TE TAI ŌHANGA
THE TREASURY

Reference: 20200382

7 December 2020

[redacted]

Thank you for your Official Information Act request, received on 9 November 2020. You requested the following:

> *14 May 2020 - Aide Memoire T2020/1388: Quantitative Easing and Monetary Financing compared*
>
> *5 May 2020 - Aide Memoire T2020/1309: Large Scale Asset Purchases of primary bond issuance*

Information being released

I have decided to release *'T2020/1309: Large Scale Asset Purchases of primary bond issuance'* subject to information being withheld under the following section of the Official Information Act, as applicable:

- direct dial phone numbers of officials, under section 9(2)(k) – to prevent the disclosure of information for improper gain or improper advantage.

Direct dial phone numbers of officials have been redacted under section 9(2)(k) in order to reduce the possibility of staff being exposed to phishing and other scams. This is because information released under the OIA may end up in the public domain, for example, on websites including Treasury's website.

Information publicly available

As you are aware, we sent the below information to you on 25 November 2020 which is covered by your request:

Item	Date	Document Description	Website Address
1.	9 October 2020	T2020/1388: Quantitative Easing and Monetary Financing compared	https://www.treasury.govt.nz/sites/default/files/2020-11/oia-20200332.pdf

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Accordingly, I have refused your request for the documents listed in the above table under section 18(d) of the Official Information Act:

- the information requested is or will soon be publicly available.

Please note that this letter (with your personal details removed) and enclosed documents may be published on the Treasury website.

This reply addresses the information you requested. You have the right to ask the Ombudsman to investigate and review my decision.

Yours sincerely

Renee Philip
Manager, Macroeconomic and Fiscal Policy

TE TAI ŌHANGA
THE TREASURY

Reference: T2020/1309 MC-1-1-1-2 (RBNZ Institutional Frameworks)

Date: 5 May 2020

To: Minister of Finance (Hon Grant Robertson)

Deadline: Prior to DEV on 6 May

Large Scale Asset Purchases of primary bond issuance

This Aide Memoire responds to your request for advice on whether the Reserve Bank (the Bank) should undertake Large Scale Asset Purchases (LSAPs) of NZGBs in the secondary market or directly purchase NZGBs from the Treasury.

This Aide Memoire explains the risks associated with LSAPs in the primary market, and why we prefer secondary market purchases.

Background

The Governor of the Reserve Bank has recently requested an expanded indemnity for financial losses arising out of LSAPs of New Zealand Government bonds (NZGBs) and Local Government Funding Agency (LGFA) bonds (T2020/1036 refers). As with the existing indemnities (T2020/728 and T2020/881 refer), the present indemnity request is for LSAPs of bonds in the secondary market. Most central banks currently conducting quantitative easing through purchases of central government debt do so on the secondary market, including in Australia, Canada, and the UK.

Section 65ZD of the Public Finance Act 1989 (the Act) empowers you, as the Minister responsible for the administration of the Act, to give an indemnity to a person, organisation or government if it appears to you to be 'necessary or expedient in the public interest' to do so, and to give such an indemnity on any terms and conditions that you think fit.

The Reserve Bank of New Zealand Act 1989 provides the Bank with the power to undertake LSAPs without an indemnity. However, the Bank has indicated that it would be unwilling to undertake LSAPs without your support. Agreeing the type and scale of alternative monetary policy (AMP) tools for which the Government is willing to provide an indemnity helps to manage the risks associated with AMP tools, and to provide clarity over the Monetary Policy Committee's mandate to use AMP tools.

You have chosen to discuss the indemnity request at DEV on 6 May before responding.

Options analysis – Market arrangements for LSAPs

The Bank could undertake LSAPs of NZGBs using several different market arrangements. These options are:

- Secondary market LSAPs – The Treasury issues NZGBs to the market through its normal means (tenders or syndications) and the market determines the cost. Then, the Bank purchases NZGBs from market participants (typically commercial banks) in the secondary market through a competitive process (like tenders). This option is the status quo.

- Primary market LSAPs – The Bank purchases NZGBs directly from the Treasury by participating in auctions of bonds to the market. There are a range of options for how this could be operationalised, including participation in tenders on a competitive basis or the Bank purchasing NZGBs at the clearing price reached through otherwise competitive auctions.

- Primary 'non-market' LSAPs – Non-market NZGBs are bonds issued by the Treasury directly to Crown agencies (the RBNZ in this case) that cannot be on-sold other than back to the Treasury. The Bank would negotiate an agreement directly with the Treasury on the type, price and scale of non-market LSAPs. The offer of purchase would be closed to other market participants.

In each case LSAPs aim to lower interest rates and stimulate the economy. However, LSAP purchase arrangements pose different risks. Compared to secondary market LSAPs, primary market and primary non-market LSAPs may offer some shorter-term fiscal benefits, but pose greater risks. Therefore we recommend you continue to indemnify the Bank for LSAPs in the secondary market.

Both primary market and primary non-market LSAPs avoid transaction costs. This is because purchases are made directly between the Treasury and the Bank, not through intermediaries. By contrast, when purchasing NZGBs in the secondary market, the Bank may pay a premium compared to the primary issuance price of the bond. In this sense, an intermediary 'clips the ticket' between the Treasury issuing the bond and the Bank acquiring it.

Transaction costs are very difficult to quantify, and depend on differences in the timing and composition of NZGB issuance and LSAP purchases. Furthermore, the Crown incurring such fiscal costs is consistent with the objective of LSAPs. By supporting prices in the secondary NZGB market, LSAPs help to lower private sector bond yields.

Secondary market LSAPs and primary market LSAPs affect recorded net debt in the same way. In both cases, the LSAPs would temporarily affect recorded net debt through a revaluation of the liabilities involved in the transaction (T2020/1036 refers).

You will receive an Aide Memoire estimating the plausible impact of an expanded LSAP programme on recorded net debt (T2020/1322 refers).

Primary non-market LSAPs are likely to have a different accounting treatment in the Treasury's fiscal forecasts. We are continuing to evaluate the impact of primary non-market LSAPs on the fiscal aggregates over time. This is because non-market LSAPs are treated as a different class of financial instrument compared to market LSAPs. We can report back to you on this matter if you are interested.

Separate to any initial impact on recorded net debt, all LSAPs pose interest rate risks. This is because LSAPs shorten the maturity of the Crown's liabilities, irrespective of whether LSAPs are purchased on the secondary market, primary market or through primary non-market arrangements. The scale of losses or gains arising from interest rate risk is highly uncertain (see T2020/1036 for scenarios). Therefore, these risks are not included in our central forecasts. Instead, these risks are recognised as contingent liabilities. Depending on how these risks eventuate, LSAPs may pose a net gain or a net loss to the Crown over the duration of the programme.

We have concerns that primary market and primary non-market LSAPs pose additional risks, compared to secondary market LSAPs. These risks include undermining:

- <u>Effectiveness</u> – Limiting indemnified LSAPs to primary purchases would limit the Bank's operational flexibility to determine the scale and type of indemnified LSAPs. In turn, this may inhibit the effectiveness of LSAPs in supporting the MPC's economic objectives.

  Indemnifying only primary purchases would limit the quantity of indemnified LSAPs the Bank could undertake. At best, primary purchases could be expected to offset the effects of increased NZGB bond issuance, but could not reduce net supply. This constrains monetary policy's ability to lower NZGB yields.

  Separately, primary purchases would limit the type of indemnified NZGBs the Bank could purchase. The Bank would be limited to purchasing bond lines that the Treasury chooses to issue. This could limit the Bank's ability to influence yields at different maturities. For example, if the Treasury chose to issue longer-term bonds, the Bank would not be able to purchase shorter-dated bonds to reduce shorter-term interest rates. This is important as rates at some maturities have a larger influence over economic activity e.g. a large proportion of mortgage lending is fixed for around two years.

  Primary purchases would also limit the Bank from using LSAPs to further market functioning objectives it may have, alongside lowering interest rates, as their actions would be conducted separately from the secondary market for NZGBs.

Finally, purchases of non-market NZGB would limit the Bank's ability to unwind the LSAP programme as they would be limited to either holding purchased NZGBs until maturity or approaching the Treasury to buy them back – this latter option would increase borrowing requirements for the Crown at that time.

- Institutional reputation – Limiting the Bank's operational flexibility also impacts its perceived independence. By limiting the type and scale of LSAPs the Bank can undertake, the government risks being seen to constrain monetary policy. Market participants and commentators may interpret that LSAPs are being directed foremost to support Crown borrowing requirements, and that monetary policy objectives have been made a secondary consideration. These reputational risks are likely to be greater for non-market purchases, where there is less transparency.

  In turn, reputational risks jeopardize the effectiveness of monetary policy. Primary purchases would reduce the supply of bonds available in the market, which would normally reduce government bond yields. However, investors' concerns about institutional reputation could cause yields to increase, increasing interest rates in New Zealand more broadly.

  The impact of institutional risks is highly uncertain and likely to be non-linear, with even small scale primary purchases having a discernible effect. A perception that New Zealand's strong institutional frameworks have been undermined could impact on New Zealand's credit rating and inflation expectations, which could increase the cost of borrowing more generally.

- Debt management objectives – The Treasury's debt management strategy seeks to maintain a deep and active market for NZGBs. This protects long-term NZGB market functioning and supports overall lower Crown financing costs.

  Primary purchases may undermine the objective of lowering Crown financing costs by reducing price transparency, market efficiency and the incentive on dealers to support the secondary market, thereby undermining a deep and active market.

  The primary market for NZGBs acts as a key pricing benchmark for the broader secondary market for NZGBs. To the extent that LSAPs affect the pricing transparency of the primary market (either by the RBNZ directly influencing prices or by reducing the effective volume issued at a tender such that the price signal offered was limited) this could affect secondary market price transparency. A reduction in transparency could reduce demand for NZGBs, increasing borrowing costs.

  Intermediaries provide price transparency and liquidity to market participants. A reduction in intermediary participation (as a result of reduced turnover and opportunity to generate revenue) would further impact price transparency and undermine liquidity – further reducing demand and increasing borrowing costs.

Limiting LSAPs to primary purchases of NZGBs could result in pricing distortions between LSAP and non-LSAP securities (as the Treasury only tends to issue a subset of NZGB each year). This distortion could further impact overall demand for NZGB.

These additional risks are likely to be longer lasting than any short-term impacts on net debt or fiscal cost. Potential negative impacts arising from institutional reputation, transparency, investor demand, market function and liquidity are likely to have impacts on borrowing costs that last much longer than any shorter-term impacts on net debt and/or leakage to the private sector. This is because it will take time after any LSAP programme is completed to rebuild confidence in institutions and market infrastructure. Borrowing costs may remain elevated until this occurs.

It is possible to strike a balance to mitigate, but not eliminate, risks. In practice, the Bank could undertake some combination of primary market LSAPs, secondary market LSAPs, and/or primary non-market LSAPs. Some combination could help to mitigate the above risks, compared to an LSAP programme of solely primary LSAPs. For example, you could indemnify the Bank for LSAPs on both the primary and secondary NZGB markets. However, the Bank has expressed its preference is to purchase on the secondary market. Therefore, to influence the Bank to undertake LSAPs on the primary market, you may need to indemnify only primary market LSAPs, or require a portion of indemnified bonds be purchased on the primary market. Although the Bank would remain empowered to undertake un-indemnified LSAPs in principle, it has said it would prefer not to, so this course of action would likely be seen to constrain the Bank's independence.

On balance, we consider secondary market LSAPs of NZGBs are likely to be the most effective, with the least risk.
The balance of these risks and benefits may change in the future. For example, we would reconsider our stance on primary purchases if the primary NZGB market became dysfunctional. In that case, however, the principal objective of LSAPs would likely shift from monetary policy considerations towards fiscal policy objectives.

External advice

The Treasury has discussed the prospect of primary purchases with Phillip Anderson and Mike Allen, members of the Treasury's Capital Markets Advisory Committee who have previously been heads of the New Zealand and Australian debt offices respectively. Both Phillip and Mike independently expressed perspectives consistent with the advice set out above.

They advised that LSAPs on the secondary market are desirable in that they are likely to be most consistent with meeting monetary policy and debt management objectives. In particular, secondary market LSAPs ensure both parties retain full control over their objectives in a transparent and 'clean' operating framework. They noted that LSAPs on the secondary market reduce any perception risk of direct financing of government by the central bank.

Lastly, they advised that, to the extent LSAPs were undertaken in the primary market, ensuring transparency and market driven price discovery were important to limit any risks.

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