Podcast Transcript – Monetary Policy during COVID-19

0.14 Narrator: Welcome to a podcast from the Reserve Bank of Australia. Today we are discussing the Reserve Bank's monetary policy measures implemented since the outbreak of COVID-19. This podcast is an opportunity to hear from the Reserve Bank's leadership team about what, how and why we took each step along the way.

The story begins in early 2020 as the world began to reckon with the rapid and widespread outbreak of the coronavirus. Joining us now is Luci Ellis, Assistant Governor for the Economic Group, and she takes us back to March, 2020. So Luci, can you begin by describing the environment at that time?

0.47 Luci Ellis: March was really the period where we realized that this was a big global shock. In January and February, the main issue for the domestic economy had been the bushfires. We knew that the lockdowns in China were going to be a hit on their output, particularly in the weeks after Chinese New Year, but we didn't know how much at that point. And it really wasn't till we got to the beginning of March, where you saw this pandemic spread to other countries, where you saw lockdowns in a range of other countries, that you could see it being a very big shock for the global economy. We knew that China was going to be heavily affected – we could see electricity output and various other indicators that were suggesting a big contraction, and by the time we got to early March, it was clear it was going to be about 10 per cent, which is roughly what it was

1:39 Narrator: During March the pandemic spread quickly. On the 11th of March, the World Health Organization formally declared COVID-19 a global pandemic. At that stage there were more than 118,000 cases in 114 countries, and over 4,000 people have lost their lives. The Australian Prime Minister announced Australia was closing its borders from the evening of the 20th of March. At that stage, Australia had close to 1,000 confirmed cases.

2:05 Luci Ellis: In terms of the effect on the Australian economy, as we knew it at that time, we did know that the closure of the border with China was going to affect a number of industries – the education industry was going to be affected. Many Chinese students were not able to get to Australia and had to study online which means they weren't spending money here. Some of them were able to get through via third countries and doing their quarantine there but others were not able to make it. And that was a big hit to our university sector. Similarly tourism, there are parts of the tourism industry that are more focused on international tourism rather than domestic tourism and so they were being affected as well. So we could see that there were these areas that were being affected but as at early March, it wasn't so clear cut that it was going to hit Australia in the same way that it hit China.

Narrator: On the 18th of March, the Reserve Bank Board held an out-of-cycle emergency meeting and the following day, on the 19th of March, Governor Philip Lowe announced some major initiatives to support the economy. These included: a further reduction in the cash rate to a quarter of a percent, from half a percent, a target for the yield on three year Australian government bonds of around a quarter of a per cent, the establishment of a Term Funding Facility to provide funds to Authorised Deposit Institutions, which are essentially the banks, for three years at a fixed interest rate of a quarter of a percent, forward guidance that the Board will not increase the cash rate until progress has been made towards full employment and is confident that inflation will be sustainably within the 2 to 3 per cent target band, and the purchase of bonds to address market dysfunction in the Australian government bond market. Out-of-cycle board meetings are very rare for the Reserve Bank. Deputy Governor Guy Debelle explains the what, and why of this extraordinary meeting. So Guy can you tell us why the Bank took these steps at that time.

3:54 Guy Debelle: Well the situation both here in Australia and globally was rapidly evolving back in March. We were looking at a significant hit to the Australian economy and to the global economy. So the Board, took the decision to provide this support to the economy, alongside the substantial support that the Government was providing through fiscal policy.

We were concerned that there'd be a very large decline in output as the health restrictions were being imposed and also through the impact of the border closures both here and elsewhere around the world. We were already seeing sharp declines in activity in China and in parts of Europe. In response to the imposition of these restrictions are were looking at a very large decline in output and employment in the Australian economy.

Narrator: Many of these programs announced by the RBA were new to this market. Unconventional monetary policy occurs when tools, other than changing a policy interest rate, are used. Having said that these tools are being increasingly used around the world. Marion Kohler, who heads Domestic Markets at the Reserve Bank of Australia, and has responsibility for implementing many of these tools, tells us a bit about them. Marion could we start with conventional monetary policy?

5:10 Marion Kohler: Most central banks in advanced economies target, in the current frameworks they have, they target short term interest rates. In Australia, that is the overnight cash rate that we have been targeting for many years. When the cash rate moves, many other interest rates move with it. This, in turn, influences borrowing, saving and investment decisions in the economy and stimulates the economy. When that cash rate is at the lower bound - because the Board decides that it doesn't want to lower it further because of costs, such as those associated with negative interest rates - that is when you then use unconventional monetary policy tools. When you set a quantity for how much you want to buy, you call this QE, and we have done that.

Narrator: Quantitative easing yes?

6:04 Marion Kohler: Yes and we have done that in our bond purchase program. If you set a target for the yield – for the price of the asset – that's not quite quantitative easing and we have done that in our yield target program where we said we want to hold the yield of the three year government bond at a certain rate. And then we just buy as much as we need to buy to achieve that.

There's another type of tool that a lot of central banks have used and that's known as forward guidance. And forward guidance as an unconventional tool – central banks obviously use forward guidance all the time; they talk about what they're expecting – but as a tool means really you give an explicit guidance to the markets, to the households, to the businesses, on what you think your future policy rates will be, often a number of years into the future. And we have, for example, had the forward guidance of the past year that we think the cash rate will not be raised for the next coming few years.

Finally, there's another type of tool that a lot of central banks have used, and we have used: the Term Funding Facility that provides low cost funding to banks. And by providing low cost funding to the banks, you lower their funding costs, and that should lead them to be able to reduce the interest rates they charge to borrowers, and that is another interest rate [reduction] going through and that will ultimately support the supply of credit as well.

So on unconventional tools and I have now described three big types, and there's other ones as well, they've always been in the toolkit of central banks – they're actually not new – and central banks have used them on occasion in history, but quite often particularly to address financial market conditions – the functioning of financial markets – where you need them. What is unconventional about that is to use these tools actually to ease financial conditions more broadly, and stimulate the economy.

Narrator: Some people have suggested unconventional monetary policy is the same as printing money. Is that concept correct?

8:20 Marion Kohler: The central bank doesn't actually print bank notes to pay for the asset purchases. So we buy government bonds, but we actually don't pay with them with bank notes. So what we have in a modern system is an electronic way of paying for this. We pay for them by creating what's known as central bank reserves and in Australia, we call that exchange settlement balances. And these are really balances the banks have in the accounts they hold with the central bank. And when a customer of a bank makes a transaction with another customer of a bank, those balances get moved into the other account and moved round. And so when we purchase a bond, either from a bank directly or from a customer of the bank, what we do is we credit the account of that bank.

Narrator: The Term Funding Facility was established by the Bank in the early stages of the pandemic and launched at the out-of-cycle board meeting in March to encourage banks to lend to consumers and business, particularly small business during the pandemic.

Narrator: Chris Kent, Assistant Governor Financial Markets, has responsibility for Domestic and International Departments, discusses how the Term Funding Facility works.

9:32 Christopher Kent: Yes, so the Term Funding Facility is the Reserve Bank saying to other commercial banks, we'll be providing you a certain amount of funding at a term of up to 3 years at the current low rate of ten basis points. And so that gives the banks an option to come to us – so they can come to us on any day and say we would like to take you up on that opportunity. And what they do is – the mechanics of it – would be the bank, coming to us and saying I'd like a hundred million (dollars) – let's make it up – if it's a large bank or a share of their total allocation I'd like to take that out in 2 days, so in 2 days' time we provide them a hundred million of cash into their exchange settlement account, which is a bank account at the Reserve Bank. And then in return, we make sure they give us some high quality collateral in one form or another. So that could be a government bond or a state government bond or it might be another type of security, and we take that as security.

10:42 Narrator: Chris why did we feel the need to introduce the TFF?

Christopher Kent: This was a way of giving banks surety that they could sort of fund credit – that their funding wouldn't be limited, because at the height of the pandemic funding markets the banks and other large corporations were considerably strained, and the price going out, to say, issue a private bank bond at three years, had gone up and it wasn't even clear that that funding would be available on the same terms as before. So to help augment what we were doing with the lower cash rate, for example, and the forward guidance, we decided well at the same price banks are lending for three years , so long as they provide us with good quality collateral, and that gives them not only surety about access to funding, but at a low price. So they then, with conviction, know they can go out and make loans for that amount of time at a low price and that's indeed what we've done. We added an extra bit in there which was an incentive for them to provide funding to business, particularly to small business.

11:54 Narrator: From March to November COVID-19 shattered the global and local economies. Luci provides a short overview of what happened during this period.

12:03 Luci Ellis: Well the activity restrictions required many businesses to shut entirely and hundreds of thousands of people lost their jobs in the first phase of those restrictions. JobKeeper helped. Once it was introduced, many workers were able to stay on the books, and they were able to retain their connection to their employer, but unemployment did go up a lot. It went from just over 5 per cent prior to the pandemic to peak at around seven and a half percent in July. And so there were an awful lot of people who lost their jobs over those months, especially in hospitality and the other industries such as travel that were most affected by restrictions, but you also saw jobs lost right across the economy in a range of different industries. Many businesses were uncertain about the demand that they might be facing – there was a lot of uncertainty. Some people would have been delaying plans to spend because they were concerned about the health situation and the economic situation. And they would have delayed hiring or laid off staff because of that. But as the year progressed, it became clear that the health situation was a lot better than we had feared – than everyone had feared really – and a lot better than you saw in many other countries. I mean the Melbourne lockdown did delay the recovery in Victoria but outside of Victoria, you saw a very rapid snap back to spending patterns that will close to where we had been pre-pandemic. There were some differences: large events weren't happening, there was more spending on goods particularly household goods than there were on services, there was still a lot of uncertainty, but it really was quite a rapid recovery. Once restrictions eased, and we realised over the course of those months that the main constraint on activity was in fact the activity restrictions that were needed for health reasons.

13:53 So how did Australia compare to other global economies?

Well, we were among the handful of countries that had a relatively rapid control over COVID-19 and over the pandemic. We were able to close our borders. We were able to prevent further cases coming in by having hotel quarantine – even though it didn't always prevent cases getting out, it certainly massively reduced the flow of new virus coming in and that meant that it was possible for test tracing and quantitative to work, it was possible to get the caseload down to very low or even zero for extended periods and that meant it was feasible to release a lot of these activity restrictions, lockdown, stay-at-home orders – and slowly some of the industries that were most affected by that were able to come back.

14:44 Narrator: At its meeting on the 3rd of November, 2020, the Reserve Bank Board announced further measures to support the recovery of the Australian economy. This package included a reduction in the cash rate to one 10th of one per cent, a reduction in the target yield on a three year Australian government bond to around one 10th of one per cent, and a reduction in the interest rate on new drawings under the Term Funding Facility to one 10th of one per cent, following the announcement in September 20 to increase and extend the Term Funding Facility to 30 June 2021.

The Board also included a new measure, which was the purchase of $100 billion of government bonds of maturities of around five and 10 years over the subsequent six months. We have Deputy Governor Guy Debelle here again to provide insights into why we took these steps.

15:32 Guy Debelle: So in November we've obviously learned more about the pandemic and its economic impact. And as time had passed it had become increasingly apparent there was going to be long lasting effects including high unemployment as a result of the pandemic. And so the outlook remained still very much uncertain, and we'd actually upgraded the near term outlook for the economy at this point, but nevertheless we still, looking forward, expected there to being very long lasting impacts.

Another consideration was that monetary policy easing at that point in November was likely to get more traction than it might have when there were widespread restrictions in place earlier in the year. So in earlier months, some of the usual transmission mechanisms of monetary policy weren't working as normally, and the challenges facing the country where better addressed by other policy tools but now, by November, as restrictions were being eased and people had more opportunities to spend, our assessment was that further easing may actually provide additional support to the other policies already in place, including both the Government's fiscal policy and the earlier steps that the RBA itself had taken.

In terms of the bond purchase program, one of the things we were taking account of was that longer term yields in Australia were higher than those in other countries and part of our assessment for that was that the impact of other central bank bond purchase programs were having on bond yields in their economies. And so our assessment was that if we were to undertake such a program it would push down bond yields further which would lead to further lowering of interest rates, both for the government but also for all other borrowers in Australia be they households buying a home or businesses wanting to borrow to expand into the recovery.

Narrator: Chris Kent explains to us how the Bank has conducted the bond buying program.

17:34 Christopher Kent: So we announce a total amount we are buying over six months – $100 billion roughly and that equates to about five billion a week. That's exactly what we've done most of the time. And so we have auctions where we buy $2 billion of the Australian government securities on a Monday; we buy $1 billion of the state government securities – the so-called semis – on a Wednesday; and then on the Thursday we buy another $2 billion of the Australian government securities – the AGS.

Narrator: At its first meeting in 2021, on the second of February, the Reserve Bank Board announced the Bank would purchase an additional hundred billion dollars of bonds, when the current bond purchase program was completed in mid April, those purchases are underway now go. Guy Debelle runs through the announcement by the Board in February 2021.

18:29 Guy Debelle: So, in February, the Board decided to purchase an additional a hundred billion dollars of bonds, in addition to that initial hundred billion dollars that we announced back in November, and maintain the other policy settings that were in place at that point. The assessment was that we need to remain committed to providing highly supportive monetary conditions and given that the outlook for inflation being sustainably within the target range and unemployment being sufficiently low and employment have been sufficiently strong was still some way off, the Board needed to continue to set monetary policy settings to support the economy to achieve those goals, to lower finance costs for borrowers, deliver a lower exchange rate than otherwise, support the supply of credit needed for the recovery and support household and business balance sheets. So the decision to extend that bond purchase program was ensuring a continuation of that monetary support.

Narrator: Finally, Guy talks to us about the outlook for some of the monetary policy measures introduced by the Bank since its first major announcement in March 2020. Guy, some of the programs such as the TFF will expire shortly. Will the stimulus remain past this time? What happens to monetary policy once some of these measures are gradually unwound?

19:56 Guy Debelle: So the Board decided not to extend the TFF when it closes at the end of June, but all of the money borrowed under the TFF, which is borrowed for three years, is going to continue to provide stimulus while ever it's out there being borrowed, and continuing to lower borrowing rates for borrowers by business and households. And similarly, the bonds purchased under the bond purchase program continue to provide stimulus until they mature, which is quite some time away, so while the TFF funds are out there and while the bonds have been purchased and before they mature, they're all continuing to provide stimulus as long as they are out there.

Narrator: There's been a lot of attention on the impact of monetary policy measures on rising house prices. Can you discuss this impact?

20:45 Guy Debelle: House price rises are part of the transmission of expansionary monetary policy to the economy. That lower interest rates are contributing to rises in house prices, but rising house prices help encourage home building and along with the government grants such as the home builder policy, they are boosting activity and employment.

So we recognise that rising house prices heighten concerns in part of the community and they can have distributional consequences, and that's certainly an issue that needs to be considered. And there are a number of tools that can be used to address the issue, but I don't think that monetary policy is one of those tools. Monetary policy is focused on supporting the economic recovery and achieving its goals in terms of employment and inflation. So it's important to remember that if we didn't have that supportive monetary policy, which was leading into those rising housing prices, then unemployment would be unambiguously higher and potentially materially higher than without the monetary stimulus and unemployment clearly has large and persistent distributional consequences.

Narrator: Could you take a step back and describe how monetary policy has supported the economic recovery so far?

12:54 Guy Debelle: So all of the policy measures that the Bank has taken since March 2020 have worked collectively to deliver lower borrowing costs for households, businesses and governments, and they're supporting the flow of credit and boosting cash flows for household and business borrowers. So while it's difficult to determine the individual contribution that each particular policy action is making, because they're all working collectively in the same direction, and they're also providing that support alongside the substantial support to the economy provided by the Commonwealth and state governments, but they have delivered lower borrowing costs for households, businesses and governments and they are supporting the flow of credit – that's very clear – and the outcome has been that the economy has turned out to be much better than expected. And the economy is actually exceeded all of the upside scenarios that we'd envisaged over the past year. Although while that's been true in terms of both economic growth and also in terms of employment and unemployment, it's not so much been the case in terms of wages and inflation which by and large have come in about where we expected they would.

10:58:30 Narrator: Thank you to our leadership team for sharing their views and explaining the implementation of monetary policy since the outbreak of COVID-19. Together monetary and fiscal policies are contributing to our recovery and demand and pick up in employment. Also thank you to Erin Walker and Henrietta Ashton for the production of this podcast.