Economic Note

RBNZ May 2020 Monetary Policy Statement Review

13 May 2020

RBNZ aiming for lower interest rates

- The RBNZ expanded its bond purchase programme to $60bn, from $33bn, as expected.
- The RBNZ clearly stated it wants to see interest rates in the economy fall further.
- A negative OCR is a possibility next year, but other tools are likely to be more effective and timelier.

As widely expected, the RBNZ lifted the size of its authorised bond purchase programme to $60 billion (from $33bn), more in keeping with the need to buy larger amounts of debt to suppress interest rates as government debt issuance balloons. Bond purchases will remain the primary monetary response for the time being.

The RBNZ keep the OCR at 0.25% and reiterated its intention to keep the OCR at 0.25% until "early 2021". Nevertheless, it noted that lowering the OCR in the future is still a possibility (amongst other policy measures) although questioned its effectiveness in pushing retail interest rates lower. The RBNZ noted it is in ongoing discussions with financial institutions about preparations for coping with a negative OCR.

Ultimately, the RBNZ wants to see interest rates within the economy fall further. Some easing is in the pipeline and the RBNZ is counting on retail lending interest rates falling. The RBNZ has several other options that will be timelier and likely more effective than setting a negative OCR. There is a good chance the RBNZ puts them to use as it assists fiscal stimulus to help get the economy out of the COVID hole.

What the RBNZ did: forward guidance and bond purchases

The Record of Meeting from the RBNZ Monetary Policy **Committee reaffirmed its forward guidance that the OCR will remain at 0.25 percent until early 2021**. The Committee noted that a negative Official Cash Rate (OCR) will become an option in future, although at present financial institutions are not yet operationally ready. Moreover, **it was noted that further OCR reductions at this stage would not be effective in reducing borrowing costs**. Nevertheless, the RBNZ did not rule out this possibility, with the Record of Meeting noting that discussions with financial institutions about preparing for a negative OCR are ongoing.

The Monetary Policy Committee noted that the economic situation had deteriorated since the previous policy meeting. From a least regrets-type analysis, delivering stimulus sooner rather than later was needed. From the RBNZ's point of view the Large-Scale Asset Purchase (LSAP) programme (i.e. bond purchases) looks to have been effective in lowering wholesale and retail interest rates and improving market functioning. It was noted, however, that further declines in retail interest rates would be needed to fully deliver the stimulus. We concur.

As such, size of the LSAP programme would need to be sufficiently large to keep interest rates lower across the yield curve. Today **the RBNZ agreed to expand the LSAP programme to purchase up to a maximum of $60bn over the next 12 months** (up from $33bn). Moreover, the RBNZ kept its options open on the composition and pace of purchases

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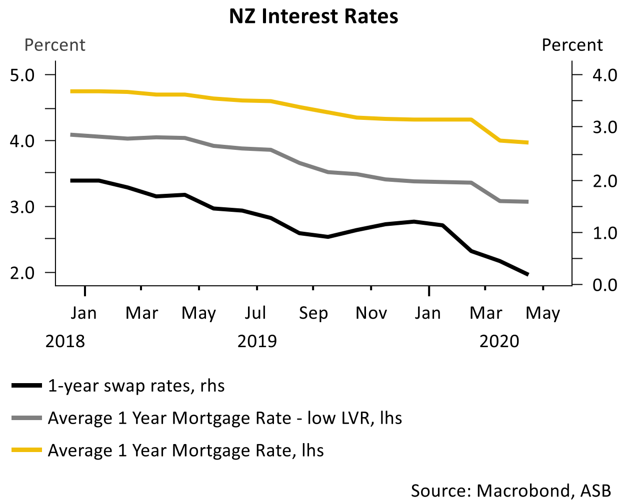
(which include NZ Government Bonds, NZ Government Inflation-Indexed Bonds, and Local Government Funding Agency bonds) with flexibility to scale the LSAP programme as needed in future.

What the RBNZ wants: lower interest rates in the economy

New Zealand's economy needs more stimulus to support a medium-term recovery in economic activity and employment and, in turn, inflation. As it has said in the past, the RBNZ noted today that "the main thing needed to support the economy is fiscal stimulus", as fiscal policy is best placed to directly support households and businesses.



The part that the RBNZ and monetary policy plays now is to support the economy by ensuring that interest rates remain low, complementing the effects of the Government's fiscal measures. And with regard to interest rates, the RBNZ is very clear within today's announcement wants to see them lower. The RBNZ states that it "expect[s] to see retail interest rates decline further as lower wholesale borrowing costs are passed through to retail customers".

How the RBNZ will achieve it: keep downward pressure on wholesale rates

The important influence on getting lending rates in the economy lower is bank funding costs – customer deposit rates and wholesale borrowing costs. Term deposit rates are at risk of hitting a limit on how far they can fall before money gets put under mattresses. That puts the weight on suppressing banks' wholesale funding costs.

The RBNZ will need to get creative, and fast, with the RBNZ now using or contemplating tools which have not been deployed before in New Zealand. There is no guarantee the RBNZ's approach will be successful, with the Record of Meeting noting "[other tools'] degree of success is something that will become evident over time".

Time unfortunately is a luxury we do not have with the NZ economy currently expected to be in its deepest downturn since the Great Depression. Here, when we think of criteria, the three T's spring to mind, namely that it is timely, targeted and temporary.

What then are further options for increasing policy stimulus:

- **Increasing Large Scale Asset Purchases:** This remains the first cab off the rank. With Government borrowing set to sharply increase, the RBNZ could step up asset purchases over and above the $60bn it has earmarked over the next 12 months. This could take the stock of RBNZ NZ Government holdings close to the 50% limit the RBNZ had earlier set. There is no hard and fast rule preventing the RBNZ in purchasing more than half of total outstanding bond holdings if the benefits of such an approach outweigh the costs. The RBNZ has flagged the possibility of foreign asset purchases, which aside from helping to lower the NZD is likely to deliver limited benefits to NZ in our view.
- **Term Lending Facility:** This and other monetary implementation measures will boost liquidity and assist the functioning of credit markets. It is not just the price of money (interest rates), it is the ability of the financial system to boost credit creation that is important.
- **Lowering the OCR:** The RBNZ did not rule out a negative OCR but has pledged to hold the OCR at 0.25% until early 2021, largely on the basis of financial institutions not being operationally ready. If they stick to this timetable the additional stimulus may come too late. However, work behind the scenes is likely advancing and the preparations of financial institutions in operating in a negative OCR regime have stepped up. We are not yet convinced that a negative OCR would support the economy via lowering borrowing interest rates. It might actually be harmful for credit creation, which is the lifeblood of a healthy economy. This is not to say

that a negative OCR would not be a useful option in future. It is good that the RBNZ are looking at this more closely.

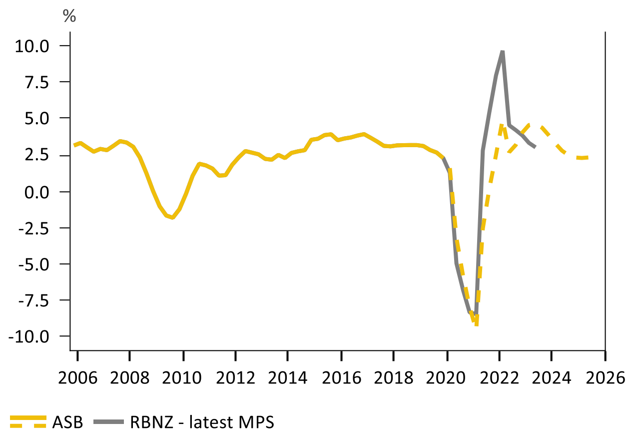
- **Other measures:** All policy options look to be on the table. The RBNZ have a number of tools in the kitbag which they have already relaxed, including dropping the LVR restrictions on mortgage borrowing and relaxing the core funding ratio to 50% of bank funding from 75%. The RBNZ could look at direct intervention into the interest rate swaps market (to lower wholesale interest rates) or purchasing mortgage-backed securities. We are not convinced as to the effectiveness of these approaches, but are open to persuasion.

The RBNZ's outlook: optimistic bounce

Given the degree of uncertainty, the RBNZ's economic forecasts are broadly similar to our own. Economic activity records an unprecedented decline in Q2, with most activity resuming from Q3 as the alert levels are relaxed, but by the end of the year the level of economic activity is still below pre-COVID-19 outbreak levels.

One of the key differences between our forecasts is we believe the RBNZ's assumed bounce back in activity is too optimistic. The Q3 bounce-back (as the Alert Level is relaxed) may prove a little too strong, likewise the pace of recovery over 2021. The RBNZ's baseline is that economic activity is down 'just' 4.5% on year-ago levels in Dec 2020 – this compares to ASB's more pessimistic forecast of a 7% annual contraction. Indeed, the RBNZ's annual contraction is likely to be at the more optimistic end of the scale of NZ economic forecasters. Having said that, the RBNZ has had clearer insights into the extent of forthcoming fiscal stimulus.

NZ Annual Average GDP Growth Forecasts



Source: Macrobond, ASB

Furthermore, given the virus outbreak is likely to prove to be a multi-year challenge, 2021 economic growth is likely to remain hampered by ongoing travel restrictions or quarantine requirements, along with elevated rates of unemployment. On that basis – we probably see the economic recovery trajectory is likely to be closer to the RBNZ's "slower recovery" scenario.

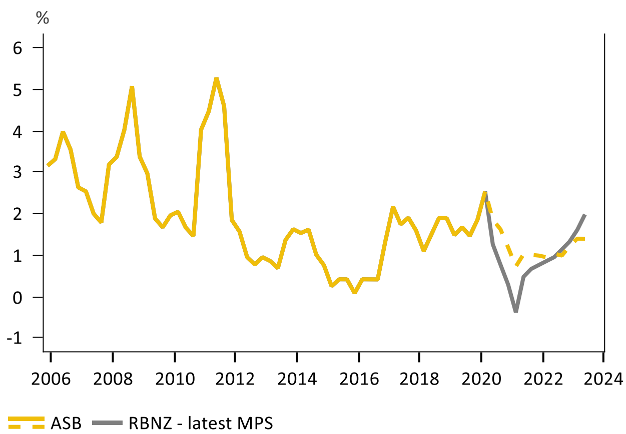
As a result of this stronger economic bounce back, the RBNZ also sees a faster fall in the rate of unemployment.

RBNZ sees deflation risks

In saying all of this, the RBNZ has a quite dire view of domestic inflation pressures, with much weaker inflation forecasts than our own. Even if the RBNZ is over-estimating the pace of recovery, it cannot be accused of under-estimating the inflation risks – which is what *really* matters for an inflation-targeting central bank. The RBNZ's central forecasts flirt with deflation – the annual CPI dipping briefly sub-zero, to -0.4% in March 2021. These weak inflation forecasts translate to a very weak interest rate projection.

In the RBNZ's model, the OCR is the representation of monetary policy stimulus – and the RBNZ's economic projections are consistent with the OCR falling to -2.4%. In practice, the RBNZ cannot cut the OCR at this time, so other policy tools are the main mechanism to deliver this additional stimulus – which is more or less equivalent to a deeply negative OCR. In today's case this has been the expansion of bond purchases – and as the RBNZ focuses on retail interest rates it may look to other tools going forward to deliver this necessary stimulus.

NZ Annual CPI Inflation Forecasts



Source: Macrobond, ASB

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