of QE (as discussed above) or (b) the Fed increases its balance sheet to curb money market volatility (note that we partly discount the effect of the Fed balance sheet increase in our calculations as it does not impact the UST curve but rather target money market dislocations), this would translate into an increase in the RBA/Fed balance sheet ratio by approximately 8%. If we use the "currency multiplier" provided by the ECB paper, the result would be a 5% depreciation in AUD/USD, all things being equal.

An RBA QE still seems unwarranted at the moment, in our view, but should Governor Lowe decide to start an asset purchase programme, we would expect the increase in the balance sheet to be only a portion of how much the Fed increased it in 2009. The lack of previous correlation between the RBA balance sheet and the Aussie dollar prevents us from creating

a specific framework to estimate the impact of central bank asset purchases. However, using the estimations of the currency impact of ECB QE in 2015-2016 - and this warrants caution due to the many differences - we could expect a negative impact on AUD/USD by around 5%, all things being equal.

Author

Robert Carnell
Regional Head of Research, Asia-Pacific
robert.carnell@asia.ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("**ING**") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.