Economic Bulletin.

7 May 2020

Preview of RBNZ MPS, 13 May – All hands on deck.

- Next week we expect the RBNZ will expand its QE programme to $60bn.
- The RBNZ may also announce a target interest rate for Government Bonds, similar to the Reserve Bank of Australia.
- And it may give more forward guidance, such as a commitment to keep buying bonds for a set period.
- We do not expect the RBNZ will explicitly signal a negative OCR. Now is not the time.
- However, we remain strongly of the view that the OCR will go negative in the future.
- What the RBNZ says next week might help us determine the timing of that.

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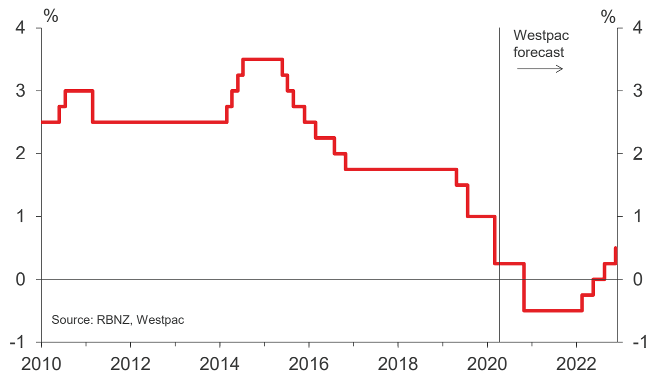
Official Cash Rate



Covid-19 has dealt the economy a very serious blow. There are a range of factors that are set to provide offsetting stimulus:

- The Government has delivered $20bn+ of fiscal stimulus and we expect more to be announced in the Budget on May 14.
- The Reserve Bank has reduced the OCR to 0.25% and has said it will keep it there for at least a year.
- The Reserve Bank has committed to buying $30bn of NZ Government Bonds and $3bn of local government bonds.
- The exchange rate has fallen 6.4% on a trade-weighted basis since the start of the year.
- The price of oil has fallen sharply.

Despite this stimulus, our analysis still suggests that the coming recession will be deep enough to cause a sharp rise in unemployment and a big drop in inflation, meaning more monetary stimulus will be required.

We expect that the Reserve Bank will come to the same conclusion in the May *Monetary Policy Statement*. In fact, a recent analytical note from the RBNZ indicated that they are significantly more pessimistic than we are about the impact of the lockdowns on economic activity.

The only question is how and when extra stimulus is delivered. That question is complicated by the fact that lowering the OCR is not feasible right now, but will be in the future. For now, the RBNZ will have to rely on a combination of fiscal stimulus, quantitative easing, and forward guidance.

Expanded QE.

Next week the RBNZ is highly likely to expand its bond-buying programme (quantitative easing, or QE). The original QE decision was expressed as a quantity. The Monetary Policy Committee (MPC) authorised the purchase of up to $30bn of bonds, but delegated decisions about the weekly pace of purchases to RBNZ staff. If this governance arrangement continues, then we expect the MPC to authorise purchases of up to $60bn over a year.

As well as stipulating a maximum cap on bond purchases, the MPC might also instruct the staff to target a particular interest rate on government bonds. Staff would then calibrate the pace of purchases accordingly. The Reserve Bank of Australia has adopted this approach, with a target of 0.25% on the three-year bond. The RBNZ might aim for something similar.

An explicit interest rate target on bonds would be an improvement in transparency. The RBNZ presumably already has some undisclosed or implicit interest rate target in mind, because it has been buying bonds at a pace that would exhaust the $30bn limit in far less time than a year, despite the fact that the interest rates on bonds have fallen a long way and markets have calmed. As well as improving transparency, the effectiveness of QE would probably be better with an interest rate target. In Australia, the three-year bond rate has traded very tightly around the targeted 0.25%. It is even possible that the RBNZ would not have to buy so many bonds if it adopted an interest rate target for bonds – just the threat of the central bank entering a market is often enough to get it trading at a certain price.

The RBNZ has stated that it is comfortable owning up to 40% to 50% of the Government Bond market. Cornering more of the market than that can reduce market liquidity. Bond buying of up to $60bn would put the RBNZ roughly in that league, depending on what the Government announces at the Budget, which is the following day. We expect that this expansion of QE is probably as far as the RBNZ will go in May, but if the RBNZ deems even more stimulus necessary, then its options will be limited.

Forward guidance.

The second possible way the RBNZ could provide further monetary stimulus next week will be via forward guidance. The RBNZ has already committed to keeping the OCR at 0.25% for at least a year. At this stage that can't be pushed much further, for reasons explained below. But the RBNZ could provide more forward guidance on its bond buying programme. This could take the form of a commitment to keep the interest rates on bonds at or below a certain level for a set *period of time*.

In its handbook on alternative monetary policy, published late last year, the RBNZ also said that it could consider publishing forecasts of the "shadow short rate," which shows the combined stimulus from the OCR and QE. This would be another way of providing guidance about how long bond buying may continue for, but we have our doubts about that being easy to communicate to markets.

The vexed question of negative interest rates.

In our assessment, a negative OCR is eventually going to have to be part of the mix. We forecast that the RBNZ will cut the OCR to -0.5%, but not until November. The RBNZ itself put a negative OCR at the top of its list of alternative monetary policy instruments when it issued its playbook last year. And in recent weeks the Governor has repeatedly stated that a negative OCR is an option for the future.

It is unlikely that the RBNZ will give any explicit endorsement to the idea of a negative OCR next week. There are too many uncertainties about the outlook for the RBNZ to be sure about taking that step, such as the size and effect of the fiscal stimulus and the actual severity of the downturn. The trading banks need time to prepare their systems before a negative OCR could be implemented. And cutting the OCR this year would technically break the RBNZ's previous commitment to keep the OCR at 0.25% for a year.

The RBNZ is highly likely to repeat that a negative OCR is an option for the future. However, we also suspect that they will emphasise that the OCR will not go negative any time soon. Exactly how the RBNZ expresses this will help us determine the timing of our negative OCR call.

There is a chance that the Reserve Bank will give an iron-clad guarantee that it will keep the OCR at 0.25% until March next year. If this really was a cross-my-heart-and-hope-to-die promise, then we would change our forecast to expecting a negative OCR early next year rather than late this year. In this scenario it is still likely that the RBNZ would increasingly talk up the chances of a negative OCR beyond March 2021, assuming the inflation outlook deteriorates as we expect. Swap rates would drift lower in anticipation of a lower OCR, which would amount to a de facto monetary easing this year.

The more likely scenario next week is that the RBNZ gives something less than an iron-clad guarantee – perhaps it will express an intention to keep the OCR at 0.25%. In that case, we would stick to our forecast of a November OCR cut to -0.5%. The RBNZ routinely updates its plans as new information on the state of the economy becomes available, and in this case we think a stark deterioration in the inflation and employment outlooks will necessitate a change of plan in favour of looser monetary policy.

Market reactions.

An expansion of QE to $60bn would be no great surprise to markets, and would cause only a small market reaction.

If the RBNZ adopts an explicit interest rate target on bonds then the relevant rates will quickly converge to the target. Given how far bond rates have fallen, the specified rate could actually be slightly higher than current bond rates.

The biggest market reaction will hinge on what the RBNZ says (or doesn't say) about the possibility of a negative OCR. In our preferred scenario of the RBNZ giving a "soft" indication that it intends to keep the OCR at 0.25% until March 2021, but that it remains open to a cut after that, markets would move little. In the possible scenario of the RBNZ giving an iron-clad guarantee that the OCR will stay at 0.25% until March, but indicating that the OCR could go negative after that, short-end swap rates would rise.

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