

Treasury Trends

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Acting on interest rate uncertainty

Since the inception of interest rate targeting in the late 1980s, one of the most profound developments has been the evolution of 'quantitative easing'. With central banks now needing to 'normalise' policy settings, the uncertainties of 'quantitative tightening' are now on the horizon.

How did we get here?

Prior to the 1970s, most economists believed that central banks could do little to control inflation. At the time, conventional wisdom held that monetary policy was relatively ineffective for controlling inflation or for economic stabilisation. Fiscal policy, not monetary policy, was the principal way that governments could stabilise the economy and keep inflation low, by filling the gap between private demand and potential output. But in the 1970s and 1980s, as oil became integral to our consumption-based lifestyles, annual inflation across New Zealand and Australia started to range between 10%-20%, as looser monetary policy was accompanied by an acceleration in government spending as politicians attempted to 'buy' electoral votes. It was a similar situation in the UK, and America, where inflation rates averaged 9.9%, and 6.4% respectively across the 1970s and 1980s.

Then, in 1989, the Reserve Bank of New Zealand ("RBNZ") became the first central bank to undertake inflation targeting upon the implementation of the Reserve Bank Act. The Act established four key objectives that were to be undertaken by the Reserve Bank to support price stability – namely; providing the Reserve Bank with operational independence; pursuing a single objective of price stability; giving the Governor authority to act as a single decision maker; and ensuring the Reserve Bank provided transparency in its approach. This was the birth of inflation targeting and the start of a new era for monetary policy.

The evolution of inflation targeting occurred because central banks ascertained that monetary policy could to some extent control

Key Points

- **The use of unconventional policy tools by central banks has become more common over recent years.**
- **As central banks look to quickly reverse course in the face of strong inflationary forces, unwinding monetary stimulus could heighten interest rate market volatility over the coming months.**
- **Businesses should have a good understanding of how adverse interest rate movements might impact on business and take steps to ensure that appropriate policies and management tools are in place to combat these risks.**

inflation, and as central banks' credibility for keeping inflation low increased, governments started to add additional targets to central bank policy actions such as, in the RBNZ's case, "*contributing to maximum sustainable employment*" and, "*contributing to the Government's housing policy objectives.*"

With inflation and employment targeting embedded either directly or indirectly into central bank mandates, as we entered the new millennium, we saw the evolution of quantitative easing. Quantitative easing ("QE") is an unconventional form of monetary policy whereby a central bank purchases government bonds or other financial assets (e.g., municipal bonds, corporate bonds, stocks, etc.) in order to inject money into an economy to expand economic activity. QE is usually implemented when nominal interest rates are at, or near, 0.00%, and when inflation is exceptionally low or even

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negative. The central bank purchases financial assets in the open market from commercial banks and other financial institutions thereby raising the prices of those assets, thus lowering their yield, and depressing the interest rate curve while simultaneously increasing money supply into the local financial system.

The onset of the pandemic in March 2020 saw most central banks cut interest rates aggressively, while governments were quick to implement fiscal stimulus to protect their citizens and their economies. As part of this process, some central banks, such as the RBNZ and the Reserve Bank of Australia (“RBA”), also embarked upon their first ever QE programmes in an attempt to reduce the risk of a liquidity shortage within their domestic economies and help suppress longer term interest rates. This saw the RBNZ undertake its Large Scale Asset Purchase (“LSAP”) programme which, as at the end of January 2022, meant the RBNZ held around NZD55 billion in government bonds (nearly 40% of all government bonds on issue). Over this time, the RBA purchased more than AUD350 billion of government bonds, helping to triple the size of its balance sheet to approximately AUD650 billion.

Where to from here?

With the global economy having ‘weathered’ the COVID pandemic, governments have scaled back and reduced their fiscal stimulus, but with supply chains disrupted and inflation reaching multi-decade highs, most central bankers are looking to finish their existing QE programmes and start raising domestic interest rates. This removal of stimulus has been well managed to date, with most central banks gradually slowing the outright amount of bond purchases each month, known as tapering, until they eventually cease outright purchases in their entirety.

But with excessive amounts of assets on their balance sheets, central banks are now contemplating how they can reduce these positions with the minimal amount of disruption to their financial systems, which has raised the possibility of utilising a new concept referred to as quantitative tightening. Quantitative tightening (“QT”) is the equal and opposite action to QE. QT potentially puts upward pressure on interest rates in order to counteract increasing inflation, increasing the cost of borrowings and reducing demand

for goods and services in the economy. Traditionally, when a central bank wants to ‘slow down’ an economy, it increases its benchmark interest rate and communicates to the market that further interest rate rises are likely, which increases interest rate pricing across the domestic interest rate curve.

What are the implications?

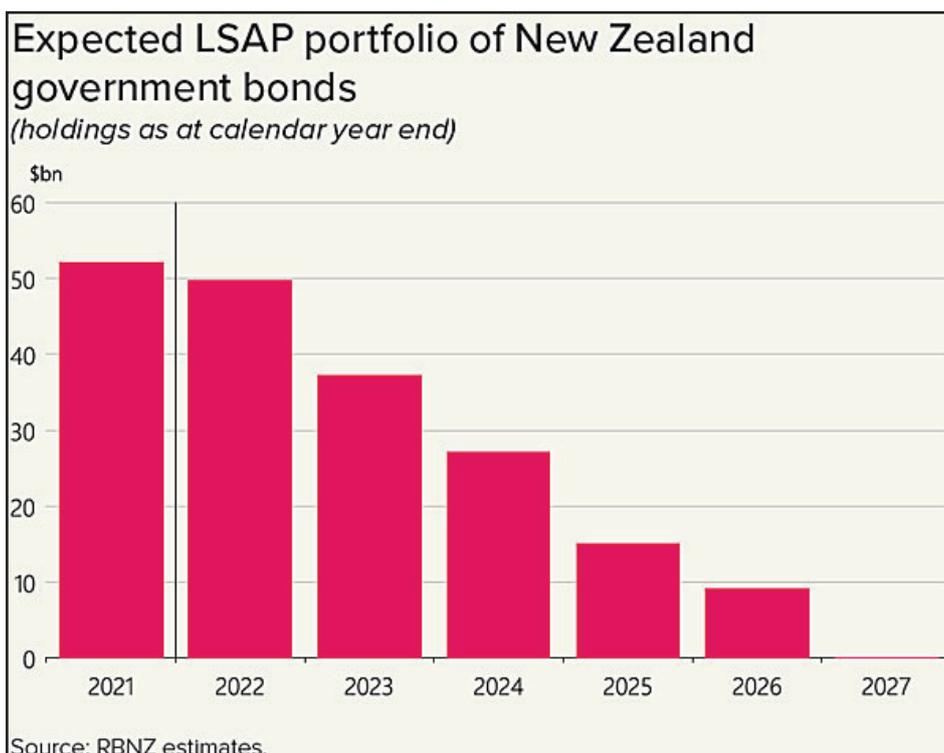
What matters to the financial markets is how disruptive this QT process will be, how long the process will take, and whether the central banks will reduce their holdings gradually over time by simply not replacing maturing securities, or speed up the process by undertaking outright asset sales.

In New Zealand, the RBNZ ended its QE purchases in July 2021 and has since raised its cash rate from the record low 0.25%, up to 1.00% currently. In February, the RBNZ announced it would not reinvest the proceeds of any upcoming bond maturities and signalled that it would direct the Reserve Bank to sell its bonds directly to the New Zealand Debt Management Office (“NZDMO”) at the rate of NZD5 billion per year. Given the RBNZ’s balance sheet has expanded by approximately NZD60 billion through the pandemic, an orderly sell-down of NZD5 billion per year should not impact the domestic bond market too much, although the NZDMO may have to increase its issuance programme. The RBNZ has said that bond sales will be gradual and predictable and will not be used to adjust monetary stimulus.

In Australia, the RBA officially ended its QE programme in February 2022 but is yet to confirm its intentions as to how it will unwind its massive bond holdings. The RBA holds around one-third of all Australian government bonds in circulation. Even if it decides against reinvestment, analysts do not expect a significant run-off in the near-term, given the first notable bond maturity isn’t until April 2023.

But in the G4 economies, where central bank balance sheets have grown exponentially, trillions of dollars of liquidity could be drained from the market in the coming months and years as central banks start to shrink their balance sheets in unison and flood international markets with excessive amounts of bonds. Whether they take a passive approach, by simply not replacing maturing securities, or

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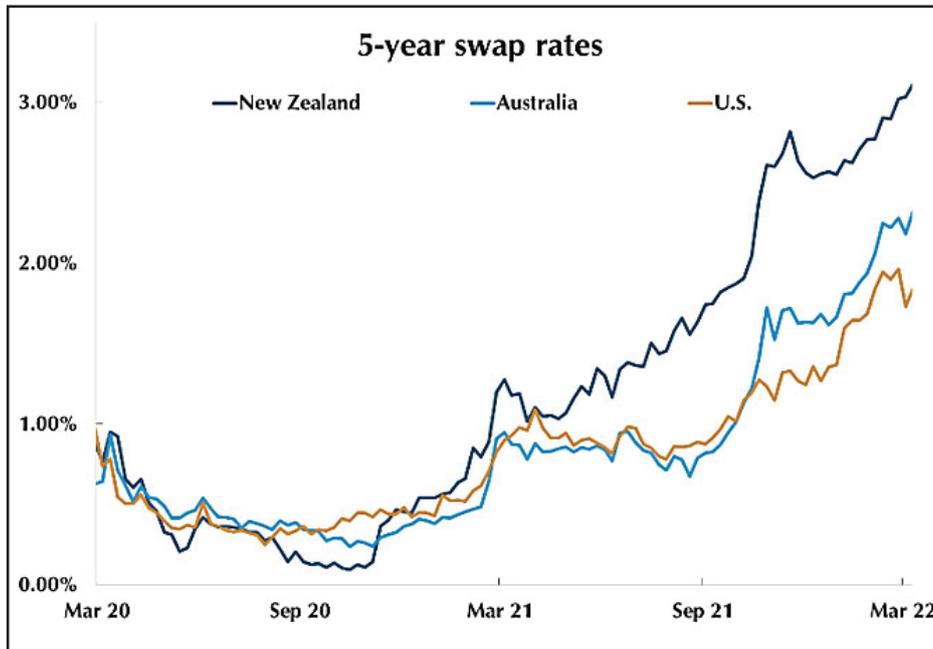


undertake a more aggressive approach via outright asset sales, there could be a substantial increase in the amount of bonds available for sale.

Most of this 'over' supply will be purchased by international banks and money-market funds, but to fund these purchases most institutions will need to reduce the amount of cash they have deposited within the financial system, which has the potential to create a squeeze in cash and repo-rates as per the famous 2019 repo squeeze where cash-rates briefly quadrupled. The other concern is how the potential flood of bonds will impact the longer-end of international bond curves, specifically the USD curve, and how this will impact the NZ and AU interest rate curves.

There is no doubt that the financial markets are about to experience a new phenomenon, and treasurers, CFOs and Boards are again seeing interest rate risk management as a real and necessary part of treasury risk management. Like any material treasury exposure, the management approach should be framed by documented policies and processes — along with a clear understanding of derivative accounting and reporting.

As we prepare ourselves for another period of heightened interest rate volatility, it is timely to consider the potential impact of adverse interest rate movements on your business and then take steps to ensure that appropriate policies and management tools are in place.



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