RBNZ MPS Preview

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RBNZ to increase QE and weigh up other tools at August MPS

Summary

The case for further significant monetary easing is clear with inflation set to plummet and unemployment heading towards double-digits. Expanding the Large-Scale Asset (LSAP) Programme (QE) remains the first choice to deploy more stimulus at the August MPS, but we also expect much more clarity on the "menu" of policy options, detailing the criteria for when each tool might be considered, and stressing that choices will depend on circumstances.

None of the policy options are straightforward, but the RBNZ will want to keep its options open, and a negative OCR and foreign asset purchases will remain firmly on the table. We don't currently expect they will deploy either, but they are non-trivial possibilities, and there is a risk that the RBNZ conveys more openness to their use than the market currently expects.

The seemingly easy choice to increase QE next week is also not straightforward. Weighing up a number of considerations, we expect QE to increase to $90bn, and that the length of the programme will be extended to 18 months. This would make a meaningful difference, keep a sizeable free-float of bonds in the market, and push the QE "cliff" into the future, though not eliminate it.

Our forecast includes an expectation that the RBNZ sticks with the approach of announcing a set programme size and time-frame for QE. However, we would see significant benefits to the RBNZ shifting to announcing a run rate or adopting a tactical approach to buying. While it's not our base case that the implementation strategy will change, now could be a good time to change tack.

Market implications

The implications for markets are potentially significant. At a minimum we expect the overall tone of the MPS to be very dovish, adding weight to our view that the NZGB curve will continue to move gradually lower and flatter. While we expect the LSAP to be increased to $90bn, sending a very strong signal, we wouldn't automatically regard anything less as underwhelming. If, for example, the RBNZ lifted QE to $75bn, moved to a constant run rate, and signalled that negative rates are their preferred next step, we would expect interest rates to rally.

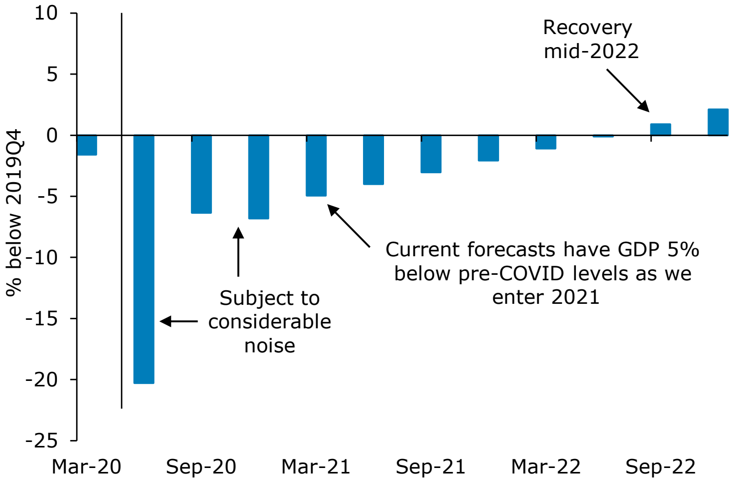
Increasing the QE programme by a set amount and keeping purchases fairly constant or moving to an announced run-rate approach will see system cash balances rise more consistently, and should, over time, drive BKBM lower, especially if accompanied by a willingness to take the OCR into negative territory. Conversely, moving to a tactical approach brings less certainty to the cash market, but would likely limit scope for the curve to steepen.

For FX, the focus isn't just on policy delivered next week – arguably NZD direction depends more on the menu of unconventional policy options that are left on the table. We expect the RBNZ to keep its options open and we'd be very surprised if they backed off signalling that they are open to negative rates. And the market seems to have discounted the prospect of foreign asset purchases, risking a negative NZD reaction if it remains on the table as we expect. Against the backdrop of broad-based USD weakness, that is likely to mean that NZD/USD holds up better than crosses like NZD/EUR and NZD/GBP.

Little reason to change dovish “least regrets” policy approach

Despite the vigour of the bounce out of lockdown (which the RBNZ will acknowledge), a very challenging period lies ahead. The COVID-19 crisis continues to shape the economic outlook, and colour it with an enormous amount of uncertainty. We expect that we will enter 2021 with GDP about 5% below pre-crisis levels (figure 1), inflation below the RBNZ’s 1-3% target band, and unemployment hovering near 10%, with a slow recovery in prospect. And there are significant downside risks; a renewed period of contraction is possible.

Figure 1. GDP % deviation from pre-COVID levels



Source: Statistics NZ, ANZ Research

An aggressive approach to monetary policy makes sense in this context. Accordingly, the RBNZ has made dovish statements at both the May MPS and June MPR, expressing a willingness to do more and a desire to make it count, saying any change in its Large-Scale Asset Purchase (LSAP) Programme (QE) would “need to be of sufficient magnitude to make a meaningful difference”.

Since the June MPR, little has changed to shift this assessment. Activity indicators have continued their rebound and commodity prices have been resilient. But the recession caused by the closed border and the global growth hit is only just getting started, with impacts expected to become more evident later this year. The exchange rate has also appreciated further and is a potent headwind, weighing particularly on inflation. And the global COVID-19 pandemic has intensified, with activity restrictions being re-imposed in many countries, including Australia. This underscores downside risks.

Even in a best-case scenario, inflation and unemployment look set to be away from the RBNZ’s targets for an extended period, necessitating very expansionary policy to see these return within an acceptable timeframe. The path of least regrets is to err towards doing more, given downside risks and the possibility that inflation expectations settle too low. The chances of doing too much and causing a growth and inflation overshoot look remote in the near term, and worth the risk, given the ability to reverse course if required.

Given all of this, we expect that dovish sentiment will colour the forecasts, policy assessment and communication at the August MPS.

Expect more colour on the “menu” of alternative policy options

The August MPS (Wednesday 12 August) is going to be action packed. In June, the RBNZ Monetary Policy Committed (MPC) promised to “outline the outlook for the LSAP programme and our readiness to deploy alternative monetary policy tools in our August Statement”, adding that they remain “committed to meeting our inflation and employment mandate”.

We expect that an expansion of the current QE programme will remain the RBNZ's first choice for providing stimulus at the August MPS, given that it is effective with the least costs. But the RBNZ's sentiment suggests they are willing to do much more beyond QE if required.

Beyond our expectation that the current QE programme will expand to $90bn (more on that later), we expect to see more analysis and rationale for the RBNZ's thinking on alternative tools, including more clarity on what the RBNZ is prepared to do, when, and in what order. However, they will stop short of an inflexible plan, as the choice of tools will always be situation dependent.

Given the sombre outlook and high degree of uncertainty, it makes sense for the RBNZ to adopt a flexible approach. But none of the policy decisions are easy - all unconventional options have disadvantages, and yet they are better than nothing (Table 1). Among other things, this speaks to the importance of maximising the impact of the current QE programme right here and now.

Table 1. Alternative monetary policy options – pick your poison

Policy tool	Pros	Cons
Increasing current QE programme – more of the current approach, potentially with a lengthened timeframe and an expanded indemnity	Lowers yields, flattens curves and provides liquidity. Assists fiscal policy, given NZGB focus. Involves purchases of low-risk assets. Widely used approach overseas.	Domestic market is small. At some point the RBNZ owns so many Government bonds the market becomes distorted.
Yield curve control	Clear forward guidance. Potent impact on yields at the target point (3-year in Australia, 10-year in Japan). Australia has implemented this with fewer purchases than seen in New Zealand.	Rigid, doesn't allow markets to respond to news dynamically. Risk that topside in yields is defended (providing liquidity) just as it should be let go (less is needed). Harder to affect the slope of the curve. Weaker liquidity channel. Less common. May be difficult or costly to exit.
Broadening QE to include foreign assets	Could lower the exchange rate, with potent economic impacts if achieved. Doesn't distort local market. Large quantities available to purchase.	Risky, in terms of getting right and market value fluctuations (asset values and currency changes). Fighting the market and perception of currency manipulation, which could threaten trade deals.
Broadening QE to include higher-risk assets	Lowers borrowing costs for companies and more broadly. Flattens credit curve and provides liquidity.	Picking winners. RBNZ taking on credit risk. Disintermediation by turning RBNZ into a bank. Potential mispricing of risk. Largely limited to mortgage-backed securities overseas, but that's not a key mortgage funding channel in NZ. There's not much to buy, so impact likely limited.
Interest rate swaps	Flattens curve, which can flow through to term structure of corporate lending and mortgage rates. No principal outlay.	Doesn't provide liquidity or lower yields in aggregate, only affects shape of the curve. Doesn't lower borrowing costs to the Government or more broadly.
Expand term lending facility	Provides liquidity to banks in times of stress.	Useful in times of stress, but not so good at assisting the recovery; RBNZ might prefer a lower OCR before implementing. Limited uptake to date (possibly because SCL is rising or because some expect a negative OCR in time). Only open to banks in its current form, but expanding to other borrowers would be risky.
Lower and/or negative OCR	Would lower the exchange rate and borrowing costs across the curve.	Systems issues to resolve. Public backlash from savers. Squeeze on bank margins could have unintended consequences. Costly to the banking system, especially given the expansion of SCL. Likely to impair the banking system and credit supply. Could impair financial stability.
Take no further action after taking QE to 50% of bonds on issue		Persistently high unemployment and weak inflation. Potentially lose credibility when it comes to inflation and employment targets being persistently missed.

Opening door to further tools could cause market reaction

We expect a NZGB-focussed QE programme to remain at the heart of the RBNZ's policy response, but the option of expanding the programme to include other assets (including foreign assets) will remain firmly on the table, just in case, and to keep the threat of extreme NZD strength somewhat at bay.

Without doubt, there are hurdles standing in the way of foreign asset purchases, and it is currently not our expectation that they will actually occur. These hurdles include perceptions of currency manipulation, a possible trade backlash, the potential for significant market value losses, and its unprecedented nature.

There's also the significant fact that it has become increasingly difficult to argue that the NZD is overvalued even if it is a headwind. A surge in global liquidity is driving USD weakness, our commodity prices remain resilient, the recent bounce in activity puts us well ahead of the pack, and our elimination of COVID-19 has put us in an enviable position.

But again, there's nothing to gain by ruling foreign asset purchases out. We see the RBNZ signalling that they are prepared to do it if push comes to shove, laying out how and under what circumstances they might be considered. On that score, we see a risk that the RBNZ is more open to the prospect than the market expects, even if they do not currently intend to pull the trigger.

Likewise, we expect the RBNZ to keep the door to a negative OCR firmly open – perhaps more so than markets are currently expecting (OIS markets are currently pricing 25bps of cuts by the middle of next year). We see a risk that the economic outlook deteriorates anew late this year. If that occurs and the RBNZ looks to expand stimulus next year, then a negative OCR could be game on. But more generally, it makes sense for the RBNZ to continue to keep this option on the table, even if it doesn't intend to use it, since this will generate a response in markets, before/without having to actually execute.

Expanding the current QE programme in August

We expect QE will lift to $90bn over 18 months

We expect the RBNZ to expand the size of the LSAP in August, but the decision is complicated and a number of considerations must be weighed up. See Appendix 1 for the range of options and considerations informing our view.

As the MPC noted in June, any expansion will need to be "meaningful" in order to be worthwhile. But because of the small size of the local bond market and the way the indemnity provided by the Minister of Finance is currently written (the cap on RBNZ purchases is expressed as a percentage of outstanding bonds), there are constraints on the size of the programme. Any significant increase in the size of the LSAP has implications for the free-float of bonds that are traded in the market, which in turn has implications for market functioning. And any material extension to the time-frame of the LSAP (purchases are currently scheduled over a 12-month period) would also go past the expiry date of the current indemnity, so the indemnity needs to be revised.

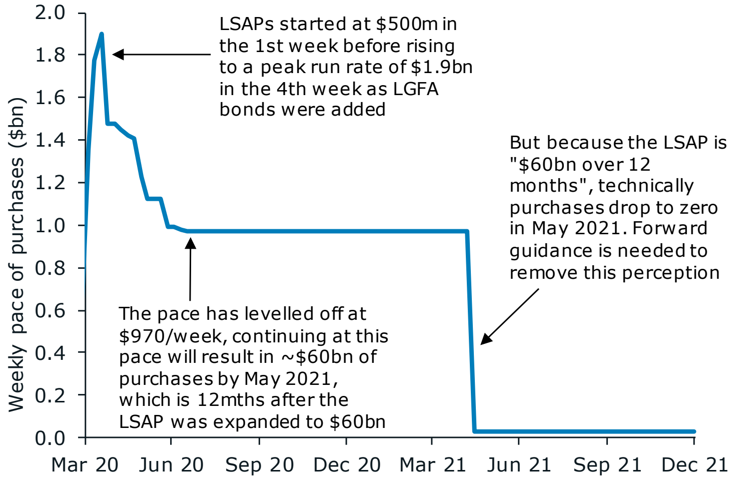
Our expectation is that the current QE programme will expand by $30bn to $90bn, over 18 months rather than 12. This would be "meaningful" in terms of its impact, and would take the programme to around 30% of GDP. That's a big increase given where we have come from (zero) but it's less than where the Federal Reserve sits (its QE holdings are currently around 32% of GDP).

Extending timing of the programme would help reassure markets

Shifting the timing of the programme out to 18 months will help with the prospect of a QE ‘cliff’, which is becoming a concern for markets (figure 2). With purchases due to end in 12 months, the question is: what happens next?

Markets need some clarity that QE will be able to continue if New Zealand is not to experience its own version of the Federal Reserve’s 2013 ‘taper tantrum’. For that reason, we think it is important for the QE programme to be extended from 12 to 18 months. This will not take away the cliff entirely, but it will defer the issue further into the future, by which time the outlook for bond issuance and the economy will be clearer, and the programme can be extended again if required.

Figure 2. RBNZ weekly LSAP purchases



Source: RBNZ, ANZ Research

The RBNZ could also shift its implementation strategy

Changing the implementation strategy of the programme is also something the RBNZ may consider. Shifting to a weekly or monthly run-rate target (like the Fed did after the GFC), or taking a tactical approach (varying the pace of purchases, like the Fed do now) are possible options for helping to reduce concerns of the QE cliff, even if the market knows that the LSAP is ultimately bounded by the small size of the domestic bond market. A tactical approach also has some additional benefits.

The two options are:

1. **Move to a weekly or monthly run-rate target:** As the name implies, this would involve specifying a particular run rate for LSAP purchases. This could be specified within a programme of a particular size, or as part of an open-ended programme. Under this approach it would be the MPC rather than RBNZ staff that would set the pace of purchases, and this would be the main policy signal. The pace could be altered at each MPS or MPR and could be augmented by a beefed-up Bond Market Liquidity Support (BMLS) programme (which would come into play if markets became dysfunctional again).

2. **Adopting a tactical approach:** This approach would see the RBNZ enter the market as needed but remain absent when they were not needed, responding dynamically to market conditions and where they would like to see the yield curve. This approach could be part of a programme of a specified size, or be open-ended. The idea would be to lean into any steepening of the curve or generalised rise in interest rates that was not consistent with economic fundamentals (ie. a “portfolio shift”), while saving ammo. This approach is less predictable and transparent, but it

would send a very strong signal to the market, would likely reduce interest rate volatility, and could save money and preserve fire-power for when it is more likely to be needed. It doesn't go as far as Yield Curve Control does (as practiced in Australia) but it's closer, in that the RBNZ would loosely target market extremes. This approach doesn't guarantee an ongoing increase in liquidity, as a volume or run rate approach does.

See Appendix 2 for more detail about these options.

We do not expect that the RBNZ will change its current approach, as it has expressed satisfaction with how it is working. However, we would see benefits to doing so, and think the possibility should not be ruled out.

A larger and more flexible indemnity would also be helpful

Regardless of the approach to purchases, a larger or more flexible indemnity cap would also be helpful to ensure the programme can deliver maximum stimulus and deal with market perceptions that the QE programme may hit its limits. In our view, being willing to buy a greater share of bonds comes with less costs and risks than some of the other unconventional policy options on the table.

One major issue with the indemnity cap as it stands is that it's defined as a percentage of the value of outstanding bonds on issue, which is uncertain. If bond issuance is expected to be lower, then a percentage cap is more likely to become binding, and sooner.

We can see a case to increase the size of the indemnity cap next week to up to 60%, or to make it more vague ("around 50%") to add flexibility. Alternatively, the indemnity could be changed to being in terms of keeping the free-float of NZGBs that are not held by the RBNZ at, say, no less than the 2019 average (around $59bn for nominal NZGBs and $18bn for linkers). This would allow limit market distortions in a way that can adjust more easily to the size of the bond issuance programme.

The path ahead will continue to break new ground

Adding everything together, there is much for the RBNZ to consider ahead of the August MPS, creating a great deal of uncertainty about exactly where the RBNZ will land. It is fair to say that it will be a big event with the potential for some market volatility as the impact of immediate sound-bites gives way to the revealed detail.

We are comfortable with our expectation that QE will increase to $90bn over 18 months, but there are a number of possible outcomes for the programme, and a number of key considerations. We are particularly wary that changes to the RBNZ's implementation strategy or the size and specification of the indemnity cap are possible.

Looking further ahead, risks are skewed towards more stimulus in time, and so there will be enormous interest as to what the next steps are beyond the QE programme. The RBNZ will have an open mind about what happens next, and so do we. We think all options will remain on the table, including a negative OCR and foreign asset purchases.

The current crisis has been unprecedented, and so too has the policy response. As conditions evolve, an even more unprecedented response should not be ruled out if downside risks materialise.

Appendix 1: Weighing up the size and duration of the QE programme

Table 2 outlines possible alternatives for the size and duration of the programme.

An increase to $75bn would roughly preserve the current run rate ($970m/week), and would keep options open for the future, when the bond market will be bigger (it's growing by about $1bn a week as fiscal policy kicks in) and if the economy faces stronger headwinds later. However, it's arguably not a "meaningful increase" and threatens to undo progress to date in terms of dampening yields.

On the other hand, increasing the programme by $90bn over 12 months significantly reduces the free-float of nominal bonds (currently around $63bn after averaging $59bn in 2019), potentially leading to market distortions, and would threaten the indemnity cap. This argues for an extension of the programme to 18 months, a larger indemnity, and/or a change in implementation approach (see Appendix 2).

In our view, expanding to $90 but extending the time-frame to 18 months strikes the best balance.

Table 2. Possible options for expanding current QE programme at August MPS

Size of LSAP from August	Programme over 12 months (current timeframe)	Purchases over 18 months
$60bn	**Pros** • Within existing LSAP capacity (~**$35bn** of capacity still to be used). • Doesn't threaten indemnity cap (we project the cap to be around **$76bn** by August 2021). • Free-float# of NZGBs keeps growing, adding to market depth. **Cons** • It isn't a further easing and would be perceived as backing away from dovishness. • Much slower run rate* of purchases (~**$700m** per week), when tapering goes against the view that more stimulus is needed. • Market would need to absorb a significant **$400m** of NZGBs per week this fiscal year^.	**Pros** • Within existing LSAP capacity. • Doesn't threaten indemnity cap. But 18 months takes us past September 2021, which is when the indemnity expires. • Free float# of NZGBs keeps growing. **Cons** • It isn't a further easing and would be perceived as backing away from dovishness. • Vastly slower run rate* of purchases than currently (to around **$460m** per week). • Market would need to absorb a whopping **$640m** of NZGBs per week this fiscal year^.
$75bn	**Pros** • Stable run rate* (**$1000m** per week), effectively a 'steady as she goes' approach, but only a modest increase in overall stimulus. • Doesn't threaten indemnity cap. • Market would only need to absorb **$100m** of NZGBs per week this fiscal year^. • Free float# of nominal NZGBs grows initially but falls to around **$59bn** in around 12 months (the 2019 average). **Cons** • Marginal easing; not enough to make a meaningful difference. • Is less than the market is looking for, would be perceived as backing away from dovishness, and risks undoing progress.	**Pros** • Doesn't threaten indemnity cap. But 18 months takes us past September 2021, which is when the indemnity expires. • Free float# of NZGBs keeps growing. **Cons** • Extremely marginal easing, with the overall programme increasing by just $15bn and pace of purchases dropping to ~**$660m** per week. • Is a lot less than the market is looking for, would be perceived as backing away from dovishness, and risks undoing progress. • Market would need to absorb a significant **$440m** of NZGBs per week this fiscal year^.
$90bn	**Pros** • Meaningful further easing (adds **$30bn** to the LSAP), building on previous dovish stance. **Cons** • Too big a lift in the run rate? Implies ~**$1300m** per week. • QE would take out more NZGBs than NZDM is issuing, shrinking the market. Net reduction of ~**$200m** of bonds per week^. • Free float# of nominal NZGBs falls to **$46b** in 18 months, significantly below the 2019 average of $59bn. • Threatens indemnity cap as currently defined fairly soon (around May 2021).	**Pros** • Meaningful further easing. • Broadly stable run rate* of purchases (slight drop to ~**$880m** per week). • Market would need to absorb **$220m** of NZGBs per week this fiscal year^. • Happy middle ground? We think so. **Cons** • Free float# of nominal NZGBs falls to **$59bn** in 18 months – the same as the 2019 average. • 18 months takes us past September 2021, so a new indemnity would be required.

Larger than $90bn	• The possibilities are endless and we can't canvass them all. • We estimate that **a $97bn** programme would be required if the RBNZ wants to continue buying at the current pace of **$970m** per week over 18 months from August, assuming the usual 2 week pause over Christmas/New Year. It would likely be expressed as $**95bn** or **$100bn**. • Anything more than $90bn is a meaningful increase and we would expect the curve to flatten materially. • A **$95-100bn** programme would hit the indemnity cap as it is currently defined in around 1 year. • A larger programme would reduce the free-float[#] of nominal NZGBs quickly if issuance slowed. Conversely, if issuance picked up, the free-float may increase. NZDM provides issuance projections but they could change.	

* Run-rate calculations assume a 2-week pause over Christmas/New Year when NZGB issuance also tends to be paused.

"Free float" refers to the value of bonds in the market excluding RBNZ holdings.

^ Assuming NZDM issues around $1bn of bonds per week for the remainder of the fiscal year ($60bn to be issued, with $8bn completed and 46 weeks left to issue the remaining $52bn).

Appendix 2: Weighing up implementation strategies

Table 3 (next page) lays out some of the options and issues that the MPC will be thinking about with regards to implementation of the QE programme. We expect that the current approach (announcing a set programme size) will be maintained, but extended to 18 months.

There would be benefits to moving to announcing a constant run-rate or tactical approach, though these may be implicitly time bound and therefore still subject to the QE cliff. The tactical approach could also ensure the RBNZ is in the market when it is most needed, save both firepower and money, and send a strong signal to markets. For this reason, we favour the tactical approach, even if we do not expect that the RBNZ will adopt it.

Table 3. Considerations and impediments to implementation

Considerations	Current approach – programme over 12mths (or extended to) 18mths	Alternatively, move to a constant run rate	Alternatively, adopt a tactical approach
The weekly pace of purchases The issue: The market has come to expect a uniform pace of purchases, defined as the size of the programme less purchases to date, divided by the amount of weeks to the end of the time period. Some are fearful that this is too formulaic and results in the RBNZ being in the market when it might not need to be, yet not hitting the market in decent size when it does need to (ie. when we see a dramatic steepening in the curve).	• A smaller programme implies a slower pace of purchases; conversely a larger programme implies a faster pace. • The market assumes that the pace is constant and formulaic (and that's what we have seen). • $75bn is the "neutral" size of the LSAP if purchases are to be maintained at around the current pace and the formulaic process remains in place.	• Purchases would be held constant, as announced. • The constant run-rate pace is forward looking and doesn't depend on purchases to date. • This doesn't help address the fact that the RBNZ might be in the market when it does not need to be, or not responding enough when it does need to. • Removes perception of a QE cliff (see below).	• The RBNZ would be in the market when the curve steepens. • The weekly pace of purchases would no longer be predictable, but would respond dynamically to market conditions – sending a strong signal of where yields should be. • This is arguably a halfway house between YCC and the current volume-based approach. • A tactical approach might targets yield levels loosely rather than specifically; is not hostage to a schedule.
:liff The issue: LSAP purchases as they stand are currently flagged over a 12-month time horizon. But what happens next?	• A fixed timeframe gives rise to the perception of a QE cliff. • The perception isn't helped by the fact that the market is small and the LSAP seems to be pushing up against the indemnity and threatening the free float of bonds.	• Both these approaches would help reduce the perception of a QE cliff. • They would be more credible if the LSAP was unlimited and/or open-ended and the indemnity was larger/more flexible and didn't have an expiry date.	
The free-float of NZGBs The issue: The NZ bond market was so small (~20% of GDP when COVID-19 hit) that it limits QE. A large extension of the LSAP isn't possible without taking the free float of nominal NZGBs below the 2019 average of $59bn (or NZGB linkers below the 2019 average of $18bn).	• An expansion in the LSAP to $75bn over 12 months or $90bn over 18 months would not reduce the free-float of nominal NZGBs below the 2019 average of $59bn. • But a $90bn programme over 12 months would reduce the free-float of nominal NZGBs materially (linkers and LGFA would not come under threat).	• A constant run rate doesn't really solve the problem of reducing the free float. • A faster pace would see the free float fall; a slower pace wouldn't. • Maintaining the current run rate would see the free-float of nominal bonds fall below the 2019 average of $59bn.	• A tactical approach to QE could simply bear the free-float in mind. • Purchases would depend on market conditions and could be increased if issuance increases (there would be more bonds to buy) and vice versa.
Indemnity cap The issue: The current agreement indemnifies the LSAP for losses on purchases for up to 50% of nominals and 30% of NZGB IIBs and LGFA bonds. The agreement expires on 30 September 2021.	• The indemnity wouldn't need to be re-negotiated if the LSAP remains at $60bn or is increased to $75bn over 12mths. • It would need to be renegotiated if the LSAP is to be expanded significantly or if the term is extended past September 2021.	• The indemnity would need to be more open-ended if the market was to believe a constant run rate or tactical approach was workable. • However, the Memorandum of Understanding with the Minister of Finance requires a time-limited indemnity, so it may be difficult to signal the programme is indefinite. • Indemnity could be written in terms of a minimum free float. • The Sep 2021 expiry date is already inconsistent with the directive to hold bonds purchased to maturity, so a new indemnity is required.	

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