Economic Note

RBNZ Pulling Out The Stops

24 March 2020

Three bold steps taken, but more may be needed

- The RBNZ has cut the OCR to its lower operational bound of 0.25% and pledged it will remain at this level for at least the next 12 months. Whether the OCR eventually goes lower than 0.25% depends on the economic outlook, willingness of financial market participants to hold eligible NZD securities and the appetite of retail depositors.
- The RBNZ and other central banks have put in place a raft of measures to improve monetary policy implementation and to keep the financial system functioning have also been announced to calm jittery markets. These have helped for now, but more will be needed if markets flare up from here.
- On March 23, the RBNZ kick-started its Quantitative Easing (QE) programme, unveiling a large $30bn Large Scale Asset Purchase Programme of NZ Government bonds over the next 12 months. The package is front-loaded and will provide considerable short-term support to NZ interest rate markets, dampening yields. RBNZ QE could be ramped up further if needed, but we are concerned that a persistent COVID-19 hit to the public finances could see it dwarfed by climbing NZ public debt. We encourage the RBNZ to look at alternative options available.

These are extraordinary times and policymakers in NZ and abroad have pulled out the stops to try and lessen the economic damage caused by COVID-19. The NZ Government has stepped up its response to the outbreak, announced a substantial $12.1bn package (4% of GDP) on March 17 and on March 23 signalled its is prepared to more significantly leverage off the crown balance sheet to support the economy over the coming years.

Recent NZ policy actions are a good example of complementary government policy, with the RBNZ having played its part. On March 17, the OCR was cut by 75bps with the pledge it will be held at its 0.25% operational and record low until early 2021. Central bank policy rates overseas have been aggressively cut and a raft of measures by the RBNZ and other central banks have been proposed and put in place to improve monetary policy implementation and to keep the financial system operating. These actions are welcome. However, such is the scale of the challenge posed by COVID-19 that markets are likely to remain on edge and further support measures could be needed.

The RBNZ also front footed its Quantitative Easing response, announcing on March 23 that it will be implementing a $30bn Large Scale Asset Purchase Programme of NZ Government bonds over the next 12 months. Of the unconventional measures available, NZ Government bond purchases look to be the most appropriate given current circumstances. Wisely, the RBNZ has kept its options open, signalling purchases will be made across a range of maturities and that the programme could be stepped up beyond that if needed. The $30bn programme is massive, around 10% of NZ's annual GDP, but it is not out of step with measures employed by other central banks. The RBNZ's bond buying, in conjunction with other measures will continue to help to dampen interest rates, with a sizeable fall in government bond and swap yields occurring following the March 23 announcement.

If COVID-19 proves to deliver a more enduring hit to the public finances, there is the risk that the RBNZ asset purchases will be dwarfed by the climb in NZ public debt over the coming years, lifting yields. We encourage the RBNZ to investigate other options, including measures to prepare financial institutions for potentially negative interest rates and investigating the possibility of direct intervention into swap markets.

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Pulling out the stops

The NZ Government has stepped up its response to the COVID-19 outbreak. In the weekend a four-level COVID-19 alert system was announced, specifying the health and social measures to be taken. The number of cases in NZ has topped 100, with growing risks of community-wide transmission. On March 23, the Alert level in NZ was raised from Level 2 to Level 3, with people not working in essential services urged to prepare to go into self-isolation within the next 48 hours (i.e. move to Level 4). **NZ looks set to go into a period of isolation for the next four weeks.** NZ's borders will remain closed to travellers, most shops and public facilities will be shut, public transport scaled back, and schools, childhood centres and tertiary institutions closed. Many workplaces will be closed, with non-essential employees urged to work from home where possible. Supermarkets, medical centres and other essential services will remain open**. It will be painful, but it is the right thing to do.** Such measures are necessary to save lives and to give NZ its best chance to get through the outbreak.

Fiscal policy looks set to step up further. The $12.1bn NZ support package announced last Tuesday was deemed to be the "beginning" of what will be a substantial fiscal response. On March 23, the NZ Minister of Finance announced further support, including expanding the wage subsidy to all impacted businesses and the self-employed, rent freezes, widening the package of income support throughout the economy and, along with banks, expanding lending to impacted businesses. NZ will not be the only ones. On March 22, Australia has announced an AUD190bn fiscal stimulus package (roughly 10% of its GDP), a considerable step up on the AUD18bn initially offered. The US, UK, and Europe have continued to look at extending fiscal policy support despite having weaker government balance sheets.

Substantial fiscal deficits lie ahead, both in NZ and overseas. We are wary of putting numbers out there without doing more comprehensive analysis but note that NZ Government debt issuance will be scaled up substantially in the coming years. The NZ government bond programme looks set to get much, much bigger and should relax some of the recent constraints to RBNZ quantitative easing from having a small NZ Government bond market (around $80bn currently on issue).

We see three broad areas where the RBNZ is playing a role:

Lower OCR settings

The RBNZ has moved decisively. In an extraordinary session of the Monetary Policy Committee (MPC) on March 15, the RBNZ cut the OCR by 75bps to a record low of 0.25% (effective March 17), citing the need for further monetary stimulus given the deteriorating economic situation relating to COVID-19. **The MPC also provided forward guidance,** pledging to hold the OCR at this level for at least the next 12 months (until at least March 2021), to provide clarity to financial market participants**.** If more stimulus was needed, the RBNZ flagged large scale asset purchases (i.e. QE) rather than cutting the OCR further. **The RBNZ has dismissed the notion of further OCR cuts over the next 12 months but have not ruled out the possibility beyond that. "**This guidance would also provide clarity to financial market participants that a negative OCR would not be implemented over this period".

Our take

COVID-19 poses a fundamental change to the outlook, and the RBNZ has decisively moved onto the front foot and have put as in much conventional monetary stimulus as quickly as they could and has been explicit in its forward guidance. Significant policy interest rate cuts have been delivered by global central banks, with policy interest rates now around zero and close to operational lows. **Could the OCR move below 0.25%?** A negative policy rate is theoretically possible, and various policy rates are currently negative in much of Europe. As we noted in our late 2019 paper on unconventional policy measures, the OCR could go as low as -0.25% to -0.75%. However, this will depend on two factors, including the willingness of financial market participants to hold eligible NZD securities (paying negative interest rates on settlement accounts held at the RBNZ would be costly to banks, impairing monetary policy transmission), and whether banks will be able to attract sufficiently high funding from depositors. Further work by the RBNZ on improving the readiness of the NZ financial system to work with a lower OCR would not go amiss.

Measures to improve monetary policy implementation and to keep the financial system functioning

The last few weeks have been characterised by wild swings in financial markets. Risk and liquidity metrics have flared up. Last week, spreads of various types - Libor-OIS, credit, corporate bonds and swaps - widened appreciably over the past few weeks **suggesting that a fundamental repricing of risk is going on**. Despite the weak economic outlook, longer-term yields had firmed as markets started to factor in the likelihood of a sizeable ramping up in government borrowing.

Over the last week or so the RBNZ has taken steps to bolster liquidity and improve monetary policy implementation:

- On Monday March 16, the RBNZ delayed the start date of increased capital requirements for NZ incorporated banks by 12 months - to 1 July 2021. This will free up close to $50bn in lending capacity.
- On Friday March 20, the RBNZ announced that it will support banking system liquidity via the Term Auction Facility (TAF). The facility will operate in a similar manner to the Reserve Bank's Open Market Operation (OMO) and will be used to inject cash into the banking system using approved eligible collateral. Liquidity will be injected via both FX swaps and the reinstated Term Auction Facility, which offers banks term funding (3,6 and 12 month) against a range of collateral. This facility will be reviewed in 12 months' time or sooner if demand diminishes.
- The RBNZ has re-established a temporary USD swap line with the US Federal Reserve. This will support the provision of up to USD30bn in liquidity to the New Zealand market.
- The RBNZ also announced the changes to its monetary policy implementation framework, to ensure that short-term interest rates continue to trade near the Official Cash Rate (OCR). These include removing credit tiers for Exchange Settlement Account System (ESAS) holders, and all ESAS credit balances will be remunerated at the OCR. Other facilities and their pricing remain unchanged.
- The RBNZ has been providing liquidity to the NZ Government bond market to support market functioning.
- Moreover, the RBNZ has affirmed that cash and other payments systems were ready for COVID-19.
- On a related note, the Reserve Bank announced it will delay or slow down most of its regulatory initiatives for an initial period of six months. This action is being taken to reduce the regulatory impost on financial institutions.

Actions from the RBNZ are in conjunction with those imposed from other central banks:

- On March 15, the US Federal Reserve created a funding facility to supply liquidity to money market funds. The FOMC also expanded its USD swap lines to nine additional countries, including NZ, for a combined total of US$450b. On March 23, the FOMC released five new or enhanced credit programmes to bolster liquidity and support lending. More look set to follow.
- Last week, the Reserve Bank of Australia (RBA) introduced a term funding facility for the banking system of at least $A90bn in size that will lower the borrowing cost for small to medium-sized businesses;
- The European Central Bank (ECB) had earlier decided on additional longer-term refinancing operations (LTROs) to provide immediate liquidity support to banks and to safeguard money market conditions.

Our Take

The RBNZ has been proactive and has taken steps to ensure that markets trade in an orderly fashion, encourage sufficient liquidity to be provided to markets and see that funding can be accessed at rates near the OCR. The decision to delay capital requirements will help reduce pressures on the supply of lending, although obtaining credit could be challenging for borrowers with high exposure to sectors impacted by COVID-19. **These large liquidity injections are welcome and should help narrow (elevated) money market spreads**. We have seen some retracement in widening spreads, with NZ yields sharply lower following the March 23 RBNZ announcement on large scale asset purchases. However, markets are likely to be more selective and risk averse and will price sectors that have a higher exposure to COVID-19 accordingly (higher risk premia or reduced availability of funds). Much of the recent widening we have observed in spreads is likely to be persistent and capital availability could remain challenging for sectors exposed to COVID-19 (e.g. tourism, hospitality). Announced government initiatives to facilitate the provision of credit to impacted businesses are welcome and will help many NZ businesses to resume trading after NZ passes through its lockdown.

Unconventional policy measures including Quantitative Easing

On March 23, the RBNZ announced that it will be purchasing up to $30 billion of New Zealand Government bonds, across a range of maturities, over the next 12 months. This is NZ's first real experiment with Quantitative Easing (QE). The program is large, equating to just shy of 10% of NZ's annual GDP and had been flagged in advance, with the March 16 OCR decision noting that further policy stimulus will come from large-scale asset purchases rather than OCR cuts. Rather than purchase NZ Government bonds directly from the Treasury, the RBNZ will buy bonds in the secondary market (i.e. participate in the regular bond tender programme) with RBNZ purchases reportedly capped at $750m per tender. Moreover, the RBNZ have kept the option of scaling up and tweaking the QE programme in future if needed.

The adoption to QE in NZ brings the RBNZ into line with what other central banks have been doing of late:

- On March 15, the US Federal Reserve signalled an additional USD700bn of asset purchases in the coming months, USD500bn of which will be US Treasuries. It has since announced it is prepared to undertake potentially unlimited purchases of US Treasuries and other asset classes.
- Last week, the Reserve Bank of Australia launched a quantitative easing programme (bond buying) with a target yield for 3-year Government bonds of "around" 0.25%. With the Australian government set to roll out a sizeable fiscal support package this week, more bond purchases by the RBA seem likely.
- In two programmes, the European Central Bank (ECB) instigated €870bn in private and public bond purchases. On March 20, the Bank of England added £200bn (total £645bn) to its asset purchase program.

Our Take

Our paper on unconventional policy measures highlighted several available options to the RBNZ, including asset purchases, direct market intervention, and the provision of long-term funding to banks to support credit creation. **As we noted, the best tool will depend on the circumstances the economy is in. Government bond purchases are clearly the appropriate tool at present, illustrating effective co-ordination between monetary and fiscal policy**. Moreover, the design of the QE package (very large and front-loaded over the next 12 months), is designed to dovetail with what looks to be a very large (and hopefully short-lived) requirement from the NZ Government to borrow a significant amount of funds. The sizeable falls in NZ Government bond yields and NZ swap rates immediately following the March 23 RBNZ announcement suggest markets are on a similar wavelength.

We caution, however, that QE is not a panacea and its track record has been mixed. A look at the Japanese experience with QE does not inspire confidence.

We note that our strong fiscal starting point and low holdings of NZ Government bond holdings provides us with the luxury only a few sovereigns have. Even if the RBNZ goes ahead and purchases $30bn in NZ Government bonds, this would still leave the same ratio of central bank government bond purchases to GDP that the US Federal Reserve has at present.

Markets also need to be functioning reasonable effectively for unconventional policy measures to have a greater chance of success. Last week's decision by the RBNZ to provide liquidity to the New Zealand Government bond market was a clear signal the QE was soon to be unveiled. Great timing, excellent tactics and well-thought out decisions will be needed to ensure that the RBNZ's QE gets its best bang for buck, in terms of its impact on lowering interest rates faced by borrowers within the economy.

The economic impacts of global pandemics have typically been short-lived, with the RBNZ QE programme designed to deal with a very large, but short-lived impact on the NZ economy (and public finances). **However, if the impacts of COVID-19 prove to be more enduring, this could place considerable strain on the New Zealand (and global) public finances for a number of years, certainly longer than the 12-month window of the current RBNZ QE package.** There is the risk that the sheer volume of NZ and global government bonds set to be issued over the coming years will push NZ and global government bond yields higher.

We encourage the RBNZ to get creative and further investigate alternative policy options, including direct intervention in the interest rate swap market and widening its bond purchase programme beyond central government debt. This will come in handy, if for example, the RBNZ, wanted to deliver more direct stimulus to household and business borrowers.

We are going through extraordinary times. Now is the time for policymakers to get creative. However, providing we look out for each other, and stick to the plan, we will get through this. There is light at the end of the tunnel.

RBNZ Policy Measures

Measures	Likely RBNZ response	Our take
OCR	Cut OCR to 0.25% operational floor. Provide guidance not to change 0.25% OCR over next 12 months. Does not rule out the OCR going below that (and possibly negative) beyond them.	OCR at/below 0.25% until early 2022 if not longer. OCR endpoint of 1% by 2024. Negative OCR remains a possibility, but effective lower bound will depend on the economic outlook, willingness of financial market participants to hold eligible NZD securities and the ability of banks to attract sufficiently high funding from depositors.
Monetary policy implementation	Delay of higher bank capital requirements by 12 months. Inject liquidity via both FX swaps and the reinstated Term Auction Facility, which offers banks funding (3-,6- and 12-month terms) against a range of collateral. Credit tiers for ESAS holders to keep short-term interest rates close to OCR. RBNZ to providing liquidity to the NZ government bond market to enhance market functioning.	Delay in higher bank capital requirements welcome. More support will be needed if liquidity and credit seize up. COVID-19 will likely prompt a reassessment of risk. Spreads and credit availability will be impaired for much of 2020, potentially longer. The RBNZ and Government may need to act to maintain access to credit for impacted sectors.
Unconventional measures	On March 23, the RBNZ announce a Large-Scale Asset Purchase Program of $30bn in NZ Govt bonds over the next 12 months, and across a range of maturities. Scope to increase issuance and to look at other options if needed.	Government bond purchases by the RBNZ likely to be the most effective and will help cap upward pressure on NZ yields. A longer-lasting hit to the NZ public finances will likely see more QE, but this could still be dwarfed by the climb in public debt, and see yields move up. The RBNZ should investigate the feasibility of other options, including intervention in interest rate swap markets and setting a negative OCR.

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