ANZ Research

NZ Insight: What now for the LSAP portfolio?

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Contact
David Croy for more details.

Summary

In this paper we outline our thoughts on the Reserve Bank's (RBNZ) next steps in relation to their Large Scale Asset Purchase (LSAP) portfolio. Bond purchases ceased in July, but the bonds purchased have maturity dates going out as far as 2041. While the time-frames are very long, this portfolio will need to be managed, and how that is done is important to financial markets.

In August, the Monetary Policy Committee (MPC) directed staff to come up with an operational strategy to manage the LSAP portfolio. We expect the next step to be the publication of a broad-based "principles" document. We expect this to outline the order in which unconventional policy will be unwound, and how that will occur. The key issue for financial markets will be whether the RBNZ intends to sell down its bonds, let them mature, or partially reinvest the proceeds. For a variety of reasons, the risks look skewed towards combinations of the latter, and that's likely to place less stress on the bond market going forward than a sell-down.

Unwinding the LSAP portfolio will have to be done in a flexible and pragmatic manner, with decisions dependent on how the economy and bond markets evolve. These are unknowns at this point, and as such we are not expecting any firm commitments until late 2022 or early 2023. We don't think the LSAP portfolio will be a permanent feature of the markets landscape, but it could be with us for some time, with the global experience suggesting that getting out of QE gracefully is a lot harder than getting in. Unwinding QE (known as Quantitative Tightening – or colloquially, "QT") tightens financial conditions, all else equal, and may thereby also reduce how high the OCR needs to go.

Background

The RBNZ embarked on QE for the first time on 23 March 2020, doubling down on its decision a week earlier to cut the OCR from 1.00% to its (then) effective lower bound of 0.25% as New Zealand was plunged into a hitherto unheard-of lockdown. The objective of QE (the Large Scale Asset Purchase – or LSAP – programme) was to put downward pressure on long-term interest rates at a time when the required (huge) fiscal response would likely have done the opposite. QE helped ease financial conditions, made it easier for the Treasury to issue bonds, likely kept the exchange rate lower than it might have been otherwise, and importantly, added significant liquidity to the banking system. For more background information on QE and the LSAP, please see earlier papers on Unconventional Monetary Policy, here.

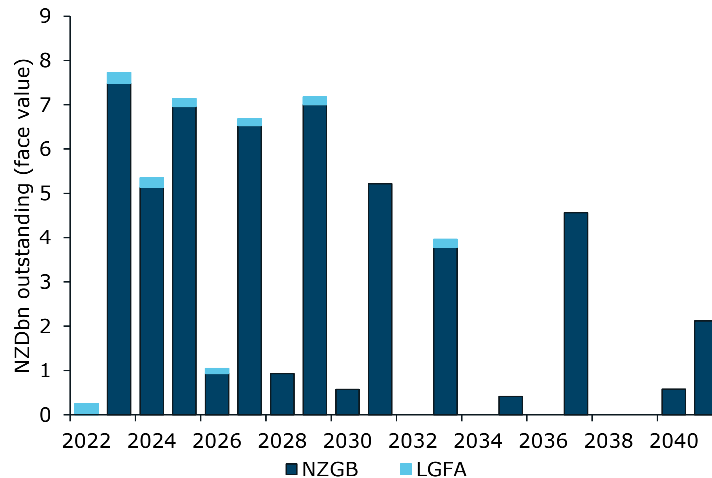
Purchases conducted under the LSAP programme have left the RBNZ with around $55bn of bonds on its balance sheet. In our view, these are bonds that it would ideally not own. During the course of its everyday interaction with financial markets and the banking system, the RBNZ will inevitably find itself owning bonds and other securities as collateral, as part of its open market operations, or to help facilitate a repo market. But in a "proper" functioning financial system, no central bank would ideally be a long-term holder of government bonds, or find itself financing the government directly or indirectly. That's one of the key pillars of monetary stability.

However, given the size and term of the bond portfolio, running it down isn't something that can be done quickly. It will take time, and in this paper, we lay out our thoughts on how that process might unfold.

Putting things in order, with lessons from the Federal Reserve

Without knowing what the future holds – in terms of how the economy is tracking or how well bond markets are functioning – it would be unwise for the RBNZ to make decisions now (or at any time significantly before 2023) about exactly what it might do with its LSAP portfolio. That's because the maturity profile of the portfolio is lumpy (Figure 1), with large maturities of both government bonds (NZGBs) and Local Government Funding Agency (LGFA) bonds on 15 discrete days over the next 20 years.

Figure 1. Maturity profile of RBNZ LSAP Portfolio



Source: RBNZ, Bloomberg, ANZ Research

Ahead of, or as we approach, these dates, we would expect the RBNZ to be in a better position to judge whether it will let individual bond holdings mature without being (partly or fully) reinvested, or sold beforehand. Because these decisions will have implications for markets and Crown finances as they occur, the RBNZ isn't well positioned to make specific decisions now.

The next major tranche of bonds doesn't mature until 2023, when $7.7bn of bonds mature (Figure 1). Technically that means there is no urgency for the RBNZ to outline its thoughts until late 2022 or early 2023. But having been directed by the Monetary Policy Committee (MPC) to come up with an operational strategy, at a minimum we expect the RBNZ to outline its guiding principles. That may also include detail on how it envisages running down the QE portfolio. In an earlier paper on the topic, we surmised that the RBNZ would take a lead from the US Federal Reserve (the "Fed"), and follow these broad steps into and out of QE:

1. Cut OCR
2. Introduce and conduct LSAP
3. Taper LSAP purchases
4. Outline normalisation principles
5. Cease LSAP purchases
6. Hike OCR
7. Allow LSAP portfolio to be run down

We are now well through that list, having reached #6. But step #4 has been skipped, and that's the step that is the focus of this paper. Deferring that step wasn't a big deal for markets or the economy, but it was a deviation from the path taken by the Fed in 2013 and 2014. Nonetheless, looking ahead, we expect the RBNZ to draw from the Fed's principles – in particular, those published in its 2014 principles paper.

That paper made it clear that the Fed's QE portfolio would not start being run down until after it had started hiking rates. That's a moot point for the RBNZ, who have already started raising rates, but have not taken steps to reduce the size of the LSAP portfolio. The other key aspects of the Fed paper were:

- a commitment not to sell agency or mortgage-backed bonds (ie the non-government bond part of its portfolio);
- an intention to "hold no more securities than necessary to implement monetary policy efficiently and effectively";
- a commitment to hold only government bonds to "minimize the effect of Federal Reserve holdings on the allocation of credit across sectors of the economy"; and
- a preparedness to be flexible, in light of economic and financial developments.

We think all of these aspects have a role to play in the New Zealand context. Rolling them together, they point to the RBNZ potentially outlining the following broad guiding principles as it looks to unwind QE, and embark on QT:

1. In the long run, the RBNZ will not be a habitual holder of bonds.
2. It will not sell down its LGFA bonds, but if any reinvestment of maturities is deemed necessary, to potentially reinvest that only in NZGBs.
3. It will be flexible in its approach to running down the portfolio.

These are just guiding principles. They wouldn't commit the RBNZ to anything, but they would reiterate to the public that the RBNZ's motivation for entering the bond market was to stimulate the economy and to assist market functioning, rather than to finance the government. That's an important signal to send, as it would clarify that QE was temporary, and that the money that was "printed" will eventually leave the financial system, and not be some sort of permanent piece of trickery.

Returning to the US experience, in 2017, the Fed modified its principles. By then it felt it was in a position to be clearer about how it would begin to run down its securities portfolio. It opted for an approach that employed caps that dictated the maximum value of bonds that would be allowed to roll off each month. Importantly, the Fed did not proactively sell bonds. The run-off rate was dictated by the maturity profile, subject to caps.

The Fed's caps started out small, and grew over a 12-month period, eventually reaching $30bn per month for government bonds and $20bn per month for agency and mortgage-backed securities. What that meant was that if, for example, $35bn of government bonds matured in a particular month, then only $5bn of them would be reinvested (across the maturity spectrum). This was a simple, intuitive and predictable way to smooth the rundown of the portfolio. Once this process was underway, it effectively went into auto-pilot.

There were two key elements to the simplicity and success of the Fed's approach. The first was the sheer number of bonds in the Fed's portfolio. As at June 2017, when the Fed's principles were amended, it held 255 different government bonds with maturity dates out to 30 years that were spread no more than 1 month apart out to around 5 years, and around 3 months apart out to 10 years. Its holdings were weighted towards shorter bonds. It also held a large number of agency and mortgage-backed bonds. What that meant was that unlike the RBNZ, the Fed didn't have to deal with a lumpy, discrete roll-off profile. And to put those caps into context, the total value of the Fed's portfolio stood at $4.2 trillion at the time.

As an aside, the Fed's QE portfolio is now almost double that, at around $8.1 trillion. That isn't directly relevant to this paper, but what it does demonstrate is that once you start QE, it can be hard to get out. Taking a softly, softly approach on the way out reduces the chances of causing volatility, but increases the odds that you won't have unwound QE before the next crisis comes along. The experience of the Fed and others in the post-GFC, pre-COVID period is a key learning in that regard. We don't expect QE to be a permanent feature of the economic and financial landscape, but realistically, it could take longer than is desirable to exit it. Life keeps happening.

In any case, we don't think the RBNZ will follow exactly the same approach as the Fed. The main reason for this is that the RBNZ's holdings are much lumpier. An obvious way to counter this would be for the RBNZ to start selling down a portion of each bond as it approaches maturity. We know, for example, that the RBNZ owns almost $8bn of bonds maturing on 15 April 2023 (the next major maturity date). It could, for example, sell $1bn of bonds per month starting 8 months earlier. These would presumably be sold to the Treasury (as implied by the Crown indemnity), so wouldn't impact financial markets directly, or alter the amount of cash in the banking system (the settlement cash level, or SCL). But it could only be done in cooperation with the Treasury.

Alternatively, the RBNZ could elect to purchase a series of shorter maturity assets like Treasury bills (T-bills) on 15 April 2023, with maturities spread out over, say, a 12-month period, so as to stagger the impact. Again, this would be best coordinated with the Treasury because (a) otherwise there may not be enough T-bills with the desired maturity dates available, and (b) so that the impact on SCL (and thus short-term interest rates) is smoothed (or minimised, depending on economic and financial conditions at the time).

The impact that the run-off of QE will have on SCL will almost certainly be a consideration, and it is an important determinant of short-end interest rates. But because it is the collective actions of the Treasury and the RBNZ (and not just the actions of the RBNZ on its own) that impact the level of SCL, co-ordination would be desirable.

What have other central banks said or done?

It's not just the Fed who have had to tackle an exit from QE. So too have others, including the Bank of England (BoE). Back in August, they took a different tack again. Instead of taking a smoothed approach dictated by the maturity profile of the portfolio like the Fed did, they have elected to be guided by where the cash rate is. They also envisage actually selling bonds, which is a more aggressive approach to running down its portfolio.

Specifically, the BoE has said that it "intends to begin to reduce the stock of purchased assets, by ceasing to reinvest maturing UK government bonds, when Bank Rate has risen to 0.5% and if appropriate given the economic circumstances". It then went on to say that "that level of Bank Rate is lower than the MPC's previous assessment of the threshold for reducing the stock of purchased assets, which was previously 1.5%. In part that reflects the MPC's judgement that setting a negative Bank Rate is now part of its monetary policy toolkit, as well as its view that the impact of reducing the stock of purchased assets on monetary conditions is likely to be smaller than that of asset purchases on average over the past." There are clear parallels here, now that New Zealand is ready for a negative OCR. Also note the final part of the first statement, which gives them an out if things don't go to plan.

With regard to selling bonds, the BoE stated that “the MPC envisages beginning the process of actively selling assets later, and will consider it only once Bank Rate has risen to at least 1%, depending on economic circumstances at the time”. It goes on to say that “any asset sales will be conducted in a predictable manner over a period of time so as not to disrupt the functioning of financial markets”, and that “the MPC will of course monitor the impact of the reduction in the stock of purchased assets, and may amend or reverse the process if needed to meet its 2% inflation target. Decisions on Bank Rate will be based on the economic circumstances at the time, and will take into account the impact of the intended profile for the stock of purchased assets on overall monetary conditions”. It concludes with the comment that “while the MPC will monitor the reduction in the stock of purchased assets on a continual basis, it also intends to review its parameters no later than two years after the process begins”.

In the RBNZ’s letter requesting a Crown indemnity in relation to LSAP purchases, Governor Orr notes that “I also request that the LSAP programme remain in place until the bonds held in the programme mature or the MPC decide to end the programme, at which point the Bank would be required to sell the bonds to the Treasury”. We read that to mean that the RBNZ can only sell bonds to the Treasury, and not into the open market. That further reinforces the likelihood of a co-ordinated Treasury and RBNZ approach to running down the QE portfolio.

Gross versus net

It is also worth noting that government bonds acquired via QE will largely affect gross government debt, with only small impacts on net core Crown debt. That’s because at a consolidated level, bonds held by the central bank are an asset, offsetting the government’s liability. That said, QE does increase the Crown account’s exposure to changes in interest rates (as the cash liability is marked at floating, while the asset is fixed at the prevailing rate when the bond was issued). Further, the difference between the book value and market value of bonds has seen net debt slightly higher than otherwise initially, but this will unwind over time as lower interest expenses are paid over the lifetime of the bond. This is more of a timing issue and the result of accounting treatment, opposed to something that affects debt issuance (ie Government funding) requirements. Looking forward, the Government’s core debt metric within its fiscal strategy can certainly be amended in the future to “look through” the impacts of unconventional monetary policy.

That being the case, if a government relied on QE to fund itself, net debt figures might mask the true state of government finances, presuming that the QE will one day be unwound. Thankfully, in New Zealand, this was not the case.

Indeed, while New Zealand’s QE programme was large in relation to the size of the economy, the Crown has actually saved a good chunk of the money that it borrowed. Part of this was deliberate (part of NZDM’s strategy), stemming from a desire to have enough cash on hand should large and unexpected Government payments be required (which was the case, in the form of Delta). But part of it was good fortune, owing to the more rapid economic rebound than expected.

Whatever the cause, what we know is that at the end of October, NZDM had around $37.5bn of cash on deposit at the RBNZ (parked in the Crown Settlement Account). We know that the Treasury wants to maintain a larger cash buffer going forward (it had to call on a RBNZ overdraft in 2020 when COVID hit). They have not specified how much larger this will be, but technically, if the RBNZ asked it to buy back a large chunk (eg $10-20bn) of

the $55bn bonds acquired via QE, the Treasury could do so without needing to borrow more money, or raise revenue. Such a transaction would have no significant impacts on markets, or the SCL; it would just be an accounting entry.

Clearly it's not realistic to expect the Treasury to spend all of the cash it has on hand to help out the RBNZ, but it does illustrate the flexibility. More likely, Treasury might be targeting perhaps a $30bn cash buffer, in which case it has $7.5bn of capacity to help the RBNZ run down its QE portfolio. This is important, as it's the sum of these moving parts that will determine the trajectory of SCL, and by association, the impact the run-down of the QE portfolio will have on short-end interest rates.

Wrapping it all up

The rationale for QT is well known and understood, and we expect the RBNZ to underscore that when it lays out its guiding principles. Central banks should not be relied on to fund governments, and QT needs to follow QE.

We expect an orderly unwind of the LSAP portfolio. That said, the international experience is that getting out is harder than getting in, and we expect the same sorts of challenges here. RBNZ documents indicate that selling down bonds is unlikely (unless to the Treasury), and that bonds will be held to maturity. That will then leave the onus on the RBNZ to come up with a plan that allows the portfolio to run off as it matures, albeit with some smoothing via the staggered sale of bonds in the lead-up to maturities, or via reinvestment in shorter-dated assets around bond maturities, or both. Either way, when it comes down to the "how", we expect the RBNZ to work closely with the Treasury when formulating a plan. Smoothing may not even be required if the Treasury has enough cash on hand to repay the RBNZ as particular maturities arise (as might be the case with the upcoming 15 April 2023 maturity date).

The RBNZ may also want to set some broad parameters like the BoE did, and state at what levels of the OCR it will let the portfolio be run down. It may also follow the BoE's lead, highlight that now that it is ready for negative interest rates, it'd prefer to have a smaller QE portfolio. As things stand, the RBNZ has not suggested the possibility of selling bonds into the open market, so its exit speed depends on the state of Crown finances (because the Treasury would have to purchase any bonds back) or the maturity profile, which extends to 2041.

Given the likelihood and benefit of working with the Treasury (which was a key expectation of the LSAP when it was agreed to by the Finance Minister), and the lumpy nature of maturities, we doubt the RBNZ will try to develop an "auto-pilot" approach like the Fed. We think it makes more sense for it to communicate to the public and markets how it intends to approach each maturity well in advance (perhaps 6-12 months). Without knowing how well markets are functioning, how Crown finances or the economy are tracking, we see little point in pre-committing to a particular run-down rate, and instead expect flexibility and pragmatism.

It should also be noted that if the RBNZ decides to go down the road of allowing its bonds to simply roll off, this will have little bearing on NZDM's funding needs into the future. That's because NZDM's issuance projections already incorporate the need to repay all maturing bonds, whether they are held by the public or by the RBNZ. But if the RBNZ does elect to partially or fully roll over its holdings at each maturity date, it will reduce the refinancing burden that would otherwise fall on the market.

Similarly, the impact that unwinding QE will have on SCL will depend not just on how many bonds the RBNZ elects to roll off or sell, but also on how much cash the Treasury is sitting on, how much it wants to keep on reserve as a buffer, and how much needs to be funded via taxes or borrowing.

We think it will mostly be a smooth ride, but it could get bumpy at times, and it will almost certainly be harder to pull off than embarking on QE was in the first place. QE was only supposed to be temporary and as it morphs into QT, that will bring with it a reduction in liquidity. As we have stated in earlier research, it is akin to the "printed money" being "burnt". It is not clear what impact QT will have on the economy, but historic international experience and logic suggest that it will have a negative impact on growth, and that could temper the need (or the ability) for the OCR to go higher. In essence, QT could see longer-term interest rates rise (which affect business and the government more), leaving less room for short-term interest rates (which affect households more) to rise.

Contact us

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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

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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