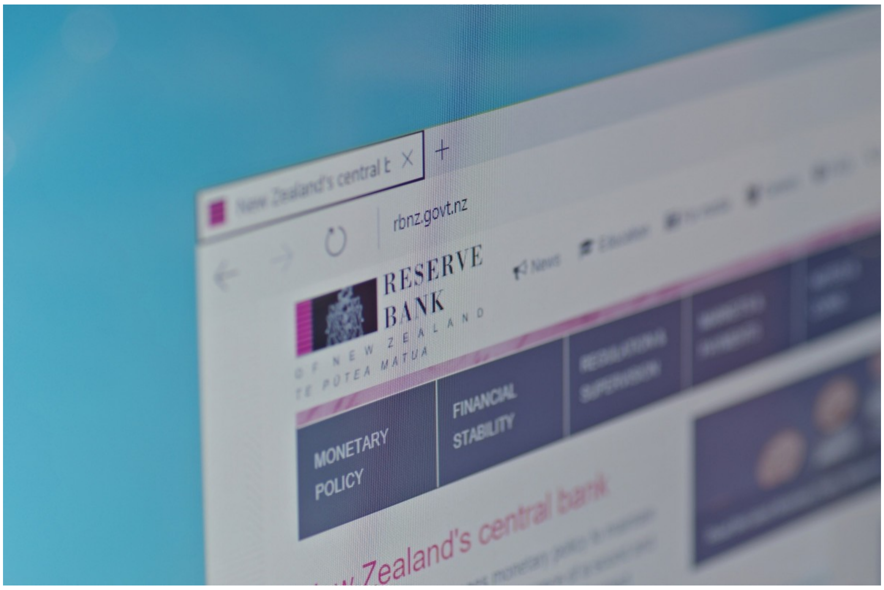
New Zealand: Limited options for the RBNZ

Weak 1Q GDP in the face of a mild Covid-19 outbreak shows that no economy is immune to the effects of this virus. There is little scope for more central bank stimulus though, except to suggest that options remain open. The aversion to a strong NZD should prompt the Bank to renew its threat of negative rates, which may put some pressure on NZD this week



Source: Shutterstock

Backdrop is about as good as it could be

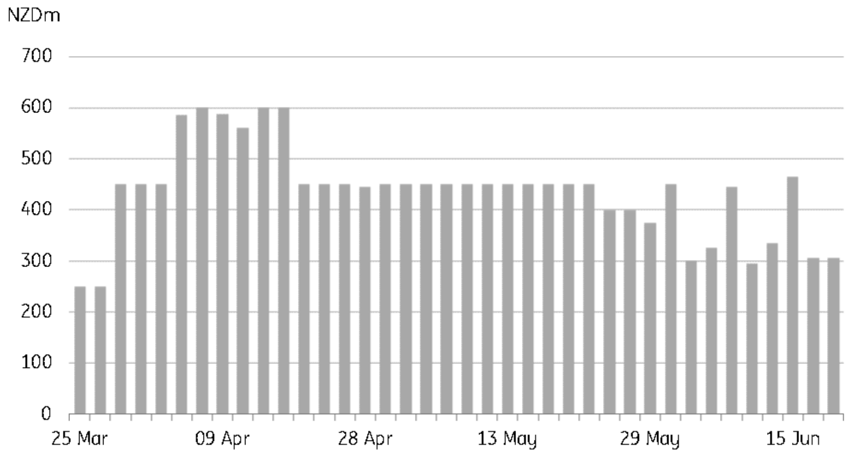
Between 22 May and 15 June, New Zealand had no new Covid-19 cases, and despite a couple of imported cases since then, the country can be regarded as one of the world's clearest success stories in Covid-19 infection control.

This has not come without a price though. 1Q20 GDP fell by 1.5% quarter-on-quarter, a bit more than we had been expecting, and although all movement restrictions were lifted on 8 June, 2Q20 is likely to show a more substantial drop.

The good news for New Zealand is that with the restrictions now fully lifted, the domestic economy can look forward to a relatively strong recovery compared to economies where easing has been much more gradual.

Also, New Zealand's predominantly food and agriculture-based exports are less likely to be subject to weak overseas demand or supply disruptions than manufactured goods in other countries, and though it won't be immune, the trade sector may also do relatively well.

Large scale asset purchases - NZ Government bonds



Source: RBNZ

LSAP Government bonds

RBNZ rules out nothing

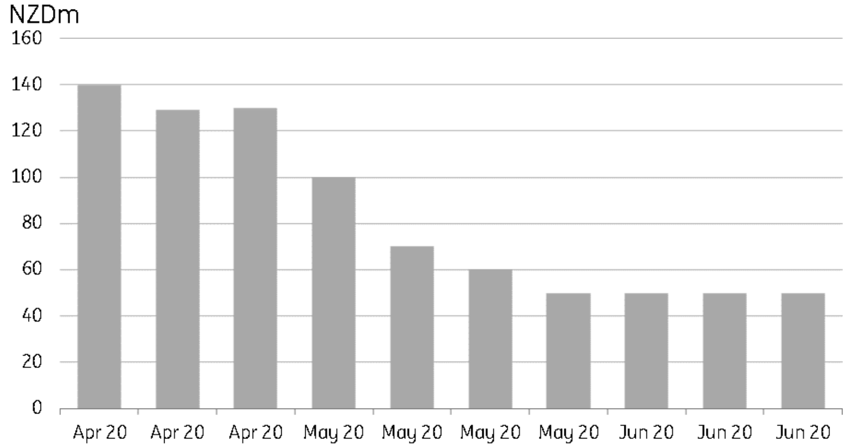
The Reserve Bank of New Zealand has taken a very proactive role during this crisis, aggressively cutting official cash rates to only 25 basis points, and embarking on a Large Scale Asset Purchase programme (LSAP - a quantitative easing programme). The policy was expanded from NZD40bn to NZD60bn at the May meeting, and now includes NZ Government index-linked bonds as well as conventional bonds and Local Government Funding Agency bonds (LGFAs).

RBNZ Governor, Adrian Orr, has been clear not to rule out any policies, including negative interest rates. But the improvement in financial market conditions has meant that the RBNZ has been able to ease back a little in terms of its LSAP, and the RBNZ is no longer required to work quite as hard at easing as it once was.

Although the economic snapshot of New Zealand remains weak, its strong relative position and favourable outlook from 3Q20 onwards suggest that the RBNZ will not need to deliver any meaningful changes to its policy stance at this week's meeting (24 June).

But given the volatility of the New Zealand dollar in recent weeks, Governor Orr may wish to convey the impression at that meeting that all options remain open to the RBNZ, in order to keep the NZD from appreciating too much (even if the reality is that there is little need for further incremental easing through expanded LSAP or adoption of alternative policies such as negative interest rates).

NZ LSAP - Local Government Funding Agency bonds



Source: RBNZ

LGFA bonds

NZD could still feel the negative rates pressure

The NZD/USD has appreciated by 7% since the latest RBNZ meeting (13 May), moving back to pre-pandemic levels, as the NZD followed the big rally in global risk assets. If a rebounding NZD was creating some mild concern in May, the current level makes it virtually impossible for the RBNZ not to input the currency in their monetary policy function (albeit implicitely).

The Bank's aversion towards a strong currency (which in an export-oriented economy such as NZ hinders the recovery) can mostly be channeled through a reiterated threat that a leap into negative rates is still an option on the table. While part of such dovish rethoric has already been priced into the NZD, the relatively high levels at which NZD is trading (considering the depressed state of the global economy) probably suggest that markets are still not entirely seeing negative rates as a tangible possibility. Incidentally, the swings of the past two weeks in global sentiment have likely deprived NZD of some of its extra resilience to negative drivers and have left the currency more exposed to the downside.

Accordingly, if indeed the RBNZ adjusts its rethoric with the aim of putting a lid on the NZD, we see the balance of risks for the currency as tilted to the downside in the aftermath of the meeting this week. Stepping away from the short-term impact, there is a significant risk that the threat of negative rates may not be enough to keep NZD appreciation contained. As we do not expect any more rate cut to be ultimately delivered, we cannot exclude the possibility that the RBNZ will attempt to step in against the NZD with other - and possibly more direct - measures.

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