ASB

Economic Note

RBNZ May 2020 Monetary Policy Statement Preview

7 May 2020

Running to stand still

- We expect the RBNZ to increase its QE programme, to $60b.
- As it accommodates the larger debt issuance plans of the NZ government.
- Implementation flexibility cautions against getting too hung up on the exact number.
- Markets will be most sensitive to any guidance on negative interest rates. We think QE represents a more effective policy weapon but, equally, we don't expect the RBNZ to rule out the OCR going negative in future.

The world has changed in a lot of ways since the RBNZ last issued a Monetary Policy Statement ~~a year~~ 2½ months ago. This extends to monetary policy, where there's now a whole lot more going on besides just the setting of the Official Cash Rate.

A key focus of the May Statement will be by how much the Monetary Policy Committee (MPC) decides to lift its quantitative easing (QE) programme. We first flagged several weeks ago that a big increase was required, and now believe the size of the programme could be lifted to $60b (more detail below). We and the consensus expect the OCR to be left at 0.25%.

Rather than additional stimulus per se, the QE upsize is more akin to running to stand still. Since the RBNZ first announced its intention to enter the world of QE and buy significant amounts of government bonds in late March, the NZ Government has massively increased its debt issuance plans as it continues to roll out fiscal support across the economy. Thus, the RBNZ needs to level-up its QE buying to ensure this extra debt issuance doesn't lead to an unhelpful increase in wholesale interest rates, particularly at a time when the economy is so vulnerable.

The second key area of interest will be any guidance provided around the potential for the cash rate to go negative in future. We think the Bank will want to keep this option open, even if our own view is that QE represents a more effective policy weapon at present. The MPC may even tinker with its forward guidance so as to not explicitly rule out the option of the OCR going negative at some point.

Putting a stake in the ground

The Bank hasn't released a set of economic projections since the now hopelessly out of date February MPS. As such, the May Statement will be important for establishing the RBNZ's COVID-19 economic base case, from which we can assess the incoming flow of data and hence future policy decisions. Reflecting the particularly uncertain economic climate, the Bank will also be publishing a range of economic scenarios and, presumably, an accompanying policy response for each.

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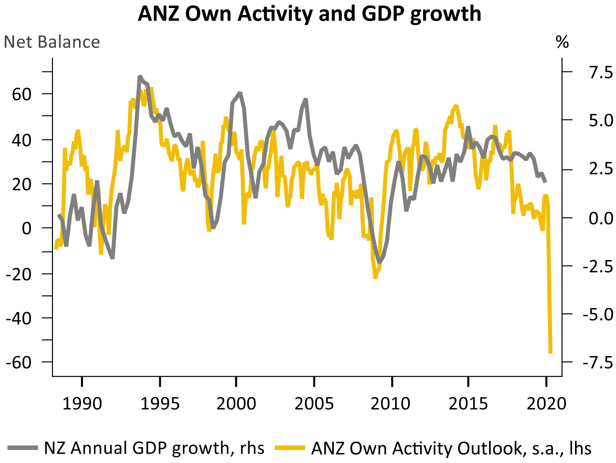
NZ is slowly emerging from lockdown, but the economy is in free fall. We've published a set of economic forecasts (see table at end of note) and scenarios for how things could play out, but the reality is we won't know with any surety for a long time.

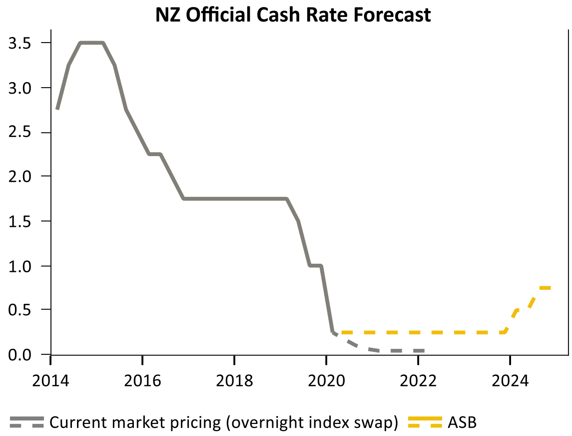


Source: Macrobond, ASB

Of the limited post-lockdown data we have seen, we doubt there would have been anything to particularly surprise the RBNZ. The timeliest forward indicators we have – business and consumer confidence – are broadly consistent with our expectation for a contraction in the NZ economy of around 7% over the coming year, and a lift in the unemployment rate to around 9½%.

Whatever the particulars of anyone's forecasts, the outlook remains beset with downside risks and uncertainty is rife. Given this, the best move from a monetary policy perspective is to keep policy as stimulatory as possible, and wait for the fog to clear a little.

The right tool for the job



Source: Macrobond, ASB

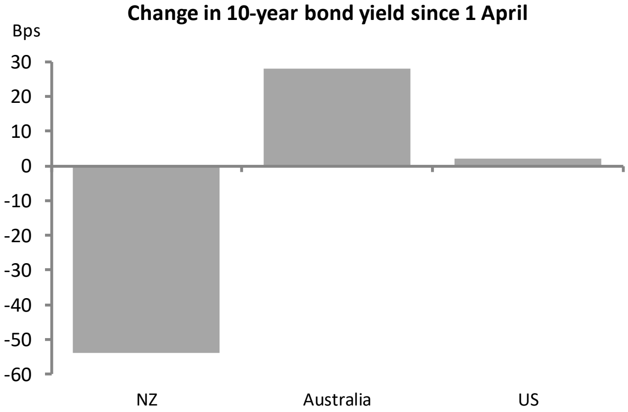
But what is the best way to achieve this?

There's been speculation that the Bank could take the OCR into negative territory. Indeed, financial market pricing now puts the OCR at 0.05% by November. An 80% chance the OCR is reduced to zero, in other words.

The RBNZ effectively pledged in March to keep the OCR at 0.25% for 12 months (which runs out in March 2021), with the MPC concluding that "this guidance would also provide clarity to financial market participants that a negative OCR would not be implemented over this period". Of course, the RBNZ is free to change its mind, and that commitment predated the economic impact of NZ's dramatic COVID lockdown.

Our take is that QE remains the more effective policy tool, and that the Bank will keep it as its policy easing 'headline act' for the meantime. But we doubt the RBNZ will rule out a negative OCR next week. It needs to keep all of its options open in dealing with a shock as unprecedented as this one. What's more, *speculation* of negative rates is actually proving relatively helpful in assisting the RBNZ in pushing wholesale interest rates down. We may even see a small change in the RBNZ's forward guidance to effectively ratify the option of the OCR going negative *at some point*. We suspect the RBNZ's OCR forecast track, which currently extends to the March quarter of 2023, will be flatlined at 0.25%, but perhaps with a faint downward slope to reflect the possibility of future OCR cuts to zero or below in future.

To be clear though, we don't think a negative OCR is the best tool for the job, at present. First, the offshore experience with negative interest rates been decidedly mixed. Even with a central bank policy rate below zero, corporate and retail lending rates have almost always remained positive (Denmark being the one exception we're aware of). The associated squeeze in banks' net interest margins from negative rates has frequently seen banks operating in this regime reduce the supply of credit. This would be the last thing the RBNZ would want to happen in the current environment.



Source: Bloomberg

Second, QE in New Zealand has been a runaway success so far. So the need to undertake new and potentially risky forms of monetary easing is not particularly pressing in our view.

In fact, QE has worked so well in reducing government bond yields, were it not for the approaching government Budget we suspect the RBNZ would probably now be 'tapering' bond purchases in the same way the Reserve Bank of Australia and US Federal Reserve have been. Ten-year NZ government bond yields have fallen around 50bps over the past month – a much larger fall than in most other developed markets running QE. The NZ financial system is flush with cash and the NZD is probably lower than it would otherwise be. That's three ticks for effective monetary easing.

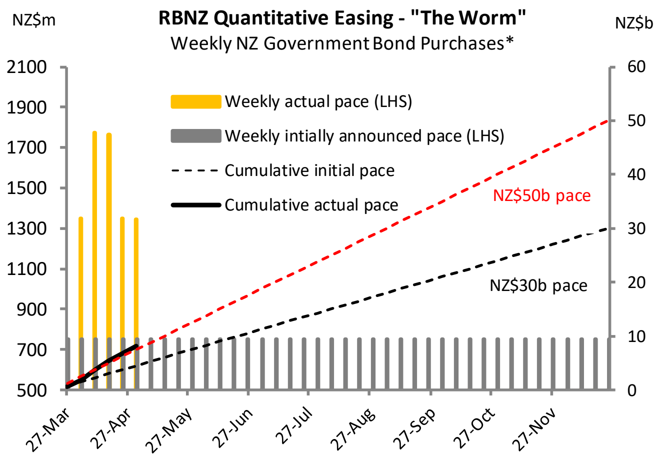
The idea of the RBNZ directly financing the government has also been floated. This would involve the central bank buying government bonds directly off the Treasury, rather than off financial institutions in the secondary market. We don't really have an issue with the concept given that the RBNZ is going to end wind up with nearly half of all government bonds on issue regardless. But for choice, the current method of operating in secondary markets appear to offer the best bang for the RBNZ's buck. Dealing actively "in-market" can exert a stabilising force where necessarily, and also provides a powerful signal to market participants.

More of the good stuff

So how big will QE get?

The first point to note, as we did in our mid-April note, is that the RBNZ has been front-loading bond purchases anyway. So much so that, practically speaking, the QE programme to date has been more akin to a $50b+ programme than the announced $30b (excluding $3b of LGFA purchases, see chart).

We've previously been calling an upsize from $33b to at least $45-50b. We now think it could be even larger, around $60b.



Source: RBNZ *does not include LGFA purchases

At the time the current $30b QE programme was announced it was large enough to purchase approximately 50% of all NZ government bonds on issue over the coming 12 months. That is no longer the case. We now project nominal government bonds outstanding will rise to around $70b by June 2020 and $110b by June 2021 as the Government's COVID package increases and broadens. The RBNZ is still happy to own 40-50% of all bonds on issue which means upgrading to a QE buying programme of $45-55b. Adding in $3b of Local Government Funding Authority bond purchases and the likely addition of $3-5b worth of inflation-linked bonds and you get to around $60b.

There is a slight scheduling headache for the Bank. The 2020 Budget, and associated update to the bond programme, will be released one day after the RBNZ's MPC announces its decision. We think the Government will throw a heap more cash at the crisis and there's every chance the bond programme could get yet another nudge higher. Whether or not the Bank knows the exact contents of the Budget (the Treasury and Bank are working very closely at present), this may well see the MPC err on the side of going larger.

In any case, our view is that the exact size of the programme is not something to get overly hung up on. Whatever the outcome, the Bank will retain its ability to flex weekly bond purchases to suit market conditions and the magnitude of government bond issuance. The MPC just needs to ensure the overall programme size is large enough not to be an immediate constraint. And it can raise its purchase ceiling quickly if it needs to.

ASB NZ economic forecasts	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Mar-22	Mar-23
	<< actual	forecast >>						
GDP real - Q%	0.5	-1.0	-17.3	11.6	1.8			
GDP real - A%	1.8	0.3	-17.0	-8.1	-6.9	-6.1	2.7	4.8
GDP real - AA%	2.3	1.6	-3.2	-5.8	-8.0	-9.5	4.9	4.6
CPI - Q%	0.5	0.8	0.0	0.5	0.0			
CPI - A%	1.9	2.5	1.9	1.7	1.2	0.8	0.9	1.4
HLFS employment growth - Q%	0.0	-0.3	-5.8	-1.5	0.6			
HLFS employment growth - A%	1.0	0.7	-5.8	-7.5	-6.9	-6.3	3.0	2.7
Unemployment rate - %sa	4.0	4.4	9.0	9.4	8.6	8.4	7.2	6.3
Annual current account balance as % of GDP	-3.1	-3.3	-3.7	-3.8	-4.3	-4.8	-3.4	-2.3

Q% = percentage change on previous quarter

A% = percentage change since same quarter the previous year

AA% = percentage change for year ending quarter since the previous year

ASB interest rate forecasts	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>					
NZ OCR	1.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25
NZ 90-day bank bill	1.29	0.51	0.50	0.50	0.50	0.50	0.50	0.50
NZ 2-year swap rate	1.26	0.53	0.50	0.50	0.50	0.50	0.50	0.60
NZ 5-year swap rate	1.45	0.63	0.65	0.65	0.65	0.65	0.65	1.05
NZ 10-year swap rate	1.78	0.93	1.00	1.00	1.50	1.50	1.10	1.50
NZ 10-year Bond	1.65	1.03	1.40	1.40	1.40	1.40	1.40	1.45

ASB foreign exchange forecasts	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>					
NZD/USD	0.67	0.60	0.55	0.58	0.60	0.61	0.64	0.65
NZD/AUD	0.96	0.97	0.96	0.97	0.95	0.94	0.94	0.94
NZD/JPY	73	65	54	58	61	63	67	69
NZD/EUR	0.60	0.54	0.47	0.51	0.53	0.54	0.57	0.58
NZD/GBP	0.51	0.49	0.46	0.47	0.48	0.48	0.49	0.50
NZD/CNY	4.7	4.3	3.9	4.1	4.2	4.3	4.5	4.6
NZD TWI	73.8	68.8	63.7	66.6	68.1	68.8	71.5	72.4

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