ANZ Research

NZ Forecast Update: OCR Call Change

18 August 2020

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Into the twilight zone

Summary

- We are now forecasting the RBNZ to cut the OCR by 50bp to -0.25% in April 2021. Beyond that, further easing is possible, but there are constraints on the OCR going below -0.75%.
- The RBNZ has ruled out changing the OCR before March 2021, but expressed a preference for a package of a lower OCR and a bank 'funding for lending' programme, should they conclude that further stimulus is required at that point. We think they will.
- We see a further increase in the large-scale asset purchase (LSAP) programme in November as likely, perhaps to $120bn. The programme in its current form will have largely done its dash by that point.

Long slog ahead

New Zealand is still only at the beginning of the economic impacts of the COVID-19 epidemic.

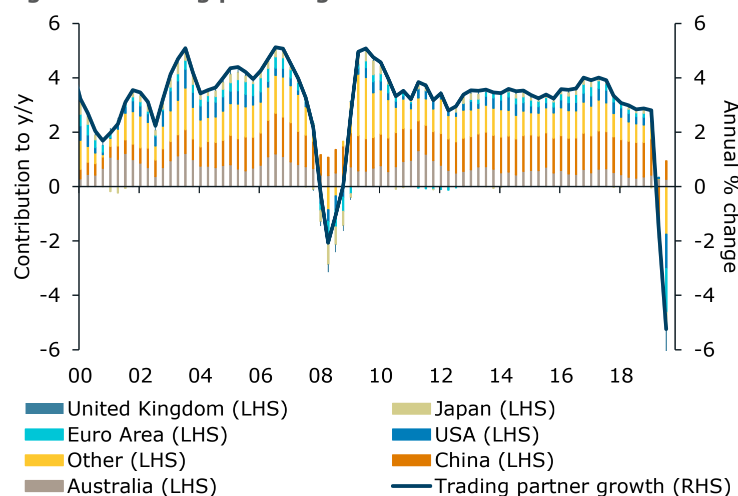
The long lockdown starting in late March made a huge dent in activity, and was followed by a vigorous bounce-back as pent-up demand and a collective sigh of relief saw spending rebound sharply. The Government's balance sheet appropriately took the lion's share of the hit, with enormously expensive wage subsidies and other business support measures meaning the overall scarring to the business sector from the first lockdown was looking less severe than many feared.

As we write we are battling a second outbreak, but it appears to be limited to one cluster – albeit a big one – and optimism is rising that we will be successful in containing it relatively quickly and eliminating COVID-19 from our shores once again. Both business and consumer confidence will have been dented by the popping of any illusion that we could be 100% secure in our defences, but a rapid re-elimination may at least boost confidence that we can avoid the fate of Melbourne or the US, and the attendant severe economic damage that comes from uncontrolled spread of the virus.

However, there are two other aspects to how COVID-19 will affect the New Zealand economy that are only starting to make themselves felt.

- The missing international tourists and students. The flow-on into retail and hospitality makes the hole bigger; the inability of kiwis to travel overseas reduces it. But on net, New Zealand with a closed border is an economy that is around 5% smaller. Because of the extreme seasonality of tourism, the blow will fall most heavily from October to March. Specialised labour shortages will also dampen output to some extent.
- Global growth is looking dreadful (figure 1). While people have to eat, they don't necessarily have to fork out a bit extra for New Zealand's premium, high-quality produce. Food supply disruptions globally are providing price support, but also logistical headaches. On the whole, New Zealand's commodity prices are holding up pretty well, but downside risks are evident, and non-commodity exporters are finding the going very tough. In addition, the robust NZD is doing our exporters no favours.

Figure 1. Trading partner growth



Source: Macrobond, ANZ Research

Note: 2020Q2 data not yet available for Australia, Canada and India so have carried forward 2020Q1.

All up, health-wise, New Zealand has dodged one bullet and is weaving, Matrix-style, around the second as we speak. However, we wrote our own name on an economic bullet when we closed the border.

Excising 5% of the economy to save the other 95% (and a lot of lives) is absolutely the best strategy as long as a relatively timely vaccine and/or better treatments are realistic prospects. And we shouldn't forget that tourists largely wouldn't be coming anyway, even if the border were open.

However, the closed border, plus the enormous temporary fiscal cash injection we're currently experiencing, mean that the strength of the recent rebound out of lockdown tells us very little in practice about how the economy will be looking by the end of the year. We are currently reviewing our GDP forecasts in light of the new lockdown, but the basic theme will remain the same: that the more persistent economic pain will start to be felt in summer. There is a significant risk that despite the significant fiscal and monetary stimulus already delivered, both inflation and employment will look set to undershoot the Reserve Bank's targets for a prolonged period, and the RBNZ is very unlikely to stand idly by in that instance.

So what's next?

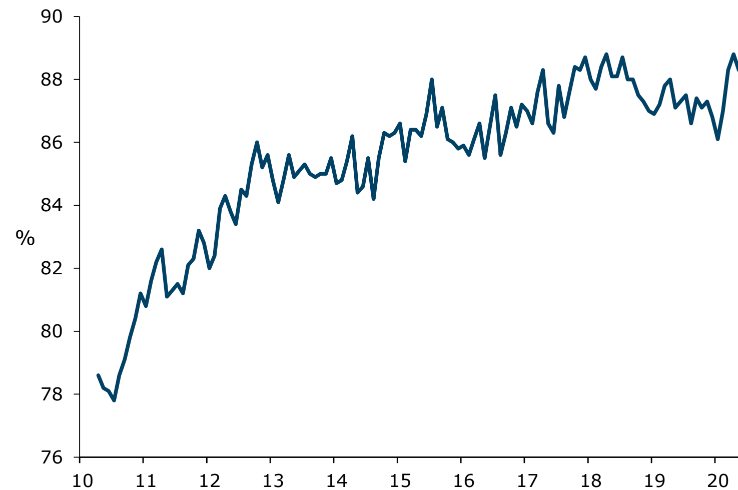
The Reserve Bank has asked banks to be technically and legally ready to handle a negative Official Cash Rate (OCR) by the end of the year. They have committed to keeping the OCR unchanged until March 2021 (and have reiterated that multiple times) but have made no promises – or even forecasts – beyond that point.

In the August Monetary Policy Statement, the RBNZ clearly expressed a preference for a package of a lower OCR and a bank 'funding for lending' programme should further stimulus be seen as warranted beyond what the current LSAP (quantitative easing) program can deliver (see our MPS Review).

A funding for lending programme (at the OCR, or close to it) is that it decouples bank funding costs at the margin from both deposit rates and global funding costs. The idea of combining these policies in the package means a lower OCR should be passed through more easily into retail lending rates, with less pressure on bank margins and credit supply. That's not to say that retail interest rates would be expected to go negative – paying customers to take a mortgage is about as likely as charging them to put their money in the bank – but it would provide more scope for retail rates to go even lower.

At this point, one may wonder what all the kerfuffle was around the robustness of bank funding following the Global Financial Crisis, if the RBNZ can just inject newly printed cash directly into the veins of the banking system anyway. Indeed, it does fail the too-good-to-be-true test if taken too far. The plan would be to enable and incentivise new lending at a lower interest rate, but stopping well short of ending up in a situation where a large proportion of bank funding is coming directly from the central bank, as this could be a difficult position from which to exit.

Figure 2. NZ registered banks core funding ratio



Source: RBNZ

At the risk of being accused of talking our book, we'd note that it is a good idea to combine a negative OCR with policies that will protect the banking sector from the worst of the impacts on their profitability, thereby protecting the free flow of credit. The direct funding scheme is one complementary programme; excluding a portion of banks' nightly deposits at the RBNZ from the unavoidable 'tax' of a negative OCR is another. These should go some way to ameliorating the negative impacts on credit availability that would otherwise offset or even outweigh the stimulatory impacts of a lower price of credit.

All alternative monetary policy tools have limits at which they will stop achieving their goals, and potentially become counter-productive and damaging to the financial system and to financial stability more generally. The challenge is to know where that point is, and it will be pretty tricky to identify in real time. Extreme-low interest rates also tend to pump up asset prices, with consequences for wealth inequality.

The Reserve Bank has made it clear that they think that a deeper-than-necessary recession is worse for financial stability than the risks associated with carefully designed unconventional policy, and that persistent unemployment is worse for inequality than asset price inflation.

But the fact remains that extremely low interest rates for prolonged periods are highly distortionary. They can encourage unsustainable borrowing, lead to asset price bubbles that worsen wealth inequality and raise financial stability risks, encourage inappropriate risk-taking, and internationally, have arguably tended to lead to more financial engineering than productive investment.

But that 'arguably' is important. There's never a counterfactual in macroeconomics, and one will always be able to argue that to do nothing would lead (or would have led) to worse outcomes. And indeed it might be true. But the risks are real; the fact is just that any manifestation of them is almost certainly well down the track and therefore more easily downplayed than the downside risks currently staring us in the face. We'll cross that bridge when we come to it and hope it holds our weight.

The RBNZ August MPS indicated that the Monetary Policy Committee has "instructed staff to prepare advice on the design of a package for deployment if deemed necessary, taking account of the operational readiness of the financial system". Unless the requested analysis and consultation unexpectedly throws up some theoretical or logistical hooks that have not been anticipated, the path forward has been clearly laid out, should the RBNZ deem the current QE programme to have largely reached its limits before the economy is back on its feet. That looks more likely than not.

Accordingly, we now expect the RBNZ to cut the OCR 50bp at the April OCR Review and clearly foreshadow this – if not outright commit to it – at the February Monetary Policy Statement. This would deliver the maximum interest rate stimulus as quickly as possible while still sticking to the earlier 12-month guidance for the OCR remaining at its current level of 0.25%. It would ensure bank systems are ready for negative rates, and provide sufficient time to design the accompanying funding for lending programme.

Amongst the practical details to be determined are the following:

- How will the bank funding for lending programme be funded? Freshly minted money seems the most straightforward.
- How long will the funding programme run? The longer it goes on for, the greater the proportion of bank funding that will have been supplied directly by the Reserve Bank, rather than traditional sources. Weaning banks off this funding will be more difficult the longer the program continues. Overseas schemes have tended to have a 2-3 year shelf life.
- How will the Reserve Bank directly incentivise lending, and will particular types of lending be prioritised?
- What should the tiering system be for bank deposits in the settlement cash system? Not exactly of great interest to the person in the street, to be fair, but a pretty essential piece of monetary policy plumbing.

Where to with quantitative easing?

For now, though, the RBNZ has made it clear that the LSAP (quantitative easing) programme is the tool of choice. It remains the least distortionary of the various unconventional policy options available to the RBNZ. While the small size of the local bond market does mean it will come to the end of its useful life soonish (it can't just be increased ad infinitum), odds are it will be extended further in November.

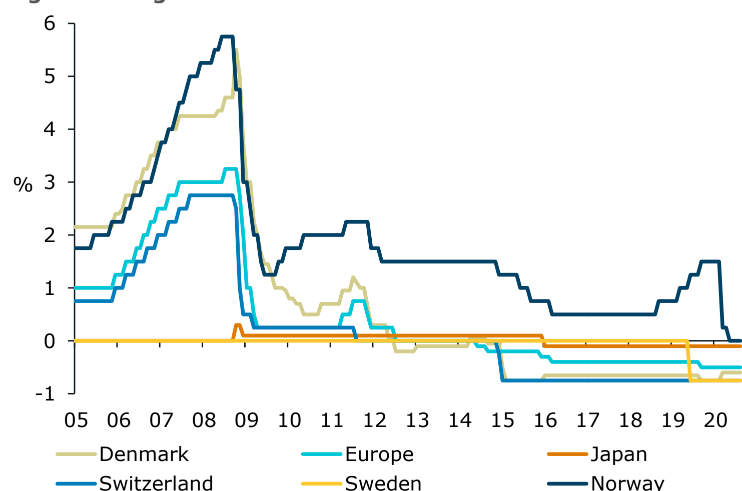
Much depends on what happens to bond issuance (and projections for issuance), but based on current projections and the existing 60% cap on nominal NZGB purchases, the programme could easily be extended to $120bn in November, with the timeframe extended to December 2022. At this stage, this seems like the most likely outcome.

That figure could rise to almost $140bn if the RBNZ were prepared to buy 70% of outstandings, or if more fiscal support is needed and the government bond market grows more quickly. But that potentially risks compromising market functioning and would see the free-float of NZGBs fall well below 2019 (pre-Covid) levels. If a much larger LSAP were seen as warranted in November, a more likely scenario is that foreign assets could comprise some part of a final lift in the size of the LSAP, with the RBNZ affirming last week that the purchase of foreign assets is still an option. It would certainly make more sense to include foreign assets in the LSAP, than to impair market functioning in the NZGB market by crowding out other investors.

Nonetheless, it is hard to envisage the size of the LSAP programme being increased materially beyond one more final lift in November. It will still provide ongoing support, with purchases slated over the next 2 years, but as we head into 2021, the LSAP will start to become the support act in an overall package that also includes a negative OCR and a funding for lending scheme.

Beyond our expectation that the OCR will be cut to -0.25%, further OCR cuts are possible, particularly if the RBNZ deems that its complementary policies have reduced risks to credit supply from taking the OCR lower. However, we see constraints on the OCR going below -0.75%. At some point, a lower OCR would encourage cash hoarding and break down the transmission of monetary policy. This point is known as the "physical lower bound", and it is thought to be around -0.75% or slightly lower. No countries have attempted to take their cash rates lower than this (figure 3).

Figure 3. Negative cash rates



Source: Bloomberg

In sum

We are not fans of negative interest rates. We have deep reservations about the long-term financial and societal implications of prolonged extremely low interest rates, and the difficulty of exiting unconventional monetary policy has been amply demonstrated over the past decade. But we're not fans of deep recessions either.

The Reserve Bank has clear inflation and employment mandates, and unless instructed otherwise, will feel duty-bound to do what they can to deliver on those mandates over the medium term. Long-term risks of unconventional policy are so blurry that of course the natural tendency is to focus on the nearer-term, more easily identifiable and quantifiable risks.

Time will tell, though we may have to wait for the economic history textbooks written thirty years from now for the full story. For now, the path forward has been laid out clearly. Into the twilight zone we go.

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