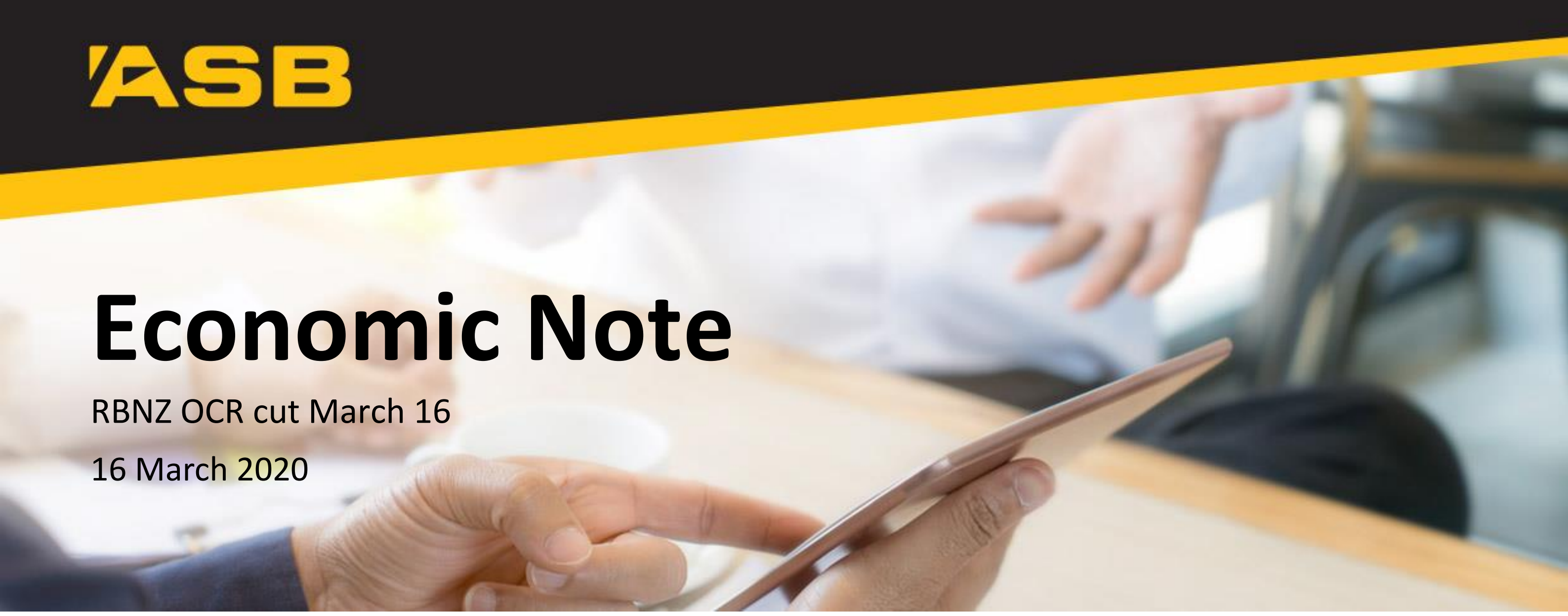

ASB

Economic Note

RBNZ OCR cut March 16

16 March 2020

Time to throw the Kitchen Sink

- Events have – again – moved rapidly. The virus is spreading; further extreme government actions are in play.
- The RBNZ has cut the OCR by 75bp this morning to cushion the significant economic hit.
- We expect the RBNZ will reach for the unconventional policy toolkit over time.

Overview

Events have yet again moved fast in a short space of time, and the Reserve Bank of NZ (RBNZ) has responded. **COVID-19 is spreading very rapidly, and more extreme travel bans are coming into effect**. **NZ's border has effectively been closed, which will heavily impact on the tourism sector and push NZ into recession.** Global financial markets have been in panic mode, even with announcements of large government support packages and central bank action.

The RBNZ is now doing its part. It's not just cost but also the availability of credit that can matter, which is something for Government, the RBNZ and the banking sector to work on together. **The RBNZ has cut the OCR by 75bp to 0.25%, which the RBNZ perceives is the current lower bound for the OCR due to financial system operational reasons. The RBNZ has provided forward guidance by committing to keep the OCR at 0.25% for at least 12 months and cancelled its March 25th decision**. The RBNZ's bank capital increases have also been postponed for at least a year. From here, unconventional monetary policy tools would be next, starting with government bond purchases – and the Government is likely to need to issue heavily soon as it spends to prop up the economy.

The global economy is going to take a hit from the spread of both the virus and of huge containment measures. **NZ is fortunate that – to date – it has very few confirmed cases. Even so, an outbreak remains near inevitable,** given how open our borders have been until now to countries with community outbreaks. Even without a local outbreak, NZ is starting to experience effects of people and organisations taking greater precautions.

Economically, we think it is important to support not just the people affected but also to preserve their jobs for the recovery phase. That means affected businesses need to receive enough support from various quarters that they get through the coming disruption intact. The vast majority of businesses in NZ were in a sound position before the COVID-19 outbreak and will have good prospects again once behaviours eventually return to normal.

The Government remains the most effective source of support and will announce a response package shortly. **We call on the Government to put in place measures that can support the wider economy at large, in addition to the targeted approach it has taken to date. Measures are needed that will quickly get cash to the people and businesses that are going to feel financial pressure very shortly.**

In this environment of uncertainty and fear, it is important that people keep calm and make well thought out decisions. It's important to do scenario and business contingency planning: if you haven't, we suggest you read our 'Be Prepared' note. Businesses also need to think actively about the implications for any financial market exposures and hedging, on which we have some thoughts here.

For our various customers sets, we have included some brief considerations at the end of this note.

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Where to from here?

We expect that monetary policy will start to push the limits of what it can do. The effectiveness of conventional monetary policy fades as you get close to zero. The RBNZ has signalled that it has cut the OCR as far as it intends to, at least for now. We estimate the practical limitation on the OCR is somewhere in a range of -0.25% to -0.75%. It is always possible that the RBNZ does push below 0.25% once operational limitations in the financial system are addressed.

So what are the unconventional options to use? Last year we went through the various possibilities in this paper. The RBNZ is also refining its views on the pros and cons of the various measures and will publish its conclusions shortly. These measures could be put in place to further support the economy if needed, if the OCR ever hit its practical lower limit. The key options are:

- Conduct asset purchases, via **purchasing NZ Government bonds – the RBNZ has indicated this is the first cab off the rank**;
- **Provide explicit forward guidance, committing to hold the OCR at the lower bound for either a long period of time (done)** or until there are signs that the trend in inflation is above the midpoint of the 1-3% inflation target;
- Introduce tiered lending to mitigate the impact of the low OCR on financial institutions (particularly if at a zero/negative OCR);
- Direct market intervention via 'receiving' long-term interest rate swaps to hold down long-term yields;
- Providing long-term funding to banks to support credit creation; and
- Undertake unsterilised FX intervention to lower the NZD.

Fiscal and monetary policy together

Both fiscal and monetary policy will be working to offset what looks to be a major economic shock. The RBNZ statement noted "imminent intentions to increase government support", citing a fiscal package to provide both "targeted and broad-based economic stimulus". This is the sort of event is when the Government's balance sheet should be used and tomorrow's Government fiscal announcement can't come too soon.

We expect the NZ fiscal package to be sizeable and front-loaded, with a major focus on minimising job losses. This "kitchen sink" approach will not come cheap and we envisage significant government deficits ahead. Luckily New Zealand's fiscal position is currently strong, with low debt, a luxury that few other governments have.

Today's statement emphasised the necessary interplay between fiscal and monetary policy in such an event. With the OCR already at its 0.25% lower bound for now, the RBNZ reiterated that further fiscal stimulus is expected to come via a Large Scale Asset Purchase programme of New Zealand government bonds. At present, there are around $81bn of government bonds outstanding. Expect the government bond portfolio to get a lot, lot bigger over the coming years. The 25% government debt limit will be binned and ratings agencies are likely to turn a blind eye.

Considerations for customers

We appreciate that the current environment raises a lot of questions and concerns for people, be they depositors, borrowers or KiwiSaver investors. For those who came to adulthood after the Global Financial Crisis, this will be people's first experience of share market meltdowns amidst an environment of fear.

Our main message is: keep calm. If you are making any decisions, make them as rationally as possible, think them through for a bit rather than making snap judgement, and don't be afraid to seek advice or sounding boards.

It is worth reflecting on "Mr Market", the hypothetical investor who oscillates wildly between optimism and pessimism, as constructed by Benjamin Graham (considered the father of value investing and Warren Buffett's mentor).

If you are a depositor: term deposit rates are likely to fall a bit further, so interest income streams will come under pressure over the next year or more. On the flip side, those low returns are also in part because deposits face far less risk than other investments – the value of your principal has not been affected by the latest market gyrations, something to put some value on. Being in cash protects your principal, though also means no exposure to any upside should other asset classes rebound when people start perceiving a light at the end of the tunnel. Banks periodically offer 'special' term rates: you can keep an eye on ASB's rates here.

If you are a borrower: wholesale and mortgage rates have fallen sharply. It is possible they fall further as a result of today's OCR cut. The next few months will provide good opportunities to lock in low fixed-rate borrowing costs. For home borrowers, ASB's mortgage rates are here, and keep an eye out for the Economics team's periodic updates of our thoughts on home loan rates. Commercial and corporate borrowers (and foreign exchange users) can get some ideas here. Businesses should keep in touch with their banking contacts over the availability of credit and their needs which could change during the downturn and subsequent upswing.

If you are a KiwiSaver, managed fund or share investor: equity markets, which form part of the investment portfolios for a number of balanced or growth funds, can gyrate wildly in times of panic when people are making decisions out of fear of making losses. But timing markets is hard, including trying to time when to exit and when to get back in. Selling shares or shifting managed funds into cash funds may simply realise losses, particularly when markets have already dropped, and shuts off any chance of benefitting when markets eventually rebound. Remembering what your investment goals are and acting *calmly* in accordance with them is worth doing. If you are saving for retirement, bouts of market declines, although unpleasant, will happen many times over the course of a full working/investing lifetime.

RBNZ's statement:

OCR reduced to 0.25 percent for next 12 months
16 March 2020

The Official Cash Rate (OCR) is 0.25 percent, reduced from 1.0 percent, and will remain at this level for at least the next 12 months.

The negative economic implications of the COVID-19 virus continue to rise warranting further monetary stimulus.

Since the outbreak of the virus, global trade, travel, and business and consumer spending have been curtailed significantly. Increasingly, governments internationally have imposed a variety of restraints on people movement within and across national borders in order to mitigate the virus transmission.

Financial market pricing has responded to these events with declining global equity prices and increased interest rate spreads on traditionally riskier asset classes.

The negative impact on the New Zealand economy is, and will continue to be, significant. Demand for New Zealand's goods and services will be constrained, as will domestic production. Spending and investment will be subdued for an extended period while the responses to the COVID-19 virus evolve.

Several factors will continue to assist and support economic activity in New Zealand.

New Zealand's financial system remains sound and our major financial institutions are well capitalised and liquid. The Reserve Bank is also ensuring that the banking system continues to function normally.

The Government is operating an expansionary fiscal policy and has imminent intentions to increase its support with a fiscal package to provide both targeted and broad-based economic stimulus.

The New Zealand dollar exchange rate has also depreciated against our trading partners acting as a partial buffer for export earnings.

And, the Monetary Policy Committee agreed to provide further support with the OCR now at 0.25 percent. The

Committee agreed unanimously to keep the OCR at this level for at least 12 months.

The Committee also agreed that should further stimulus be required, a Large Scale Asset Purchase programme of New Zealand government bonds would be preferable to further OCR reductions.

More information:

- There will be no OCR Review on 25 March 2020
- Record of Meeting
- The revised OCR will be effective from 17 March 2020
- A live-stream of a media conference, with Governor Adrian Orr, will be available on the RBNZ YouTube channel at 11am today.

Record of meeting – Extraordinary OCR Review – 15 March 2020

Members met for an extraordinary session of the Monetary Policy Committee on 15 March at 2.30pm. This meeting was called in response to the rapidly deteriorating economic situation relating to COVID-19.

Staff briefed the Committee on agreed Reserve Bank financial stability measures that were to be announced in co-ordination with any monetary policy decision. The Secretary to the Treasury outlined the broad scale of intended fiscal policy measures in light of the deteriorating economic outlook.

Staff presented indicative scenarios of the impact of COVID-19 developments on the economy. However, it was noted that there is extreme uncertainty around these estimates, and that risks had already shifted to the downside since the scenarios had been finalised.

It was agreed that, since meeting in February, the outlook for the economy had deteriorated significantly as a result of the impacts of COVID-19. The slowdown in the global economy would act as a serious headwind for the New Zealand economy. International and domestic initiatives to limit the spread of the virus would have a serious impact on travel and trade affecting both supply and demand channels in the economy. It was agreed that the Government and the Reserve Bank of New Zealand had a vital role to play in cushioning the economic impact through fiscal, monetary and financial stability measures. The members welcomed the Government fiscal response and the Reserve Bank's financial stability measures.

The Committee discussed the effectiveness of a monetary policy response given the nature of the economic shock and agreed that a significant easing in monetary policy was required in order to achieve the goals of price stability and maximum sustainable employment. Such a response would also support co-ordinated financial stability measures, and the upcoming announcement of fiscal stimulus.

The members discussed the broad range of Official Cash Rate (OCR) settings that would be suitable. Staff briefed the Committee on the scale of policy stimulus required given deteriorating global conditions and the impact of travel restrictions. The Committee discussed the relative contributions of planned fiscal and financial stability measures in consideration of the monetary policy response. Staff also advised that an OCR of 0.25 percent was currently the lower limit, given the operational readiness of the financial system for very low or negative interest rates.

Subsequent Committee discussion focused on two scenarios:

- A 0.5 percentage point cut in the OCR to 0.5 percent, followed by an assessment of the rapidly developing COVID-19 situation, with the ability to follow up with more stimulus as needed at the scheduled March OCR review
- A 0.75 percentage point reduction in the OCR to 0.25 percent.

Members noted that lower interest rates would likely support the soundness of the financial system – in the context of the Committee's Remit.

Given views on the required level of stimulus given the economic impact of COVID-19, the committee agreed a 0.75 percentage point reduction in the OCR would be a more suitable option.

The Committee then discussed supporting this significant monetary stimulus with forward guidance. Members agreed to provide forward guidance that the OCR would stay at the level of 0.25 percent for at least 12 months. This guidance would also provide clarity to financial market participants that a negative OCR would not be implemented over this period.

The Committee was also briefed by staff on additional monetary tools, and which were likely best suited to providing additional stimulus, noting that the recently published principles recognise the best tool depends on the particular circumstances. Assuming markets are functioning effectively, staff indicated Large Scale Asset Purchases of New Zealand Government bonds were the next best monetary tool available to the Committee. The Committee agreed with this assessment. However, the Committee agreed that additional tools were not needed at this point.

The Committee reached a consensus to:

- Cut the Official Cash Rate to 0.25 percent.
- Provide forward guidance that the OCR would remain at 0.25 percent for at least 12 months.
- Agree that Large Scale Asset Purchases of New Zealand government bonds would be the best additional tool to provide further monetary stimulus in the current situation – if needed.

The committee agreed that the scheduled meeting of the Committee on 25th of March was no longer required.

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