RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Adrian Orr
Governor

30 April 2020

Hon Grant Robertson
Minister of Finance
The Beehive
Wellington

Dear Hon. Grant Robertson

The economic shock faced by New Zealand and the globe from the Covid-19 outbreak is expected to be severe and long lasting. In response, the Reserve Bank (the 'Bank') has rapidly implemented a wide range of measures to support the economy, reinforce the financial system and improve the functioning of key financial markets.

The Monetary Policy Committee (MPC) has adopted new tools to achieve its economic objectives as specified in the remit and section 8 of the Reserve Bank of New Zealand Act (1989), namely: (a) achieving and maintaining stability in the general level of prices over the medium term; and (b) supporting maximum sustainable employment. The MPC has reduced the Official Cash Rate (OCR) to 0.25 percent, its historic low. The financial system is not yet operationally ready for a negative OCR.

The MPC has also instructed the Bank to commence the large scale asset purchase (LSAP) of up to $30 billion New Zealand government nominal bonds (NZGB), announced on 23 March, and up to $3 billion Local Government Funding Agency (LGFA) bonds, announced on 7 April. The Bank does this by purchasing existing NZGB and LGFA bonds from bondholders using newly created settlement balances – it does not purchase bonds directly from the Crown or the LGFA. These purchases support the economy by pushing down longer-term interest rates, depreciating the NZD and reducing the Government's funding costs. This allows the MPC to influence key interest rates in New Zealand without altering the OCR.

The Crown has indemnified the Bank against interest rate and credit losses associated with these bond purchases, in an indemnity for NZGBs purchases provided on 21 March 2020 and an indemnity for LGFA bond purchases provided on 7 April 2020. The indemnities were provided in accordance with the *Memorandum of Understanding between the Minister of Finance and the Reserve Bank of New Zealand regarding the use of alternative monetary policy tools* (MoU) dated 21 March 2020.

To date, the Bank has purchased $7.6 billion NZGB and $0.4 billion LGFA bonds. This has been effective in supporting the economy and financial markets. Liquidity in NZGB and LGFA bond markets has markedly improved and yields on these bonds, at all maturities, have fallen since the Bank commenced its purchases. This has contributed to an improvement in broader market functioning, with volumes and bid-ask spreads moving closer to normal levels, and has supported economic conditions.

It is important, however, that the MPC has the ability to use its tools, including the LSAP, flexibly over time, while respecting the agreement set out in the MoU. There is significant uncertainty about the spread of Covid-19 and its economic impact, and as the economic outlook evolves the MPC may find it necessary to increase the amount of monetary policy stimulus in New Zealand.

Consequently, I am writing to you to request an amendment to the existing Crown indemnities, which indemnify the Bank against losses on the purchase of up to $30 billion of NZGBs and $3 billion of LGFA bonds. In particular, I request that the Crown indemnify the Bank from losses arising out of or in connection with the purchase of up to:

- 50% of the face value of New Zealand government nominal bonds on issue;
- 30% of the face value of New Zealand government inflation-indexed bonds (IIBs) on issue;
- 30% of the face value of Local Government Funding Agency bonds on issue.

The indemnity will be needed until the MPC is confident that it can sustainably achieve its inflation and employment objectives in the medium term without conducting LSAPs. Without the indemnity, the Bank would not have sufficient capital to conduct the bond purchases necessary for the MPC to achieve its economic objectives. Given the uncertainty about the scale and duration of the economic shock, I propose that the indemnity remain in place initially for at least 18 months.

For the avoidance of doubt, these caps are limits, not targets. The actual size of LSAP purchases will be determined by the MPC's assessment of the amount of stimulus required to support its monetary policy objectives, applying its principles for choosing alternative monetary policy tools, including effectiveness, efficiency and financial stability.

The suggested caps and asset classes are based on the Bank's published *Principles for Using Alternative Monetary Policy*. In particular, they reflect the expected effectiveness and efficiency of the Bank conducting LSAPs of these assets.

On effectiveness, the caps are designed to allow the MPC to increase the scale of LSAPs over time, as the amount of bonds on issue change. This would provide the MPC with the flexibility to quickly respond to market and economic conditions by varying the scale of its LSAPs, in order to achieve its economic objectives, without seeking a new indemnity.

The proposed caps also reflect our belief about the best balance of purchases for delivering economic stimulus through LSAPs. Purchases would remain focused on NZGBs, given yields on these bonds are a key benchmark rate, influencing interest rates faced by New Zealand households and businesses and the exchange rate. Allowing purchases of up to 30% of IIBs would help the MPC to achieve its economic objectives by reducing interest rates and depreciating the NZD, as the IIB market is large and a significant amount of IIBs are held by offshore investors. Allowing purchases of up to 30% of LGFA bonds would continue to allow the MPC to support functioning in the market for that debt, which is a critical benchmark for non-government credit instruments in New Zealand, thereby supporting the transmission of monetary policy.

On efficiency, the caps are set at a level that we believe would not disrupt the functioning of the debt markets or cause a scarcity of domestic safe assets. However, the Bank would continue to closely monitor the effect of its purchases on the functioning of financial and credit markets and on financial stability risks, and will adapt its purchase operations when necessary. The Bank would also continue to work with the Treasury's Capital Markets unit when planning purchases.

The Bank would continue to purchase the bonds in the secondary market. It is important that the Government's debt management policy remains independent, and is not implemented in a way that purposely contradicts the aims of monetary policy. We recommend that both parties agree to continue to act in a coordinated manner and in a way that does not intentionally undermine the objectives of debt management in the case of the Treasury and alternative monetary policy tools in the case of the Bank.

It is important that the Bank continues to manage the risks associated with LSAPs and the Government understands these risks. To achieve that, the risk control framework would be updated to reflect the change in the indemnity and to reflect the purchase of IIBs, which have an inflation risk element not associated with NZGB or LGFA bond purchases. Changes to the framework would be agreed with the Treasury.

The Bank would continue to report to the Treasury monthly on the bond purchases, including information on the scale of operations and the associated gains or losses associated with the purchases. This information will also be included in the Bank's Annual Report and daily public reporting on the scale of LSAPs for each asset class would continue, to be found in the D3 statistical series on the Bank's open market operations.

The MPC will continue to monitor the effectiveness of monetary policy, including the bond purchases, and its broad impact on the economy and financial system. This includes an assessment of whether the current monetary policy settings provide the right amount of stimulus to meet the MPC's economic objectives. This analysis will be set out in the upcoming May *Monetary Policy Statement*.

Amending the indemnity in the proposed manner would provide the MPC with significantly more flexibility and headroom to use LSAPs to respond to economic and financial market shocks. But should the MPC determine that a change in the caps or asset classes included in the LSAP programme is necessary to meet its economic objectives, the Bank will write to you to request a change in the indemnity, as per the MoU.

I look forward to receiving your reply.

Yours sincerely

Adrian Orr
Governor