ANZ Research

RBNZ MPS Preview

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QE hui

- We expect the RBNZ to leave the OCR unchanged at 0.25% next Wednesday.
- We expect an approximate doubling of its quantitative easing (QE) programme from $33bn of purchases to $60bn, if not more, with additional purchases oriented towards NZGBs. To have more impact, the RBNZ may also choose to give more explicit guidance on where they would like to see the yield curve.
- We are unconvinced that lower or negative rates will be on the cards any time soon, though the RBNZ may not choose to continue to rule it out. We would not be surprised to see a tweak to their forward guidance to keep their options open. The market will be keenly watching this.
- The RBNZ is likely pleased with the success of its efforts to ease monetary conditions and facilitate the fiscal expansion so far. But there is more trouble ahead for the economy and the RBNZ can – and should – do more. We think QE will remain the tool of choice to up the ante, and in our view it is the right one.

Key points

Much has happened since the RBNZ cut the OCR 75bps to 0.25% on 16 March. At that time, they committed to leaving the OCR unchanged at 0.25% for "at least 12 months", and launched quantitative easing (QE) shortly afterward. Next Wednesday, the RBNZ will release its Monetary Policy Statement. We expect the RBNZ to leave the OCR unchanged at 0.25%. But economic conditions have deteriorated and fiscal policy has stepped up, and accordingly we think the RBNZ will signal an approximate doubling of the QE programme from $33bn to $60bn, if not more.

We expect that additional purchases will be oriented towards Government bonds (NZGBs). It is possible that more LGFA bonds could be purchased or inflation-linked bonds added to the programme, but this would not be substantial relative to any increase in NZGBs. So far, the RBNZ has focused on purchasing longer-end bonds, and that has been very effective at flattening the yield curve. But more stimulus is required, with a difficult outlook ahead for the economy, and the RBNZ will need to ramp up its purchases to ease financial conditions further.

Although QE has been effective, bond markets have still been volatile and there could be a case for the RBNZ to adjust its forward guidance to help yields settle at lower levels. To do this, they could choose to give more explicit guidance on where they would like to see the yield curve.

We do not expect the OCR to be cut closer to zero next week. When the OCR was cut to 0.25% in March, the RBNZ noted that it was operational constraints that were behind the forward guidance that they intended to keep the OCR at 0.25% (not lower), rather than a strong judgement on where the effective lower bound for the OCR sits: "Staff… advised that an OCR of 0.25 percent was currently the lower limit, given the operational readiness of the financial system for very low or negative interest rates".

We are assuming that advice has not changed. However, a tweak in the forward guidance could be used to signal openness to a future cut to close to or even below zero once the financial system is operationally ready. This possibility would help maintain downward pressure on interest rates at the short end, even if the timing of when it might be feasible is unknown.

The hurdles for negative rates

Technical constraints aside, a few other ducks would need to line up to make negative rates likely, in our view.

- The ground would have to be laid in terms of socialising the idea. Negative rates are pretty rough on savers, confusing for the public, and face specific technical issues in a New Zealand context. We have not yet seen the promised research paper on the topic, but that would be a good start.
- Negative rates here would become more likely in our view if we saw them in countries such as the US and Australia who have so far eschewed them.
- Quantitative easing would in some sense have to be seen to be tapped out, or at least inadequate. This could be either because the economic situation takes a severe turn for the worse, or QE starts to hit its limits or lose its efficacy at keeping long yields down, with the economy still in dire straits. Even then, there would be other options that we think would be effective and considerably less risky than negative rates, such as yield curve guidance.
- Global credit markets would need to be in decent shape. They remain highly vulnerable to a change in sentiment and abrupt reassessment and repricing of risk. New Zealand banks are an important conduit for the required funding for our net debtor nation. Negative interest rates severely damage bank profitability and therefore might mean that the cost of raising funds in a severely risk-off environment is higher than otherwise.

Timing is also key. Negative rates are, in one sense, simply a more extreme version of 'low' – they would further reduce financing costs for businesses and put downward pressure on the exchange rate. But they also have a punitive aspect; they are the 'big stick' to encourage lending by effectively 'taxing' banks' unused cash parked at the central bank. In that context, the idea is that they can stimulate credit (and thereby activity) in an environment where firms are keen to borrow to expand and employ, but banks are 'over-cautious'. We are still far off the point where firms are seeking credit for expansion, but demand for working capital is currently strong as banks help customers through the lockdown revenue hit.

Regular readers will know we are not enamoured of the concept of negative interest rates, particularly for long periods. Negative rates inflate asset prices and encourage excessive risk taking and leverage, not all of it for economically productive purposes. And although they are aimed at stimulating credit growth, they severely impact the health of the banking sector and therefore may impair the free flow of credit over the longer run.

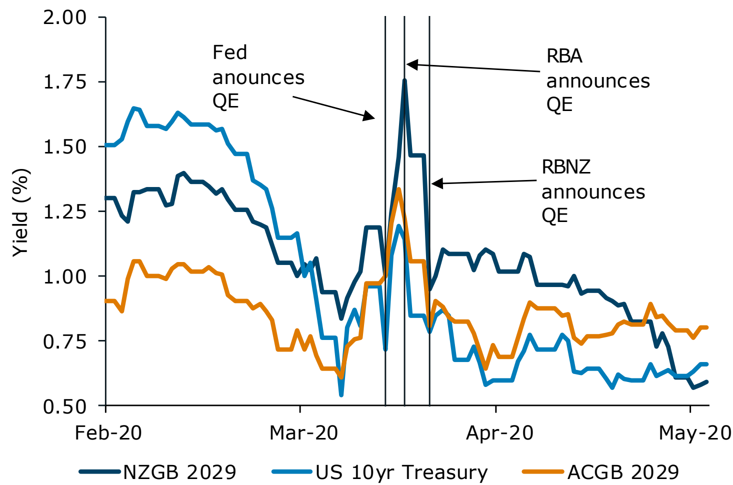
But nonetheless we may get to a point where taking these risks is seen as justified. COVID-19 is an unprecedented economic shock and many previously taboo policy prescriptions are being rolled out globally, with the long-term consequences shelved as a problem for another day. We think we are a long way from that point here in New Zealand, though.

Quantitative easing is working well

In the meantime, the Reserve Bank's quantitative easing programme has been very successful, seeing 10-year yields once more hovering near new lows – and sitting lower than in Australia (figure 1). The QE programme has been equivalent to roughly another 200bp of conventional easing in a shadow short rate framework.[1]

[1] In broad terms, the shadow short rate is the OCR in a world without lower bounds that would have resulted in the yield curve that QE and forward guidance has achieved. It's a way of measuring the overall policy stance including unconventional measures like QE. But one cannot transact at the shadow short rate, so it is not strictly equivalent stimulus. See www.ljkmfa.com.

Figure 1. 10-year bond yields in NZ, Australia and the US



Source: Bloomberg, ANZ Research

So far, the RBNZ has spent $9.4bn of the $33bn headroom they were granted by the Government in March ($30bn of NZGBs) and April ($3bn LFGA). To ensure no doubt in the market's mind that they will continue to succeed even as bond issuance ramps up massively, we expect the RBNZ to roughly double the size of its programme to $60bn. We expect the extra $27bn to be oriented towards NZGBs.

We see purchases of NZGBs roughly keeping pace with expected government bond issuance over the next 15 months. Indeed, the Treasury has said that it intends to issue $17bn of bonds in the current quarter, and we expect next year's bond programme (for the year ending June 2021) to be $45bn. With government bond issuance focussed on nominal bonds rather than inflation-linked bonds (linkers), we think the expansion in QE will be largely (if not solely) aimed at nominal bonds. However, we would not rule out token purchases of linkers (perhaps $2-3bn). Similarly, we may see the volume of QE aimed at LGFA increased slightly, but our base assumption is that the programme will remain primarily aimed at NZGBs.

Further down the track, the RBNZ could run into limits regarding the share of government bonds it is comfortable buying. It's not a hard and fast rule, but the market took note of Assistant Governor Hawkesby's comment in a Bloomberg news interview when he said that overseas, other central banks holdings "do sit in that broad range of 40 to 50% as a limit." With the amount of bonds on issue set to rise to just over $120bn by mid-2021, this could be an issue eventually. However, at that point, the RBNZ could loosen that constraint, or get more flexible in terms of its purchases, perhaps including linkers (inflation-indexed bonds), more quasi-government bonds, and potentially even corporate bonds in its purchase programme. But for now, "conventional" quantitative easing focussed primarily on nominal NZGBs is doing the job admirably, that job being twofold: flattening the yield curve and supporting fiscal policy by absorbing sharply higher bond issuance.

Forecasts

The Reserve Bank's economic forecasts will have wide confidence intervals and a short shelf life, like everyone else's best guesstimates at present. However, they will provide a useful benchmark against which to gauge economic data as it comes in. Given the uncertainty, some scenario analysis would be particularly useful. We won't speculate too much here about what the Reserve Bank's central forecasts will be. We're confident their forecasts will show an economy facing an enormous negative shock and a strong need for policy stimulus. There's not great value in nuance at this point.

Encouragingly, it has recently become more likely that New Zealand will successfully maintain COVID-19 cases at the extremely low levels that can give firms confidence that a return to lockdown can be avoided. Our own growth forecasts assume as much and we remain comfortable with them, but the recent dramatic fall in new cases does pave the way to a gradual re-opening of the economy, diminishing one particularly large source of downside risk and uncertainty: a prolonged or oscillating lockdown situation. But despite the public health situation looking better, plenty of big economic questions remain, including:

- whether a trans-Tasman bubble could give a glimmer of hope to our battered tourism industry;
- the global economic outlook, including New Zealand's commodity prices;
- whether central banks can keep a lid on global financial market stresses;
- the extent to which firms will be able to hang onto their staff; and
- how ugly it might get for residential and commercial property.

Conclusion

Monetary conditions in New Zealand have been eased substantially since the COID-19 crisis began. The Official Cash Rate has been eased 75bp, and the aggressive QE programme is keeping long rates low. Various backstops have also been put in place to ensure the free flow of credit should stresses emerge. The Reserve Bank has been very proactive – and it is working, and will cushion the blow to some degree. Fiscal policy is by necessity (and quite appropriately) the main game in town, and we expect more initiatives are on the way, with the Budget out next week.

Overall, we think the RBNZ will be quietly pleased with what they have managed to achieve so far. But the full brunt of the economic impact is yet to be seen and a larger monetary response is required. Looking further ahead, the scars of this crisis will take a long time to heal, and the RBNZ will need to be prepared to provide support well into the eventual recovery.

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