Economic Update – First Impressions.

20 March 2020

RBNZ provides crucial market support measures.

- The RBNZ has stepped up with a range of measures to support financial markets and bank funding. These will keep short-term interest rates down, but more needs to be done to prevent long-term interest rates from rising unhelpfully.

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The Reserve Bank has announced a range of measures to support stressed financial markets. These measures were necessary, and we applaud the RBNZ's proactivity. These actions will help keep short-term interest rates low. However, the RBNZ needs to do more to prevent long-term interest rates from rising unhelpfully.

- **A Term Auction Facility.** The RBNZ will lend to banks for up to 12 months, taking Government bonds, residential mortgage-backed securities, and other bonds as collateral. This basically ensures banks will be well-funded for the foreseeable future. This will prevent an increase in the cost of bank funding, which in turn will help ensure that short-term interest rates for businesses and households remain low.

- **FX swap market funding.** Banks sometimes borrow money from offshore and swap the debt back to New Zealand dollars. In recent days the cost of performing this swap has exploded. Left unchecked, this could have caused an increase in the cost of funding New Zealand banks, which in turn could have led to higher interest rates in New Zealand. The RBNZ has essentially offered to facilitate some of those swap arrangements, which will keep the cost of overseas funding contained.

- **The US Federal Reserve and the Reserve Bank of New Zealand have established a $30bn US dollar swap line.** This will enable the Reserve Bank of New Zealand to borrow US dollars if it needs.

- **Providing liquidity in NZ Government bond markets.** As we noted yesterday, the interest rate on New Zealand Government bonds has shot higher because bond market liquidity has dried up. Yesterday the NZ Government borrowed at 2.6% for 17 years, whereas last week the interest rate would have been 1.3%. The RBNZ is now actively buying NZ Government Bonds on the open market, in an effort to provide liquidity. However, the amount of liquidity provided seems tiny so far, and has had little effect on longer-term Government bond rates.

- **The RBNZ is now paying the OCR on all cash balances banks hold at the RBNZ** (previously, banks were paid a lower rate if they held large balances). This will give the RBNZ greater control over short-term interest rates, keeping them closer to the OCR.

Yesterday we predicted that the RBNZ would have to take actions similar to these to calm stressed financial markets and reduce the cost of bank funding. The ultimate aim of these actions is to prevent New Zealand interest rates from rising in an unintended way, because higher interest rates would worsen the economic downturn.

Today's actions are likely to be effective at keeping short-term interest rates down, and will allow banks to continue lending smoothly.

However, so far the RBNZ has announced little that will effectively reduce long-term interest rates. In the wake of the RBNZ's announcement, long-term Government bond rates have fallen only 10 basis points or so.

We suspect the RBNZ is going to have to begin a Quantitative Easing program very soon, similar to the Reserve Bank of Australia's move yesterday. This would involve buying large quantities of Government bonds, which would reduce long-term Government bond rates.

The other way to keep longer-term Government bond markets calm is for the New Zealand Government to ensure that any future stimulus measures are temporary. Markets need to be assured that the Government has a plausible path to repaying the large debt it is going to incur as it cushions the economy through the Covid-19 recession.

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