ANZ Research

NZ Insight: More QE is on the way

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for more details.

RBNZ to ramp up LSAP purchases in short term, then increase QE and widen its net in August

Summary

Wednesday's Monetary Policy Review has strongly reaffirmed our view that the RBNZ's Large-Scale Asset Purchase Programme (LSAP, or QE) will increase to $90bn in August, consistent with our downbeat economic forecasts.

However, given the forthright tone of the Monetary Policy Review, which flagged a willingness to ease policy further and to be ready to deploy additional unconventional monetary policy tools, we also now expect the following:

- A shift in the pace and composition of LSAP purchases, with an emphasis on containing the recent steepening of the NZGB curve. We expect that to occur before August – with the first step possibly as soon as today, given how much the NZGB curve has steepened this week alone.
- The RBNZ will increase the LSAP limit to $90bn in August. Beyond that, it will signal willingness to do even more through other tools or by expanding the LSAP programme further.
- Within the $90bn limit that we expect, we think NZGBs will remain the first choice for purchases, but other assets will need to be added in time, given the small size of the domestic bond market. We expect the RBNZ to clarify its criteria, process and preparedness to purchase other assets when the time comes in August. As things stand, foreign assets would be the next choice in our view, and we expect they will be needed, but the RBNZ may choose to keep its options open in the first instance.
- We expect a new indemnity to be agreed with the Minister of Finance that extends the timeframe of the existing indemnity and widens the range of assets the RBNZ will be allowed to purchase within its LSAP to include foreign assets and other highly rated domestic private sector bonds. We are not suggesting the RBNZ will necessarily start foreign asset purchases from August, but we expect foreign asset purchases to be formally added to the toolkit from August, as opposed to being an abstract concept.
- We can't rule out OCR cuts (potentially into negative territory) next year, and the RBNZ won't either. But there are reasons to be cautious and whether we see further cuts will depend on economic conditions next year.

The implications for the market from our view are nuanced. We expect the NZGB curve to ultimately go lower and flatter on the back of an eventual increase in the LSAP limit. However, this may be borne out sooner if the pace of weekly purchases is increased as we think is on the cards.

We see the short end remaining anchored, given that a negative OCR is not in play, at least for now.

The threat that the RBNZ might buy foreign assets will weigh on the NZD, which may also come under pressure as the weak outlook for global growth settles in. The wall of global liquidity will provide an offset that is hard to fight, but RBNZ dovishness and continued policy action will keep the exchange rate capped.

A dovish RBNZ reaffirms that more QE is coming

Wednesday's Monetary Policy Review was extremely dovish and consistent with our expectation that more stimulus will come in August.

For us, the following points were significant:

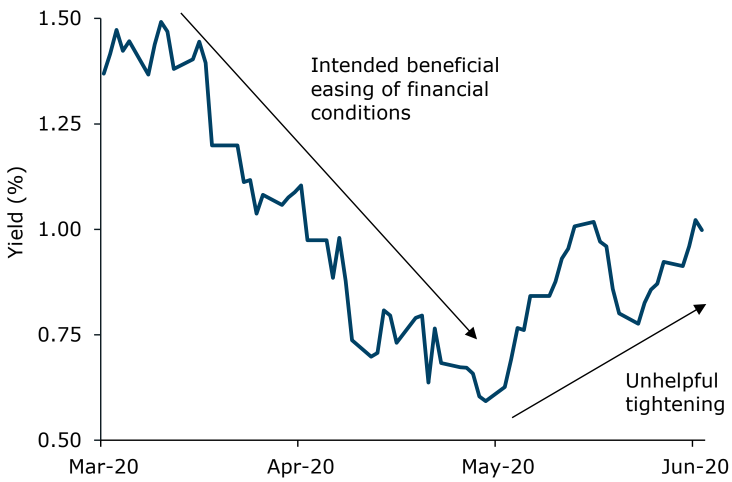
- Willingness to do more was front and centre, with the statement titled "Monetary Policy easing to continue" and the RBNZ saying it is "prepared to provide additional stimulus as necessary".
- The outlook is uncertain and "any expansion [in LSAP] would need to be driven by the economic outlook and assessment of the effectiveness of the programme". The RBNZ will have a clearer picture in August, with a new set of projections that is expected to be downbeat.
- The economic assessment was very cautious, only acknowledging the recent run of better data in passing: "these outcomes give cause for some confidence but significant economic challenges remain" with "risks to the downside". They also said: "possible negative outcomes remain severe and larger than any near-term upside surprises."
- The RBNZ noted that "the existing LSAP is programme is continuing to ease monetary conditions" but "it is not yet clear that monetary stimulus delivered to date is sufficient to meet its mandate."
- And the RBNZ aren't going to muck around if they need to do more: "A change in the size of the [LSAP] programme would … need to be of sufficient magnitude to make a meaningful difference." To us that speaks of a "big bang" coming in August, when the Bank has said that it will "outline the outlook for the LSAP programme and our readiness to deploy alternative monetary policy tools."

This dovish assessment makes it clear that the RBNZ are willing and able to do more to stimulate the economy. An increase in the LSAP limit will be considered in August, and in our view it will be judged to be needed, given our assessment of the outlook. The RBNZ appears to maintain a "least regrets" mind-set and is clearly worried about downside risks. Everything they said on Wednesday speaks to expanding the LSAP limit to $90bn in August – a quantum that we believe will make a material difference in markets.

Pace of purchases to increase

The RBNZ are comfortable with the effectiveness of the LSAP so far, but yield curves have steepened significantly recently (figure 1).

Figure 1. NZGB 2037 Spread to cash

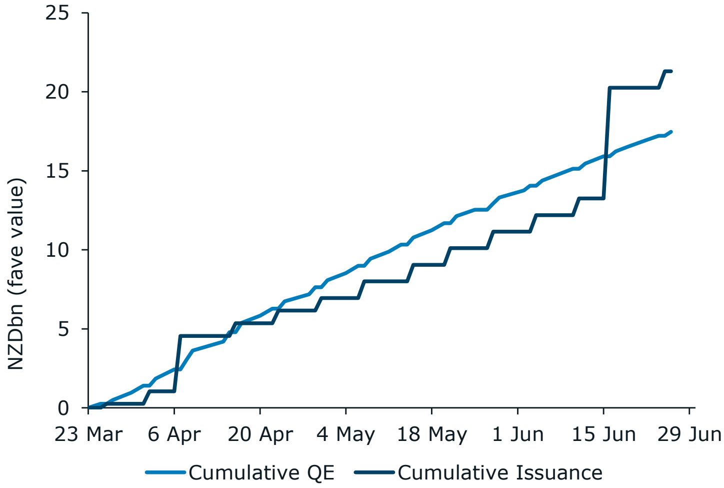


Source: Bloomberg, ANZ Research

In the Record of Meeting, it was noted that "financial markets are functioning well and that the NZ government bond yield curve has flattened". But developments in recent days threaten that assessment, and arguably call for a riposte. The recent increase in bond issuance has not been met by a commensurate increase in the pace of weekly RBNZ purchases; in our view this would assist in keeping the curve flat and work against the recent unhelpful tightening in yields (figure 2).

Given the RBNZ have made a commitment to "continue monetary easing through the existing LSAP programme", we think there is a clear case for the RBNZ to lean against the recent increase in yields to ensure that monetary conditions remain easy. We think the RBNZ is likely to lift the pace of LSAP purchases and/or tilt the focus of purchases toward the longer end of the curve, even as early as today.

Figure 2. LSAP NZGB purchases and issuance



Source: RBNZ, NZDM, ANZ Research

Tactically, there is an argument for the RBNZ to wait until the new NZGB May 2041 bond has been launched, so as to avoid the appearance of "fighting" the market. However, doing so runs the risk that the market gets away on them, which would be counter-productive and go against their monetary policy commitment. It's never ideal to be fighting a market, but at the end of the day, QE is a direct intervention, so they may as well make it count. Overall, it would be costlier to the economy to wait – the 2041 bond would be issued at a higher yield and monetary conditions would be tighter. Given what's at stake, August is too long to wait.

RBNZ to widen its net, expand its indemnity

The RBNZ is also working towards expanding its unconventional (or "alternative") monetary policy toolkit. The RBNZ said "staff are working towards ensuring a broader range of monetary policy tools would be deployable in coming months, including a term lending facility, reductions in the OCR, and foreign asset purchases, as well as reassessing the appropriate quantum of the current LSAP."

There's nothing vague about that, and we expect that August will bring clarity on what the RBNZ is considering and how likely those options are. Views in the RBNZ will be evolving – partly as the extent of the economic slowdown becomes clearer – so we can't predict exactly what will come out of that. But it's clear there are reasons to be wary about taking the OCR lower than its current level of 0.25%, and there are operational constraints in any case that mean that this option won't be on the table until next year.

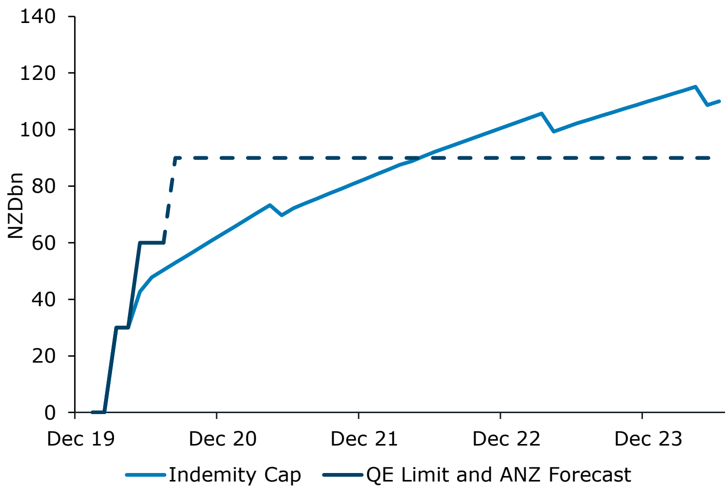
Broadly speaking, we therefore expect that the LSAP will remain the RBNZ's preferred approach to monetary stimulus for the time being, but that they will look to widen their scope and potential impact, while keeping their options open.

The timeframe

As well as increasing the programme to $90bn in August, we think it also makes sense for the RBNZ to extend the timeframe of LSAP purchases from 12 months ahead to 24 months ahead (or more). Extending the timeframe of the indemnity doesn't just remove ambiguities associated with purchases running into the cap – it would also further reinforce forward guidance that the RBNZ are in this for as long as it takes.

As it stands the RBNZ is indemnified by the Crown to purchase up to 50% of nominal NZGBs on issue, and 30% of linkers and LGFA bonds on issue. Our projections show that the indemnity cap reaches $72bn by June 2021 and $92bn by June 2022 if the focus is to remain on NZGBs and LGFAs (figure 3).

Figure 3. Indemnity cap



Source: RBNZ, Minister of Finance, ANZ estimates

Given that the economic recovery is going to be slow and the option to expand the LSAP needs to be on the table for a while, it makes sense to extend the timeframe of the indemnity. The current indemnity runs through 30 September 2021. But with the LSAP being expressed in terms of purchases over a 12-month period ahead, the indemnity will need to be extended before the September Monetary Policy Review anyway. That's because 12 months from the six weeks starting with the September 23 Monetary Policy Review and ending with the 11 November MPS takes us past the expiry of the existing indemnity.

While the RBNZ are negotiating an extension of the indemnity, it makes sense to negotiate a more comprehensive agreement that has a longer expiry date (say 31 December 2022).

Types of assets

But not only that. While they're at it, why not take the opportunity to include more assets? Currently the indemnity explicitly excludes foreign assets, interest rates swaps and private sector assets.

We expect that a new indemnity will be agreed with the Minister of Finance that includes other assets that can potentially be purchased under the RBNZ's monetary policy mandate, including foreign and other domestic private sector assets. Interest rate swaps could be a policy option in the future, but it makes more sense to be active in cash markets such as the NZGB market, with purchases lowering and flattening the curve, increasing liquidity and injecting cash into the banking system. This tends to have wider flow-on effects, including to swap markets. Interest rate swap interventions would not have the same spill-over or liquidity benefits.

The RBNZ would not need to purchase these other assets immediately, with plenty of NZGBs still to soak up within existing limits. But a widening of the programme will be needed in time, given the small size of the NZGB market and the intention of the RBNZ to not cause market distortions. We estimate that the RBNZ's indemnity for NZGBs will reach $90bn by May 2022.

We flagged this possibility when we forecast the increase in the LSAP to $90bn back in May. We said: "Should $90bn exceed the existing caps for which they are indemnified, it would leave open the option of purchasing short-term US Treasury bonds with the remainder, thereby placing downward pressure on the NZD."

Announcing in August that the RBNZ is indemnified to make such purchases, has a framework for it and is willing to do so would send a strong signal and would thereby have an immediate – and desirable – market impact, even if such purchases are unlikely to take place straightaway. The exchange rate would be immediately impacted if foreign assets are part of the mix as we expect. Indeed, we see foreign assets (likely short-term US Treasury bonds) as being the RBNZ's first choice outside its current NZGB and LGFA portfolio should LSAP purchases be broadened.

The RBNZ is likely to look to include other highly rated private sector or government agency bonds, and term lending as part of its toolkit too, to keep its options open. But we don't see these making up a large portion of the response at this stage. The RBNZ has plenty of scope to expand its balance sheet without taking on additional credit risk, and foreign purchases would give the best bang for buck outside of NZGBs, especially with the exchange rate currently elevated.

The RBNZ has made it clear that they will tailor their policy mix to the prevailing conditions. Currently, conditions are pointing to purchases of short-dated US Treasuries as being a relatively low risk and potentially very effective option. This could change if global risk aversion were to spike materially, in which case market risk to the taxpayer would become a more pertinent concern – and the NZD might fall out of bed all on its own in any case. See our paper from a year ago, Prospects for Unconventional Monetary Policy in New Zealand, for more detail on the risks and benefits of foreign asset purchases versus other unconventional alternatives.

Act sooner rather than later

The recovery ahead is going to be slow, and it makes sense strategically for the RBNZ to keep its options as open as possible, go early and go hard. The market needs to be in no doubt that the RBNZ has "got this" so that maximum stimulus can be delivered. Recent upward pressure on yields suggests that the RBNZ's needs to up the ante on its weekly purchases, and soon.

We see QE being expanded in August and the net for those purchases needs to be cast wider. A lower (and even negative OCR) remains a non-trivial possibility next year. But there are reasons to be cautious about taking interest rates into negative territory. QE can have a meaningful impact if the RBNZ goes hard and fast when the economy needs it. Not doing enough soon enough may result in needing to do more purchases in the long run, not less, and could increase the risk that a negative OCR is required. The August MPS looks set to up the ante significantly.

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