ANZ Research

NZ Insight – Where to now for the LSAP?

12 April 2021

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Contact

David Croy for more details.

Where to now for the LSAP?

Non-technical summary

- The Reserve Bank's Large Scale Asset Purchase Programme (LSAP) was at the centre of the monetary policy response to the COVID-19 crisis. It helped flatten the yield curve, arguably kept the NZD lower than it otherwise would have been, and caused a rise in system settlement cash (SCL) that helped fund a surge in mortgage lending.
- The pace of purchases has slowed significantly since the peak early in the programme, and will likely slow further over coming months. Exactly how quickly it falls depends on the pace of bond issuance, and the trajectory of SCL. Both these factors suggest that the LSAP will go into auto-pilot mode and become less influential on rates going forward.
- Slower bond issuance will mean there are fewer bonds for the RBNZ to buy, constraining the LSAP. But, it's also a sign that the economy is doing better, requiring less fiscal and monetary support.
- With a brighter global economic outlook being the main force currently driving yields higher we don't expect the RBNZ to stand in the way of higher long-end bond yields – though its ability to do so is constrained by the limited headroom remaining for long-end purchases.
- Slower growth in SCL due to the Government not spending money as fast as it's raising it does means the RBNZ will have to continue its bond purchases for the foreseeable future. Otherwise, SCL could fall, putting pressure on bank funding positions and wholesale interest rates (like bank bills), which might in turn drive retail interest rates (such as term deposit and mortgage rates) higher. The RBNZ is keen to keep financial conditions easy.
- The logical way for the RBNZ to manage these conflicting forces is to continue the recent trend of buying shorter-dated bonds. If SCL does end up rising due to the Government spending funds that have already been raised via tax or bond issuance, the pace of LSAP purchases could be allowed to drop below the pace of issuance without seeing financial conditions tighten.
- The LSAP runs through till June 2022 and purchases to that date will grow the RBNZ's portfolio. We do expect purchases to continue beyond that date, but they will be aimed at maintaining or gradually reducing the size of the RBNZ's balance sheet. This phase will be all about managing the run-off of the RBNZ's portfolio in order to prevent an abrupt tightening in financial conditions.
- For now, it is looking very unlikely that the RBNZ will end up buying $100bn of bonds by June 2022, but that could change if the outlook were to worsen.
- Although the RBNZ has the capacity to intervene at any time, and could enter the market in the event of genuine market dysfunction, inaction in February suggests that the RBNZ will take a laissez faire approach in future, and the hurdle to intervention remains high.
- We expect it will take decades to fully unwind QE.

The launch of unconventional monetary policy in New Zealand

March 2020 saw the RBNZ launch its then $30bn Large Scale Asset Programme (LSAP), which was announced seven days after the OCR was cut by 75 basis points to 0.25%. Triggered by the COVID-19 crisis, this was the Bank's first foray into unconventional monetary policy. Having taken the OCR to close to its then-effective lower bound (a negative OCR was not feasible back then, though it is now), the RBNZ was forced to be more inventive.

The most common form of unconventional monetary policy globally has been quantitative easing (QE), which has been undertaken by the majority of G10 central banks. Other unconventional options have been employed, and in New Zealand, the RBNZ outlined a number of alternatives prior to the COVID-19 crisis. These included QE, interest rate swap market interventions, foreign asset purchases, and a negative OCR. In the end, QE was the obvious choice.

As the COVID-19 crisis unfolded, it became clear that fiscal policy would need to do the heavy lifting. This in turn implied a significant lift in government bond issuance to fund recovery initiatives, wage subsidies and the like. Therefore, it made sense for the RBNZ to embark on large-scale purchases of NZGBs to lend fiscal policy a hand by absorbing the massive spike in bond issuance, and lean into the dramatic steepening of the yield curve that occurred after the OCR was cut.

The LSAP has been expanded twice since it was first introduced, and is now capped at $100bn, with purchases flagged to continue until June 2022.

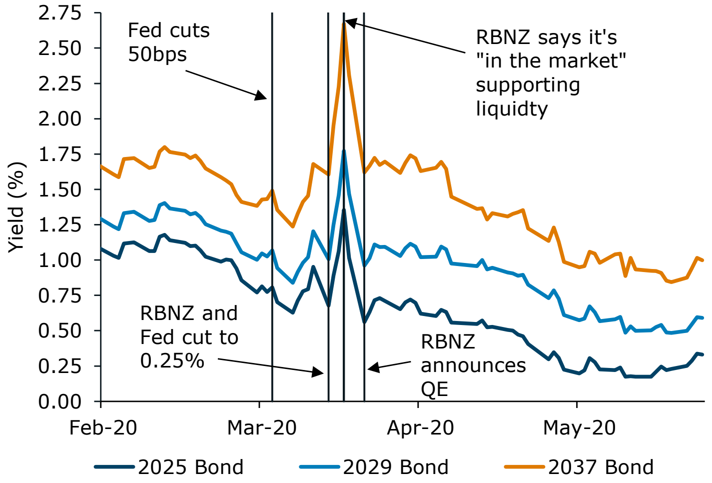
Bond purchases are slowing, but the economy is stronger

When the LSAP was introduced in New Zealand, markets reacted with "shock and awe" at the size of the programme. It was not just large (when the $30bn programme was initially announced, there were only $80bn of NZGBs on issue) but purchases were weighted heavily towards the long end. Perhaps even more impressive was the fact that when it was upsized for the second time to $100bn last August, there were only $108bn of NZGBs on issue.

Record new bond issuance was expected to see NZGB outstandings grow rapidly, and the $100bn programme size was consistent with the RBNZ's agreement with the Government (the indemnity cap), which limits purchases to 60% and 30% of outstanding nominal and inflation-linked bonds respectively. Had the RBNZ bought the maximum percentage of bonds the indemnity allowed and if issuance over 2020, 2021 and 2022 had matched projections in the May 2020 Budget, the RBNZ would indeed have been on track to own $100bn of bonds by June 2022. But as things have turned, out, the cap is not a constraint at all.

In practice, it's been the better-than-expected fiscal outturns that have constrained QE (ie a higher tax take and lower spending than forecast, and subsequent reduced bond issuance). But those better fiscal outcomes reflect better economy-wide outcomes, so it's all come out in the wash. The LSAP had done its job: settling down the market alarm a year ago regarding how it was going to absorb looming unprecedented bond issuance (figure 1), and helping keep the yield curve low and flat subsequently.

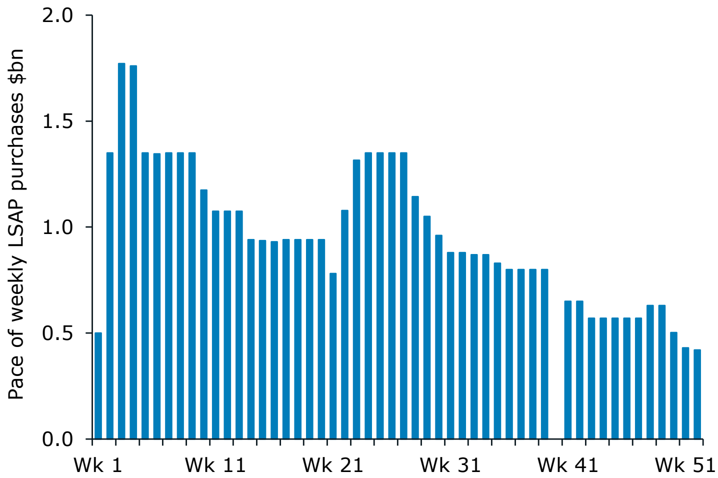
Figure 1. Yields on selected New Zealand government bonds



Source: Bloomberg, RBNZ, ANZ Research

As issuance projections and the actual weekly pace of bond issuance have fallen, the pace of LSAP purchases has been able to be wound back too (figure 2). While that technically represents a reduction in the amount of stimulus being delivered, it is occurring against a backdrop of an improving economy and reduced upward pressure on bond yields, so in net terms, it is fairly neutral. For this reason, we are not alarmed by the fall in the pace of LSAP purchases seen recently.

Figure 2. Pace of weekly LSAP purchases



Source: RBNZ, ANZ Research

With bond yields rising on a more-positive global economic outlook, there is little point in the RBNZ standing in the way, and we don't expect them to do so. However, if we were to see yields rise for NZ-specific reasons (leading to wider geographic bond spreads), and these reasons were inconsistent with the economic outlook, there would be a case for the RBNZ to respond.

If, for example, yields were rising because of unfounded fears of an early tightening or because of persistent selling pressure in the market (eg a large seller exiting the market), some sort of response might be warranted. Similarly, if we were to see large-scale market dislocation and poor liquidity conditions, the RBNZ might also want to respond. If this were sustained, it would make sense to respond via the LSAP, but if it were a "flash crash" style event, it would be make more sense for the RBNZ to enter the market via the Bond Market Liquidity Support facility.

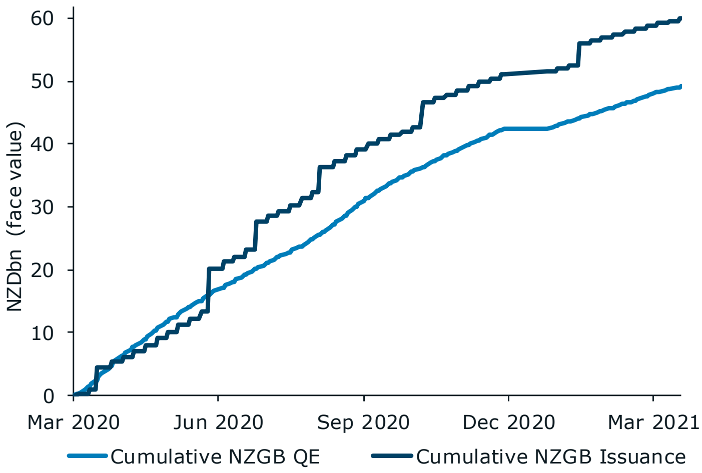
But the hurdle for entering the market and buying more bonds for any reason is higher now that the economy is recovering and the pace of bond issuance is slowing. As the outlook improves, there is less need to keep the yield curve low and flat, and the RBNZ are clearly comfortable allowing the yield curve to steepen. Financial conditions have tightened as a result, but if the outlook soured again the RBNZ could re-engage QE – that option (alongside a negative OCR) remains firmly on the table. But the days of engaging in hard-hitting QE with the intention of flattening the yield curve and suppressing yields look to be behind us, and if growth pans out as we (and the RBNZ) expect, we don't think we'll see a lift in the pace or duration of bonds purchased going forward.

But SCL is off its highs and is not rising quickly

As the economy recovers there is less of an argument for the RBNZ to "lean into" the slope of the yield curve, and as issuance slows, there is even less of a need to do so. Collectively, these two factors suggest that the RBNZ might be justified in gradually tapering the pace of purchases further, perhaps to a pace that is slower than the pace of issuance.

After all, prior to COVID, the market was comfortable buying around $10bn of bonds per annum, and over the last 12 months has averaged about $11bn. If issuance were to slow to, say, $20bn per year, and the RBNZ purchased $10bn, the market should be able to absorb the rest.

Figure 3: Cumulative LSAP purchase and NZDM issuance since the launch of QE in New Zealand



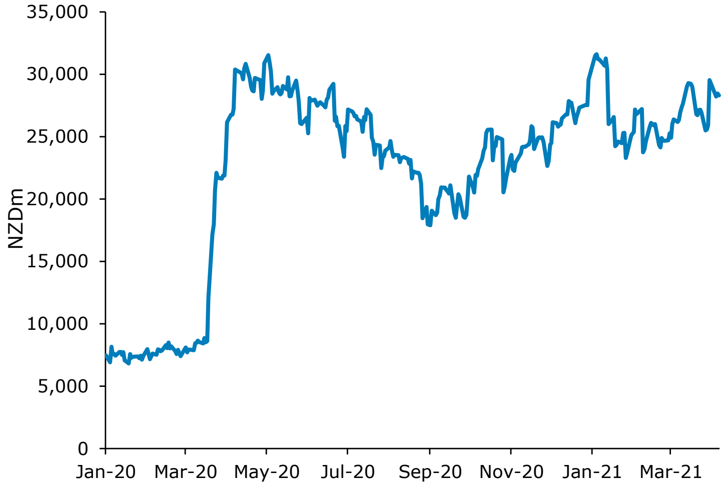
Source: RBNZ, NZDM, ANZ Research

The only trouble is, the LSAP is not just about buying bonds and keeping the yield curve flat. One of the other key aspects of the LSAP is the impact it has on the level of settlement cash, or SCL. This is the "money printing" bit, and it is this aspect of the LSAP that might be threatened were the RBNZ to slow the pace of purchases too much.

The level of SCL matters because it impacts the level of bank deposits, all else equal, which in turn has a direct impact on the price and availability of credit, which in turn influences monetary conditions. At the height of the crisis, for example, the RBNZ was buying bonds at a similar pace as the Government was issuing them (so the net impact on SCL was negligible), but as the Government spent the money on things like wage subsidies and the like, the money ended up on deposit at banks, funds which were then able to be lent out.

And this is where things get a bit complicated. The SCL doesn't just depend on the RBNZ's actions. If the Government over- or under-funds its cash position, there is a net withdrawal or injection to SCL. Ordinarily, this isn't a big deal. Prior to COVID and the LSAP, the RBNZ managed the "overs and unders" to keep the level of cash in the system broadly stable from day to day and month to month.

Figure 4. RBNZ Settlement Cash



Source: RBNZ, ANZ Research

However, the Government has in the past year funded vastly more than it has spent, to the point where the Crown Settlement Account (the balance of the Government's account with the RBNZ) sat at $38.4bn as at the end of February. This represents a pool of cash that has been withdrawn from the banking system. If this $38.4bn were to be spent tomorrow, SCL would go up accordingly. But for now, it is liquidity that's been sucked out of the system.

In our view, maintaining the SCL is the main reason why the RBNZ is likely to continue buying bonds at a pace that broadly matches the pace of issuance going forward. It is still not clear what level or growth rate of SCL the RBNZ deems to be "stimulatory". But it's clear that the rise in SCL seen since the LSAP's inception has facilitated deposit growth and thereby credit growth, and if it were to stop rising, banks would need to go elsewhere to fund credit growth. And if SCL falls, it could crimp credit growth by reducing bank funding from this source.

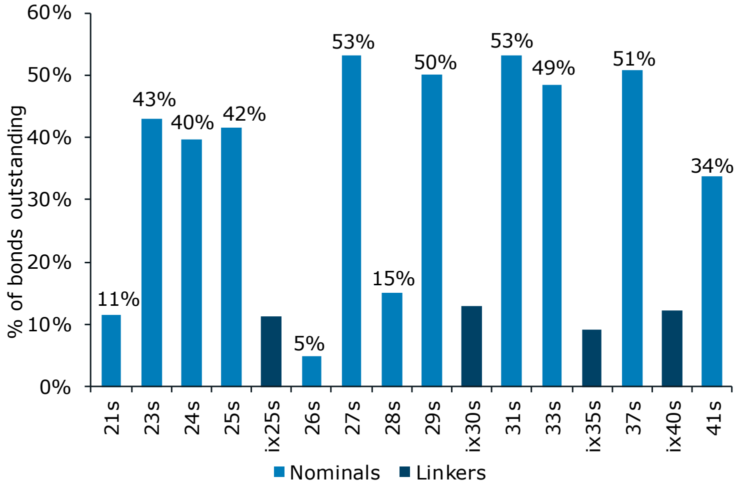
Further, if SCL were to stop growing, or fall, that would put upward pressure on bill and term deposit rates, and basis swap spreads, and eventually retail interest rates such as mortgages. It's worth noting here that while the Funding for Lending Programme (FLP) is large in terms of *new* mortgage lending, it is very small in terms of banks' *rolling* funding needs – while FLP drawdowns do raise the SCL, it can't offset QE impacts.

Without knowing what the Government plans to do on the spending front going forward, it is impossible for us (or the RBNZ) to know what the Government's influence on SCL will be going forward. In that context, it's probably prudent to at least keep the LSAP at the pace of issuance.

Big swings one way or the other in the SCL may necessitate a speeding up (or more likely a slowing down) in the pace of LSAP purchases. But for the foreseeable future, holding steady seems a fair assumption. That said, since it's no longer about leaning into the slope of the yield curve and more about keeping SCL up, it does make sense for the RBNZ to continue to tilt towards buying shorter bonds, as it has done in recent weeks. These purchases may need to be recycled in future (more on that later), but if we presume that the Government doesn't intend sitting on such a large sum of cash for ever, the Government's influence on SCL going forward will be to raise it, and at that point in time, LSAP purchases might be able to slow further.

The other factor driving a tilt towards the short end is the lack of capacity that has resulted from a long period of purchases weighted towards the long end. When many of these purchases were made, the presumption was that there would be a lot more bonds to come, but as issuance has slowed, past activity has crimped future options, given the RBNZ has hinted that it doesn't want to hold more than 60% of any given bond line.

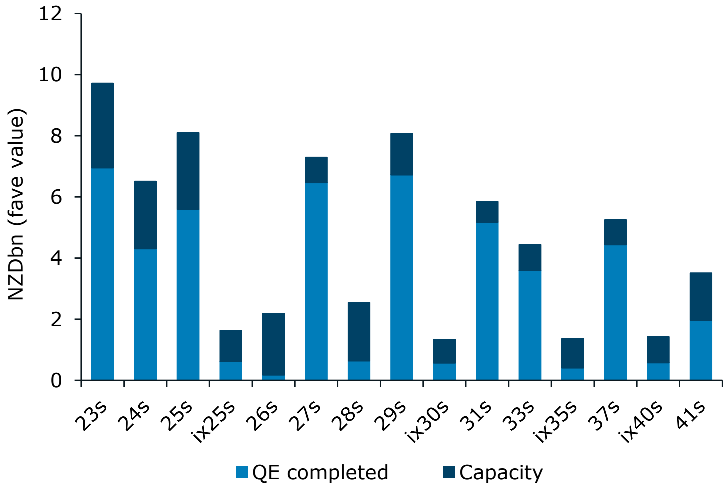
Figure 5. RBNZ holdings of NZGBs



Source: RBNZ, Bloomberg, ANZ Research

Although that is obvious from percentage holding data (figure 5), it is even more stark when viewed in dollar terms. As figure 6 shows, if we ignore the 2021 bonds, which mature next month, most of the dollar capacity to buy that the RBNZ has remaining resides with the 2023s, 2024s and 2025s (with a little bit more in the 2026s and 2028s). So in sum, it's not just the better outlook that makes buying longer bonds less appealing; capacity constraints also make it harder.

Figure 6. Dollar capacity of LSAP purchases against indemnity cap



Source: RBNZ, ANZ Research

The smaller-than-expected overall size of the bond market is also reducing the RBNZ's capacity to buy bonds (if it wanted to). This is because the indemnity cap is expressed as a percentage of the amount of bonds outstanding. When the current indemnity was agreed (at the time the LSAP was expanded to $100bn), it would have been possible for the LSAP to get to $100bn, assuming projections for bond issuance at the time. At the moment (based on the latest HYEFU projections), we estimate that the indemnity cap will rise to just $89bn by June 2022. The cap could be smaller still if we see further reductions in issuance, which is a risk. But if reduced issuance is a result of better economic outcomes – which it broadly is – this need not be a concern.

Whatever happens, it seems unlikely that the RBNZ will end up accumulating anything near $100bn of bonds via the LSAP by June 2022. At the current $420m per week pace, the cumulative volume of purchases might get to $75bn; any slowing would imply an even lower total. But we don't see that as a problem as long as the recovery remains on track.

With the LSAP set to become less of an influence on the shape of the curve and more of a tool to manage SCL, purchases will need to continue beyond June 2022 to allow for an orderly unwinding of the RBNZ's balance sheet. Whereas we earlier felt that an extension would be required because further stimulus was needed, the stronger recovery means that is no longer the case. It may well still be tweaked: perhaps slow more if government spending picks up (and SCL increases), or if issuance slows by more. It may need to lend markets a helping hand if issuance projections are significantly larger than $20bn going forward.

What about maturities?

It would be absurd to think that QE can simply cease in June 2022 and the RBNZ's portfolio of bonds will just mature.

Technically speaking, when the Treasury makes principal (and coupon) payments to the RBNZ, that doesn't have an impact on SCL – it's just one government entity paying another and it skirts the banking system. But if the Treasury raises the money needed to make the payments by issuing bills or bonds, that is a withdrawal of liquidity from the banking system, and a reduction in SCL.

Indeed, it is almost certain that the pace of quantitative tightening (akin to "burning" the printed money) won't align with the run-off rate of the LSAP portfolio and that the RBNZ will need to continue wholly or partly re-investing coupon and principal payments. It could manage this by actively buying shorter dated assets like Treasury bills and AAA-rated Kauri bonds and the like, but either way the RBNZ will need to actively manage the run-off rate of its LSAP portfolio, which will affect the trajectory of SCL.

It's worth noting that there is an important distinction here. Not allowing the RBNZ's asset portfolio to sharply decline as bonds mature is not the same as growing the overall size of the Reserve Bank's balance sheet. The former is a mechanical operation aimed at preventing volatility in SCL; the latter is about providing additional monetary stimulus.

Facilitating a smooth exit from QE (rather than a desire to suppress or flatten the yield curve) is the main reason we expect bond purchases to continue beyond June 2022. That being the case, we attach less importance to the extension, as it doesn't represent a policy shift in the traditional sense. We also attach less significance to changes in the pace of weekly purchases, especially with the duration of bonds purchased also declining, as noted earlier.

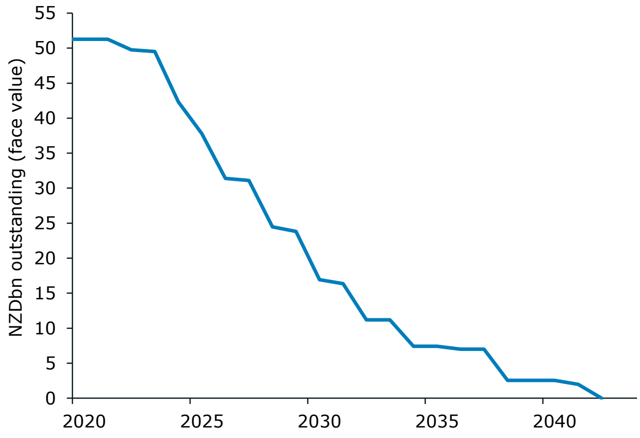
Indeed, we had been of the view that it made sense for the RBNZ Monetary Policy Committee (MPC) to "own" decisions relating to the pace of weekly LSAP purchases (so as to be crystal clear about what degree of stimulus the RBNZ was looking to provide), and for the pace of LSAP purchases to be gradually wound back over time. However, given the degree of uncertainty about the trajectory of SCL, government spending and the pace of issuance - all of which directly impact the LSAP but are out of the RBNZ's control – it makes sense for RBNZ staff, rather than MPC, to continue to determine the pace of asset purchases.

Our reading of the RBNZ's indemnity against losses (provided by the Minister of Finance) is that a new indemnity would not be required if the LSAP were to continue past 2022, provided it maintains, rather than grows its portfolio. This is because the indemnity covers the RBNZ for purchases up to and including 31 August 2022, and for reinvestments up to the nominal value of the bonds held at that date. The existing indemnity thus allows the RBNZ to manage the gradual run-down of its LSAP portfolio. And by gradual, we mean very gradual; it could take a few decades.

We would expect the RBNZ to outline how it intends to manage the LSAP portfolio once purchases cease (in terms of reinvesting coupon and principal payments) when it eventually publishes its normalisation principles, but that won't need to happen until well down the track.

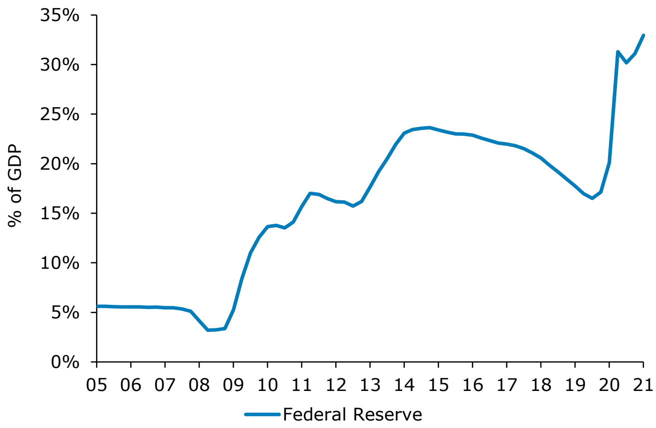
This is more technical, rather than policy driven, in the sense that it is likely to be liquidity that drives decisions and not a desire to affect the slope of the curve. But even if purchases in future are just short term, they will still need to be conducted so as to keep the financial system in balance, and to ward off any undue tightening. As figure 7 shows, almost $20bn of LSAP bonds mature between now and April 2025. Given the impact SCL growth had on bank funding conditions last year, we doubt the economy can sustain that sort of tightening (that would occur if the LSAP were left alone). As the Fed found out after it employed QE after the GFC, unwinding QE can take a lot longer than embarking in it, and a good chunk of it is likely to prove permanent.

Figure 7. How quickly does the RBNZ's QE portfolio run-off?



Source: RBNZ, ANZ Research estimates

Figure 8. Federal Reserve SOMA (QE) bond holdings as a % of GDP



Source: Federal Reserve, Bloomberg, ANZ Research

Contact us

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We welcome your questions and feedback. Click here for more information about our team.

Sharon Zollner
Chief Economist

Follow Sharon on Twitter
@sharon_zollner

Telephone: +64 27 664 3554
Email: sharon.zollner@anz.com

General enquiries:
research@anz.com

Follow ANZ Research
@ANZ_Research (global)

David Croy
Senior Strategist

Market developments, interest rates, FX, unconventional monetary policy, liaison with market participants.

Telephone: +64 4 576 1022
Email: david.croy@anz.com

Susan Kilsby
Agricultural Economist

Primary industry developments and outlook, structural change and regulation, liaison with industry.

Telephone: +64 21 633 469
Email: susan.kilsby@anz.com

Liz Kendall (maternity leave)
Senior Economist

Research co-ordinator, publication strategy, property market analysis, monetary and prudential policy.

Telephone: +64 27 240 9969
Email: elizabeth.kendall@anz.com

Miles Workman
Senior Economist

Macroeconomic forecast co-ordinator, fiscal policy, economic risk assessment and credit developments.

Telephone: +64 21 661 792
Email: miles.workman@anz.com

Finn Robinson
Economist

Macroeconomic forecasting, economic developments, labour market dynamics, inflation and monetary policy.

Telephone: +64 21 629 553
Email: finn.robinson@anz.com

Kyle Uerata
Economic Statistician

Economic statistics, ANZ proprietary data (including ANZ Business Outlook), data capability and infrastructure.

Telephone: +64 21 633 894
Email: kyle.uerata@anz.com

Natalie Denne
PA / Desktop Publisher

Business management, general enquiries, mailing lists, publications, chief economist's diary.

Telephone: +64 21 253 6808
Email: natalie.denne@anz.com

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