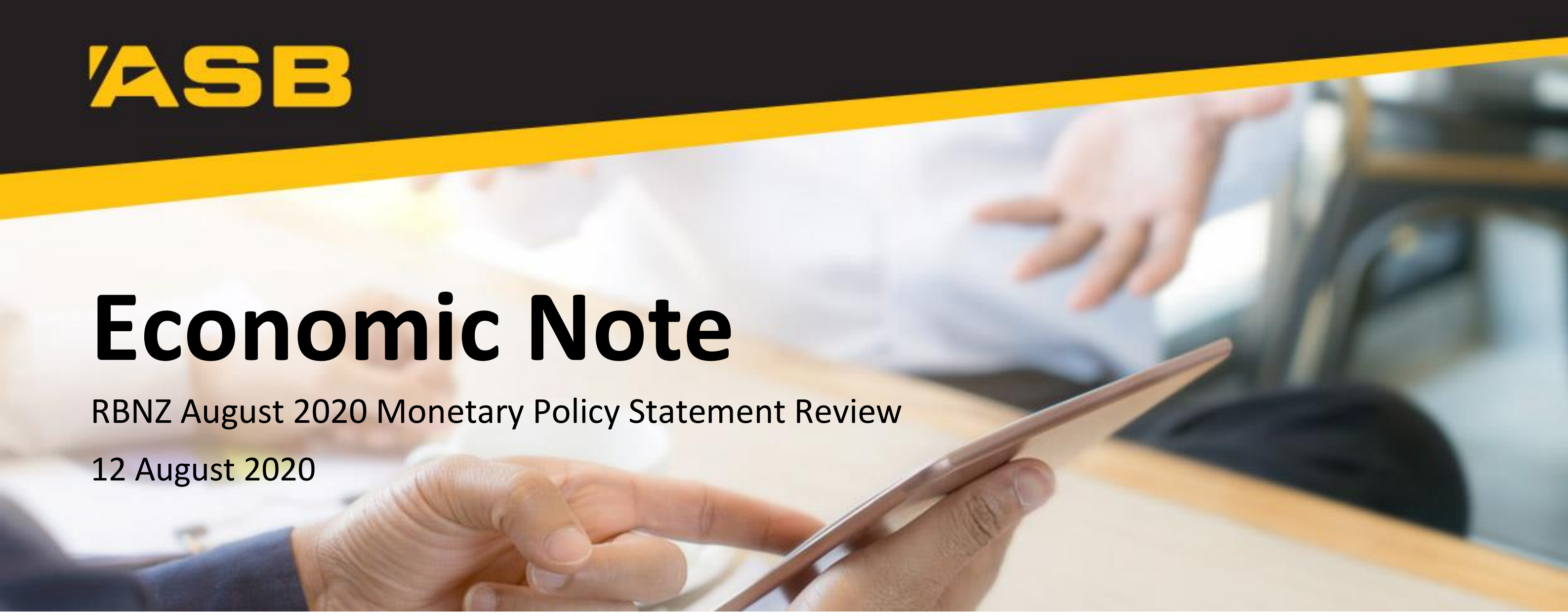

Economic Note

RBNZ August 2020 Monetary Policy Statement Review

12 August 2020

Priming the Big Guns

- The RBNZ expanded its asset purchase programme, as we flagged, and will prepare further monetary tools.
- Added tools are: a negative OCR; direct lending to banks, and; foreign asset purchases. The Bank's order of preference on these appears to broadly match our own, as discussed in our recent note.
- Although the OCR remained at 0.25%, the bias for interest rates is clearly down for the time being.

The RBNZ's Monetary Policy Committee (MPC) has given a clear signal to the market that it has a strong commitment to keeping NZ interest rates low and is amassing the firepower to back that commitment up. It has lifted the purchase ceiling on its Large Scale Asset Purchase (LSAP) programme to $100bn. In addition, the MPC has given the go-ahead for the RBNZ to prepare further tools to use: a negative OCR; direct funding for banks at an interest rate near the OCR, and; foreign asset purchases. All these measures will help allay market concerns over where to for interest rates after the previous LSAP programme expired next May. The OCR remained at 0.25% in line with the commitment to keep it at that level until early next year.

The RBNZ appears largely satisfied with the progress towards lowering effective interest rates in the economy, though notes the risks are all skewed to a weaker than expected economic environment and the need for more monetary support. The RBNZ revised its GDP growth forecasts to be closer to our own, including a smaller decline in Q2 GDP – which will reflect the fact that events (up until this week) have evolved more favourably than the RBNZ assumed in May. The most recent COVID outbreak is an evolving event and it is too soon to say how much of an impact it will have on the economy, but it does reinforce the RBNZ's view about the risks to the economy.

So, where to? If more stimulus is needed beyond the expanded LSAP programme, a negative OCR and direct lending to banks through the Funding for Lending Programme (FLP) look like they will be the first cabs off the rank. Of the two we see the FLP as likely to be more effective (and can be made conditional on lending outcomes). But we acknowledge that the RBNZ may not want to use the FLP without lowering the OCR in tandem.

It is possible that the new tools do get used next year, though we expect the RBNZ will keep up with the LSAP purchases for now. The RBNZ's growth outlook still appears a little strong to us, and there is the added uncertainty of what happens with the latest COVID-19 outbreak. In any case, the message is clear: the bias for the OCR and interest rates in general is that they could fall further over the next year if the economy needs added monetary support.

Boosting the LSAP firepower

The Large Scale Asset Purchase (LSAP) programme cap was lifted to $100bn, from $60bn, and the programme end-point extended to June 2022. We had flagged in our preview note last week that the cap could eventually be lifted to $100bn, but we were unsure of the timing, plumping for a lift to $80bn today. In the event the RBNZ has decided to front-load the increase, and separately announced a lift in the weekly pace of bond purchases – to $1.13bn for next week – to further solidify its intent to front-load bond purchases and drive wholesale interest rates lower still. This is

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important. The pace of week-to-week bond purchases is really where monetary policy is being set at present.

We noted in our preview that, whatever the announcement in regards to the LSAP cap, it is the indemnity signed with the Finance Minister that would remain the immediate constraint for the size of the RBNZ's bond buying programme. This continues to hold, albeit the indemnity was lifted today to allow the Bank to purchase up to 60% of the face value of New Zealand Government Bonds on issue, up from the 50% limit agreed in May. The caps on Local Government Funding Agency and inflation-linked bonds remained at 30%. The changes give the Bank further flexibility to tweak weekly purchases as appropriate.

Priming the other guns

In addition to extending the size of the LSAP programme to $100bn by June 2022 and raising the indemnity for conventional Government bond purchases, the RBNZ also flagged potential next options should additional policy stimulus be required. Additional options that the RBNZ outlined included:

- Setting a negative OCR;
- The provision of direct funding for banks via a Funding for Lending Programme, and;
- Purchases of foreign assets.

The Monetary Policy Statement was careful to note that the Bank was still undertaking detailed assessments of these policy instruments, and there is the possibility that the effectiveness of options could likely change. Still, it provided a useful stocktake for the RBNZ's thinking.

Importantly the RBNZ asserted that the choice of which instrument (or instruments) to use depend on the exact economic and financial conditions facing the economy at any point in time. We concur and had a similar viewpoint in our recent note. The table at the end of this note provides our ranking of what the RBNZ should do next, which continues to stand and appears to be similar in nature to RBNZ thinking.

Regarding the negative OCR, the RBNZ noted that a negative OCR influences activity in the economy through channels similar to those for a positive OCR, including lower borrowing rates and lowering the NZD. Both are important pillars of support. How low could the OCR go? The RBNZ has cited economic evidence which points to reduced effectiveness if it pushes deposit rates below zero. Our note suggests that the OCR could go as low as -1%, which would still leave retail deposit rates mildly positive. While the RBNZ has signalled the readiness to move the OCR, this looks unlikely to occur until early 2021 at the earliest. If the economy needed added stimulus sooner, the OCR would be off the table.

Moreover, setting a negative OCR is not completely without cost. There is a considerable body of evidence suggesting that the effectiveness of interest rate cuts tends to diminish the lower that rates go. An extended period of negative interest rates squeezes banks' net interest margins, potentially impairing the supply of credit – the opposite of what monetary easing aims to do.

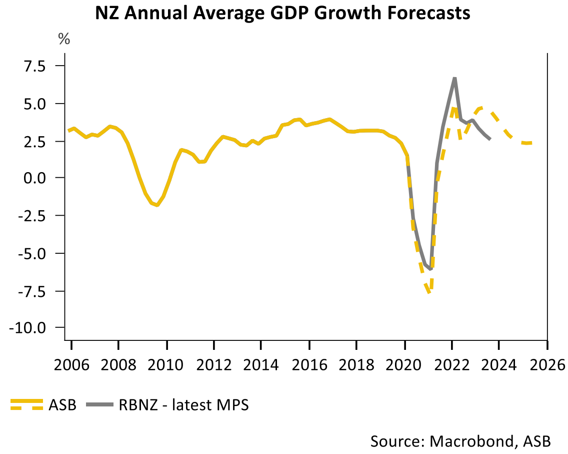
The second option outlined by the RBNZ was to launch a broader expanded term lending programme (Funding for Lending Programme) beyond those put in place at the start of the COVID-19 outbreak. By offering low-cost, long-term funding to banks, the aim of the programme would be to lower banks' funding costs. Doing that would in turn help to lower the cost of loans for households and businesses. It would also help ensure that bank lending rates remain more responsive to declines in the policy rate even as retail deposit rates approached zero, bolstering the flow-through of policy actions to borrowers. Our recent note has encouraged the RBNZ to look more closely at such a scheme and actually deemed this to be a more preferable option ahead of OCR cuts.

The RBNZ's discussions with banks and businesses are indicating that monetary policy is passing through to businesses but by less than to households. To monitor this, the RBNZ has begun collecting information on actual new lending rates faced by firms. A term lending programme would lower bank funding costs, and in turn help to lower the cost of loans for businesses (as well as households). Term lending programmes can be targeted to encourage lending to specific parts of the economy (i.e. businesses), as we have observed offshore.

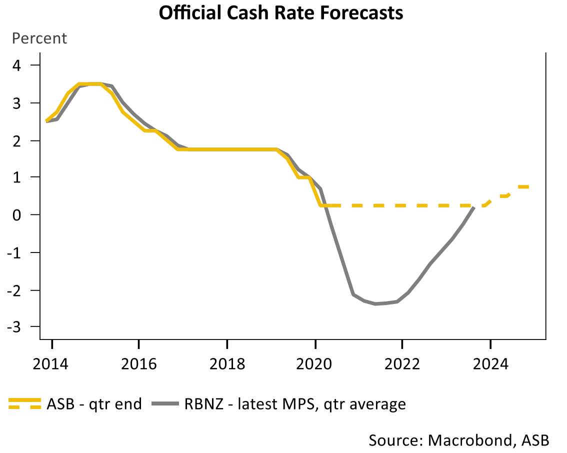
The final option outlined was that the RBNZ initiates large-scale purchases of foreign assets (such as foreign government bonds) in addition to the current programme of purchasing domestic bonds. The major route through which this would bolster monetary stimulus would be via a weaker NZD. With the NZD not appearing to be considerably out of line with fundamentals against the USD, our view is that this option would only be seriously considered during periods of market disfunction and when the NZD was exceptionally high.

Near-term growth better, though longer-term outlook may still be a touch rosy

The RBNZ revised its GDP growth forecasts to be closer to our own, in particular forecasting a smaller decline in Q2 GDP – which will reflect the fact that events (up until this week) have evolved more favourably than the RBNZ assumed in May. Not only did NZ appear to eliminate the virus, it was able to shift back into Alert Level 1 much sooner than the RBNZ had assumed back in May. The economy has bounced back into action very quickly, taking most economists by surprise by the economy's resilience.



The RBNZ still appears a touch too optimistic on the strength of GDP growth over 2021 (next year) in our opinion, notwithstanding its assumption that the border will remain closed until 2022. Furthermore, the most recent outbreak is an evolving event and it is too soon to say how much of an impact it will have on the economy.



The RBNZ's 'unconstrained' OCR produced by its in-house model (to indicate what the OCR would need to do to fully achieve its mandate) still reaches a low of -2.4% in early March 2021 but takes longer to fall to these lows. Very technically speaking this implies slightly less stimulus is needed compared to the May forecasts – in line with the improved economic outlook. Going forward, the key risk and uncertainty on the economic outlook will be the health of the global economy. With many key trading partners now struggling with a second COVID wave, the global economic backdrop is likely to be weaker than many expect. Back in NZ, the current outbreak is also a clear risk, and will slow the recovery over the second half of 2020. But, if officials are able to maintain a more targeted lockdown, this could limit the economic cost.

The New Zealand dollar trade-weighted index (TWI) has appreciated by about 6% since the RBNZ's May Statement. The RBNZ notes that accommodative monetary policy is reducing interest rates, and keeping the exchange rate lower than it would otherwise be. But the Bank also observes that robust prices for New Zealand's commodity exports have been partly offset by a rise in the exchange rate. The RBNZ's forecasts include the NZD (on a TWI basis) holding up at current levels (around 72) over the forecast horizon.

Options by preference	Pros	Cons
1. Increase NZ asset purchases	Bolsters financial market liquidity and keeps wholesale interest rates under downward pressure. Assists with government debt issuance.	Can only reduce interest rates so far with the OCR where it is at 0.25%. Exposes RBNZ to large balance sheet risks. Exit strategies can be difficult to manage.
2. Introduce a term lending programme	Would assist directly in dragging bank interest rates lower. Increases funding options available for financial sector.	Slow acting. Balance sheet risks for the RBNZ. Increased financial sector reliance on RBNZ.
3. Cut the OCR, potentially to as low as -1%	Provides modest additional interest rate stimulus. Essentially brings economic activity forward. Discourages bank cash hoarding and encourages lending. Helps dampen NZD.	Unlikely to provide all the needed stimulus on its own. Global central banks have mixed views on the effectiveness and efficacy. Could impair market functioning, bank profitability and credit provision. Can be difficult to exit policy.
4. Foreign asset purchases	May help lower NZD.	Question marks over effectiveness. Does not directly lower interest rates. Massively increases FX risk to RBNZ balance sheet.

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