DIFFERENT APPROACHES TO QT

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Introduction

Most, though not all, central banks have been unwinding QE, having switched from QE to QT last year. While there are common elements to QT, approaches have varied somewhat across central banks. I'll start with a high level discussion of some key aspects of the different approaches to QT. Then I'll step through the considerations that lay behind the approaches we've adopted at the RBA. My sense is that at least some of the variation in approaches across central banks reflects differences in our financial systems and some of it is likely to have an element of path dependency.

In the discussion that follows, I'd be interested to about your own motivations for the approaches you are following.

Approaches to QT

Table 1 (attached) summarises some of the different approaches to QT adopted across selected advanced economy central banks. There may be other elements, but there are at least 3 key aspects to QT.

First, there is the timing of QT. When to end QE and when to start QT? And is there a period in between with full reinvestment of maturing securities? What guidance on the timing was given – was it time based, conditional on the state of and outlook for the economy? Was the timing linked to other policy choices – on rates or other balance sheet policies? In other words, was there a concern about the sequencing of unwinding the different monetary policy measures? What role did market functioning play in the decisions on timing?

A second key dimension is the speed of QT once it starts. Is it a slow approach – at least for a time – with some reinvestment of securities as they mature? That's fairly common. Then there's the intermediate option of passive QT, whereby there is no reinvestment of maturing securities. In this case, QE unwinds with the maturity profile of the central bank's holdings; although duration of the portfolio, which arguably matters for financial conditions, declines day by day. Finally, there's the faster option of 'active QT' whereby the central bank sells securities ahead of maturity. It could sell back to the market or to the debt management office, and there's a choice also to be made about the sequencing of sales by tenor (e.g. the RBNZ is selling back bonds with the longest tenors rather than just selling across the curve).

A third dimension, which is related to the speed, is whether QT is set on autopilot or can be adjusted along the way, perhaps subject to occasional reviews? And if so, what would drive any adjustment – economic developments or concerns about market functioning, or perhaps both?

While there have been some important differences in the approaches to QT, it is worth highlighting that there have also been a number of similarities across central banks. Most notable is the fact that the primary means to tightening policy has been to focus

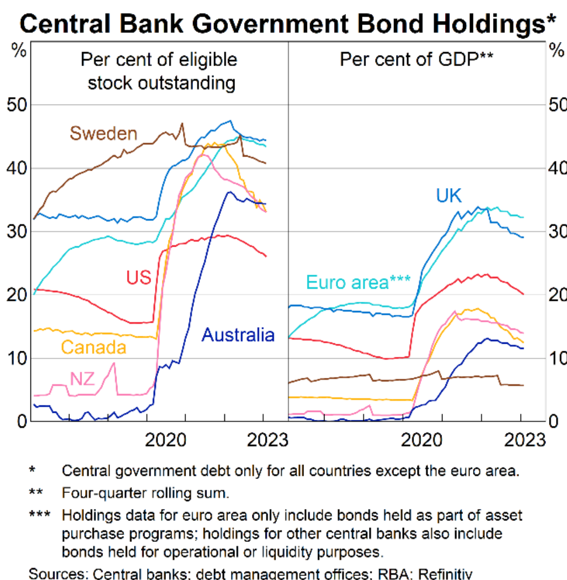
on increasing the policy rate. And despite the variations in the speed of QT, it is worth emphasising that QT is being pursued in a relatively gradual and predictable manner, at least when compared with the speed with which central banks pursued QE.

Background on the RBA's QE Program

We came to QE later than most and it wasn't a part of our initial package of measures adopted at the outset of the pandemic. At that time, we lowered the policy rate to close to the effective lower bound, adopted forward guidance, started a term funding facility for banks and introduced a yield target on the 3-year Australian government bond. We also purchased Australian Government Securities (AGS) and bonds issued by the Australian states and territories (semis) to address dysfunction in those critical markets. Those purchases were able to end by early May.

Our QE program was adopted later that year. In November, we committed to purchase $100 billion of government bonds over the subsequent 6 months.[1] We thought QE would be helpful at the margin to lower funding costs further out the curve and help offset the effect of the balance sheet expansions of other major central banks on the Australian dollar. But we did not expect it would provide as much support to the economy as the first package of measures. Bond market dysfunction had already been addressed. Moreover, it's the very short end of the curve that matters most for funding costs in Australia. Banks dominate our financial system, providing the vast bulk of housing credit and business debt. Banks' funding costs are driven largely by the bank bill swap (BBSW) rates at 3 and 6 month tenors and variable rate loans are the predominant forms of household and business credit.

The pace of the RBA's bond purchases was relatively rapid. The initial commitment saw our share of the stock of outstanding government bonds rise at a pace comparable to the increases of the RBNZ and the Bank of Canada, and much faster than in Europe.



1 For further details and a detailed analysis of this program see Review of the Bond Purchase Program and Kent (2022).

We extended the purchases for another 5 months after the first $100 billion at the same $5 billion per week pace, and then again, for what turned out to be a similar period but at a slightly lower pace of $4 billion per week.

In total, our QE purchases led our share of government bonds outstanding to rise to around 30 per cent, higher than the Fed, but a bit lower than other advanced economies. But given that public debt levels in Australia remained relatively low, the value of our holdings relative to GDP was quite a bit lower than most others.

The Issue of Timing and Sequencing

Further phases of QE were based three considerations:

- actions of other central banks, which would influence global financial conditions and the value of the Australia dollar;
- actual and expected progress towards our inflation and unemployment goals; and
- how the domestic bond market was functioning.

By February 2022, the Board announced an end to bond purchases. By then many other central banks – the Fed included – had completed their bond-buying programs, or would do so soon. Progress on the Board's employment and inflation goals had been faster than expected. Finally, our assessment was that although the bond market could have accommodated further bond purchases, additional strains would be likely to emerge if purchases continued for too long.

Each of the announcements on extensions and then the end of the program were widely anticipated. So they were not associated with material changes in yields.

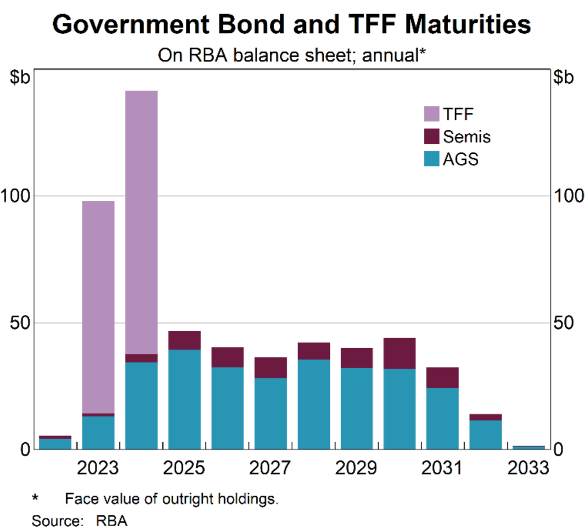
The conditions guiding decisions on ending QE were similar to those described in the forward guidance. However, forward guidance was much stricter. The first rate rise would require actual inflation to have risen into the target range on a sustainable basis, compared with sufficient progress towards our goals for QE to end. Hence, it was widely understood that QE would end prior to raising the policy rate. We thought it would have been odd to be tightening policy by raising interest rates while still easing policy by purchasing more bonds under a QE program. Among other things, we thought it would complicate our messages on the appropriate stance of monetary policy.

When the end of QE was announced in February 2022, the RBA also flagged that reinvestment of future bond maturities would be considered in 3 months. That the decision would depend on economic conditions and the outlook for inflation and unemployment. As it turned out, at that same meeting in May 2022, the Board decided it was time to begin raising the policy interest rate and to start the process of QT.

The Issue of Speed

The RBA decided to pursue passive QT, with the contribution of our bond holdings to easier financial conditions slowly diminishing over time.

Unlike some other central banks, we didn't feel the need to slow this process via partial reinvestment. Market participants had anticipated well the end of QE and the beginning of QT and our broad approach to it. Accordingly, we were not concerned about a sharp increase in bond yields and if anything there were indications that market functioning would improve as our bond holdings diminished as a share of outstanding bonds. Also, the maturities of our holdings were quite spaced out, and the value of our holdings due to mature in the first year or so were relatively modest. So in the early days of QT, partial reinvestment would have made little difference to financial conditions.



The RBA currently has no plans to sell bonds. The Board judged that raising the cash rate was the most effective way of reducing monetary stimulus in the economy. In particular, it is easier to adjust policy and influence financial conditions by calibrating and then communicating about one instrument rather than two in response to evolving conditions. And the very short end of the yield curve is the key to funding conditions in the Australian economy. Moreover, we didn't feel that there was a strong case to run down our balance sheet more rapidly given that the sizeable first leg of our term funding facility unwinds in 2023 and the remainder by June 2024. Also, duration on our bond portfolio is already down from 63 months to 52 months.

Second, sales of bonds by the Bank into the market could potentially complicate the task of issuance by the federal, state and territory authorities. That could have been managed to some extent by coming to a suitable arrangement to sell our bonds back to those authorities. However, this ran against our desire for the bond purchase program to stay at arm's length from the government. And even putting that aside, the need to sell additional bonds on behalf of the central bank could complicate the debt management office's task. This has arguably occurred in New Zealand, where the debt management office has had two under-subscribed auctions in recent months.

A final, though less important, consideration was that should a bond buying program be needed in the future to provide support to the economy we judged that it would be likely to be more effective if sales were avoided this time around. Setting a precedent of sales in the QT phase of the current program could reduce the effectiveness of a given value of any future bond purchase program. That's because the effect of those purchases on bond yields and the exchange rate would arguably be lessened if the market were to anticipate sales of holdings next time around.

I acknowledge though that it’s possible to create more capacity to purchase to address potential near term future bond market dysfunction by running down today’s holdings. But we didn’t feel the need at the time to create that extra capacity. In part this was due to the relatively short duration of our bond holdings, which had a weighted-average maturity of 5½ years when we started QT. Also, we judged that our holdings were not so large as to prevent us addressing any future dysfunction associated with a lack of bond buyers.

Conclusion

I’ve highlighted variation in the different approaches to QT across advanced economy central banks, while at the same time emphasising some of the core similarities. I’ve described our thinking on those issues, which has been coloured in part by some of the features of our financial system.

I’d be interested in the discussion to hear about the motivations for others approaches on timing, sequencing, and the speed of QT.

One lingering question on my mind is whether we collectively had an overly cautious approach to ending QE and starting QT out of concerns for avoiding a sharp rise in bond yields in a repeat of the taper tantrum episode. However, perhaps this time around a significant tightening in financial conditions would have been of less concern given the significant inflation pressures we all face. So was the concern more about market functioning? And if so was that warranted?