

# Economic Note

Interest Rate Outlook: How low can you go?

4 October 2019

## How low can you go? A checklist for the RBNZ

- We believe the OCR floor is somewhere between -0.25% and -0.75%.
- Our preference would be for the OCR lever to be fully exercised before other measures are contemplated.
- There are a variety of other unconventional policy options available, but none are without cost. To provide the best bang for your policy buck, closer co-ordination will be needed.

### Summary

Policy rates globally are approaching zero, including in NZ. Against this backdrop, it is prudent to think about where the floor in the OCR might be, and what other forms of monetary easing the RBNZ could use to support the economy.

**To be clear, our view remains that the trough in the OCR will be 0.50% this cycle (or slightly below it).**

But if the proverbial does hit the fan, a **suggested course of action for the RBNZ could be the following:**

- Cut the OCR to its limit - the floor could be as low as -0.75% according to our estimates. However, where this floor is depends crucially on the policy settings of other central banks;
- Introduce tiered lending to mitigate the impact of the low OCR on financial institutions;
- Provide explicit forward guidance, committing to hold the OCR at the lower bound for either a long period of time or until there are signs that the trend in inflation is above the midpoint of the 1-3% inflation target;
- Conduct asset purchases, via purchasing NZ Government bonds;
- Direct market intervention via receiving long-term interest rate swaps to hold down long-term yields;
- Providing long-term funding to banks to support credit creation; and
- Undertake unsterilised FX intervention to lower the NZD.

**Increased and more effective policy co-ordination is the key to boosting the effectiveness for unconventional policy.**

There are three levels of co-ordination: first, better co-ordination between the various policy levers at the RBNZ's disposal; second, enhanced co-ordination between the Treasury and RBNZ to ensure policy is heading in a unified direction, and, finally co-ordination between the actions of the RBNZ and its peers offshore.

**We warn that unconventional policies are not a panacea** and there is no guarantee they will prove effective in kick-starting the economy. **Their adoption can also impose significant costs and distortions.** These include: adding unpredictability over policy direction; significantly eroding policy credibility (particularly if ineffectual); widening inequality via boosting asset prices; imposing political risks; and placing greater risk on the RBNZ's (and Government's) balance sheet.

**At best, these policies are likely to provide a temporary band aid solution to what may be longer lasting issues.** The adoption of unconventional policy represents another form of 'can kicking'. The conversation needs to turn to whether it is beneficial for economic welfare to eschew this policy route as opposed to keeping the can rolling and face the risk of a larger mess to eventually clean-up and with fewer policy options available.

## 2019: Yet another leg lower for the global interest rate outlook

**This year has seen a sea change in the global interest rate outlook.** The catalysts appear to be the weakening global outlook and still-muted inflation, which has seen global central banks step up their provision of policy stimulus. US Fed hikes over 2018 have been replaced by Fed cuts in 2019. Some policy interest rates in much of Europe are already negative and the European Central Bank cut deposit interest rates last month to -0.50% and signalled the resumption of asset purchases in November. Central bank policy rates have been cut on either side of the Tasman, and look set to move lower still to new record lows.

After delivering a 50bp OCR cut in August, which took the OCR to 1.00%, RBNZ Governor Orr warned “it’s easily within the realms of possibility that we might have to use negative interest rates.” Governor Orr also confirmed that the RBNZ was preparing for this eventuality by looking at its broader policy toolkit and working with external experts on unconventional policy. This looks to be a prudent move by the RBNZ.

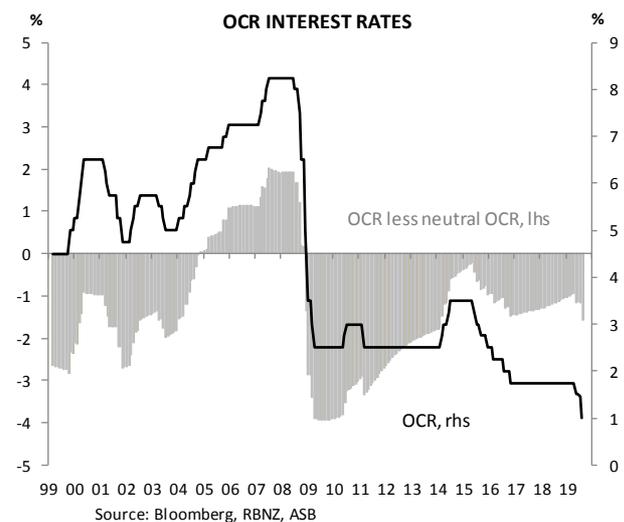
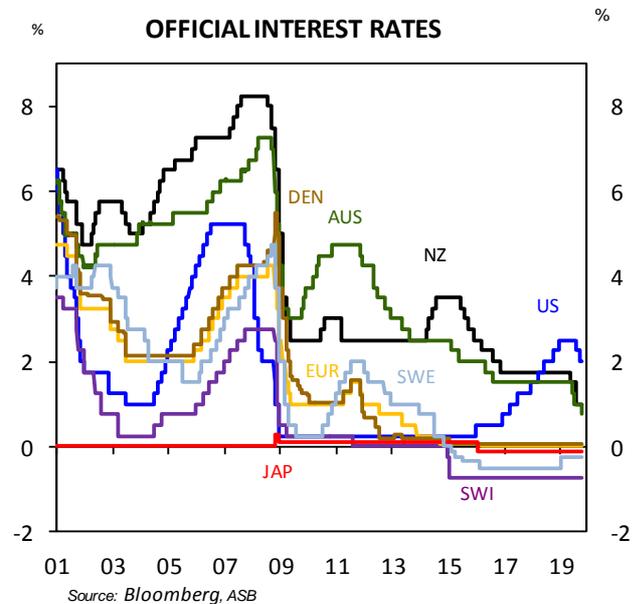
The \$64,000 question is whether policy (and wider interest rates) in NZ will join their European cousins and move below zero and whether the RBNZ will employ other unconventional policy measures to support the economy. Here, we provide our insights.

### How does monetary policy and the OCR work?

There is the general consensus that monetary policy cannot permanently boost the level of economic activity, but it can enhance welfare by reducing cyclical peaks and troughs. Monetary policy impacts the economy via a variety of transmission channels (see [RBNZ \(2008\)](#)), which can be boiled down into its impact on market interest rates, the NZD and expectations. Traditionally, the most powerful monetary policy transmission channels in New Zealand have been the pass-through to interest rates for mortgage borrowers and via its impact on the NZD exchange rate.

Lower market interest rates and the lower NZD, all else equal, would likely spur economic activity by increasing borrowing, business and consumer spending and export activity. These impacts and rising prices for imports would see inflationary pressures firm. **An important component in the recent NZ monetary framework is the Official Cash Rate (OCR).** Banks hold settlement accounts with the RBNZ, used to settle transactions between each other or with the Government. A bank can borrow overnight from the RBNZ at the OCR plus a margin of 50bps, or from another bank at a mutually agreed rate. The RBNZ pays banks (usually positive) interest on their Settlement account balance, at the OCR. Since banks can always either borrow from or lend to the RBNZ at roughly the OCR, short-term interest rates can’t deviate far from the OCR.

Despite the OCR being at a record low of 1.00%, inflation in NZ has remained muted. This has naturally raised the question as to whether the OCR (and wider monetary transmission) is effective. Governor Orr has maintained that monetary policy was still effective, citing recently published RBNZ [research](#). Using a variety of techniques, the RBNZ research showed that a 25bp cut to the Official Cash Rate (OCR) led to an increase in inflation and GDP growth. The peak impacts of a 25bp cut – which adds about +0.2% to quarterly GDP and 0.2 percentage points to annual CPI inflation – have been relatively stable across time.



We know that NZ (and global) interest rates have been on the decline since the Global Financial Crisis. A 25bp cut (or hike) is a greater proportion of a 1% OCR than an OCR of 5% or 10%. All else equal, this suggests that a 25bp move should have more potency today than a similarly sized move a decade or so ago. It is worrying that the RBNZ analysis did not identify this. We are not as convinced as the RBNZ that the OCR has not lost at least some of its potency. However, it does follow that with the neutral OCR currently around 2½% (ASB [estimates](#)), a 1% OCR is not providing as much stimulus as it would have when the neutral OCR was higher (see chart).

## Unconventional forms of monetary policy

When standard expansionary monetary policy has become ineffective, authorities can resort to using unconventional forms of monetary policy (UP), of which there are several forms, including:

- Negative policy rates;
- Introducing tiered lending to mitigate the impact of the low OCR on financial institutions;
- Explicit forward guidance that policy rates will remain at a very low level until stated conditions are met;
- Lowering long-term risk-free rates by purchasing government securities;
- Intervening in wholesale interest rate markets to lower long-term interest rates;
- Purchasing private sector assets, including mortgage-backed securities, and corporate bonds;
- Providing long-term funding to banks to support credit creation; and
- Foreign exchange intervention.

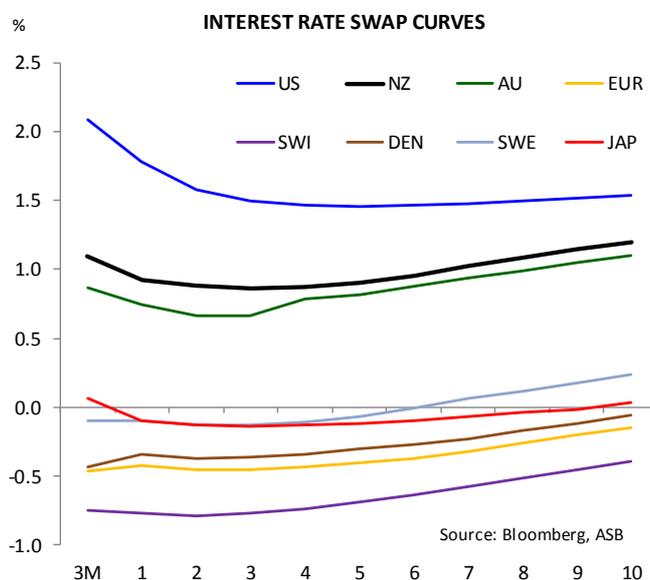
## Negative Interest rates

**Negative policy rates were expected to work in a similar way to conventional monetary policy, by lowering interest rates across the yield curve and stimulating economic activity.** Under a negative rate policy, financial institutions are required to pay interest for depositing excess reserves with the central bank. That way, central banks penalise financial institutions for holding on to cash in hope of prompting them to boost lending. Exactly how negative the policy rate could go would be constrained by how costly it would be for institutions to securely hold physical cash. If these costs are low, people may prefer to hold cash over placing funds in an account with negative interest rates.

The experiences of (mostly European) central banks so far have shown that policy rates can be modestly negative:

- The European Central Bank (ECB) introduced negative rates in June 2014, lowering its deposit rate to -0.1%. In September 2019, the ECB cut its deposit rate by 10bps to -0.5%.
- The Bank of Japan (BOJ) adopted negative rates in January 2016. It charges 0.1% interest on a portion of excess reserves financial institutions hold with the BOJ.
- In late 2014, the Swiss National Bank (SNB) cut its policy rate to -0.25%. At the start of 2015, the policy interest rate was lowered to -0.75%, where it has remained since then.
- The policy rate of the Swedish Riksbank has been negative since early 2015. At the start of 2019, the Riksbank hiked its policy rate by 25bps (-0.25%) from the -0.50% it had been since early 2016.
- The Danish Central Bank has charged negative interest rates on certificates of deposit since 2012. This rate is currently -0.75%.

Government bond yields and yields from interest rate swaps have also been negative in these economies across much of the term structure. **The move to negative interest rates has been complemented by policymakers' pledges that policy accommodation will be continued until certain conditions are met.** The ECB recently pledged to maintain its current rate settings "for as long as necessary" and to not to raise interest rates until inflation outlook "robustly improves". Other policy actions (including Quantitative Easing) have also been effective in holding down the interest rate term structure. **It's not just in money markets, where negative interest rates are increasingly becoming the**



**norm.** Bloomberg estimates suggest that around 30% of the global government bond market, around half of European government bond yields and 20% of investment grade bonds are currently trading with negative yields.

**What is the NZ interest rate floor?**

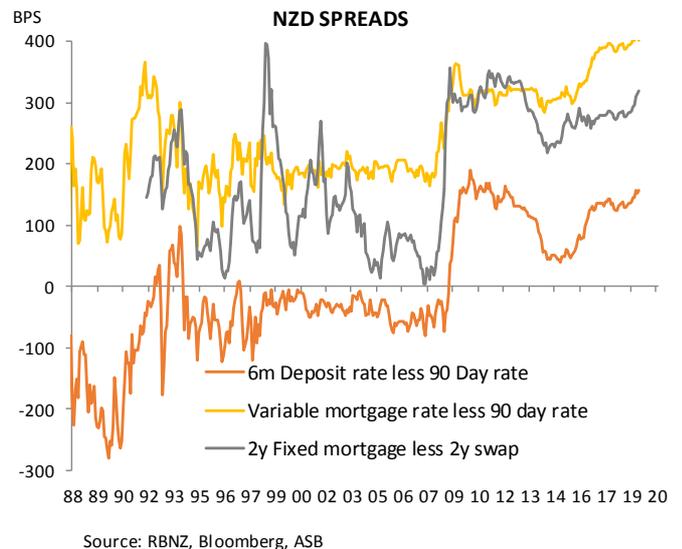
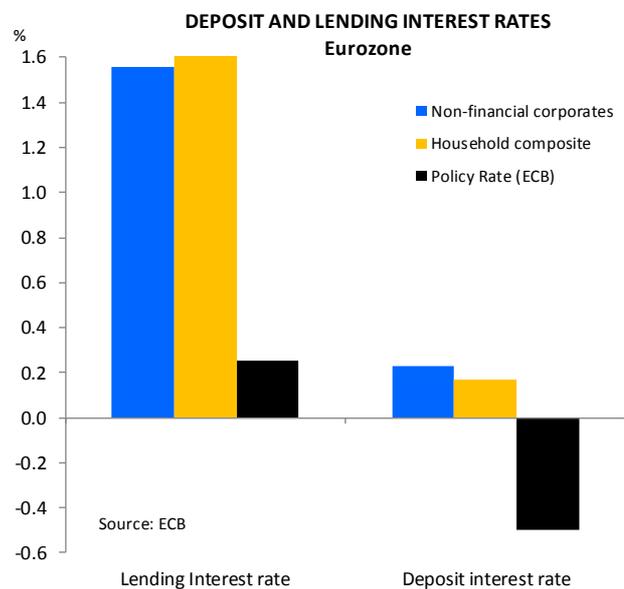
In the NZ context, the ability of the OCR to move below zero is by and large determined by the willingness of financial market participants to hold eligible NZD securities (including cash). Banks in NZ hold settlement accounts with the RBNZ that are used to settle transactions between each other or with the Government. If the OCR is set to a level that would impair the functioning of key financial sector firms, the transmission of further policy interest rate reductions to the wider economy would be hampered. In the NZ banking system, paying negative interest rates on settlement balances would be costly to banks, particularly when settlement cash balances are large.

**Another constraint is that the level of the OCR will likely have to be such that it delivers positive retail deposit interest rates.** The [NZ Treasury](#) cites international evidence that while banks remain willing to deposit funds at the central bank when the policy rate is negative, they are reluctant to let retail corporate or household interest rates turn negative.

Government bond yields and yields from interest rate swaps have generally been negative in some European jurisdictions and Japan, but retail deposit and mortgage rates (Denmark excepted) have not. **Banks have generally remained willing to deposit funds at the central bank when the policy rate is negative, but they are reluctant to let retail corporate or household interest rates turn negative.** Why is this? If retail rates were to fall below zero, it is likely households and businesses would prefer to hold physical currency, increasing the demand for cash and limiting the efficacy of monetary policy.

**Financial institutions in NZ rely on deposits for a significant chunk of their funding,** with deposits (\$360bn in July) equivalent to approximately 80% of total lending to households, businesses and agriculture. About half of total bank deposits are from the household sector, whereas slightly more than 60% of bank lending is provided to households. This dwarfs the funding that financial markets obtain from wholesale interest rate markets. Locally-incorporated banks in NZ are currently above their 75% floor for [core funding](#) and could potentially obtain more shorter-term wholesale funding (less than 12 months). There is also scope for NZ banks to obtain more stable longer-term funding from wholesale interest rate markets.

Since the Global Financial Crisis (GFC) the wedge between the OCR and NZ retail deposit and lending interest rates has widened (see accompanying chart). This is typically the result of banks moving to secure more stable (but typically more expensive) funding. The gap between various short-term deposit interest rates and the OCR is roughly 100bps on average, which is typically wider than that observed in other OECD economies. **If this gap persists, the OCR could go as low as -0.75% and banks would still be able to offer a positive deposit rate to customers.** In our view the proposed deposit guarantee scheme – which would protect deposits below a certain threshold – will likely maintain the allure of bank deposits, although it is likely to lower deposit rates of financial institutions who qualify for the scheme. Assuming the floor for retail deposit interest rates is around zero (or slightly above it), the floor for lending interest rates in NZ is



likely to be around 2% to 3% rather than 0% (or below it). Very low OCR settings could also result in lenders passing on costs that they have typically absorbed in their margins, with a negative OCR an added cost to bear.

**The other limit is likely to be the extent to which corporate borrowing rates could fall.** In NZ, most corporate facility agreements contain a zero floor for lending contracts. As such, borrowers would not benefit if the underlying market base interest rate fell below zero. Moreover, negative interest rates will likely reduce the protection provided from some interest rate hedging. If the borrower entered into an interest rate hedge to reduce their risk, negative interest would likely reduce the proceeds from the received leg of the swap, whereas zero floors would not result in lower interest rate payments under the swap agreement<sup>1</sup>. How low could the OCR go before corporate bond yields fell below 0%? Providing the spread between the OCR and other interest rates is little changed, [NZ Treasury](#) finds that the limit on the OCR, before corporate bond yields reach zero, is between -0.20% and -0.35%.

### Tiering may help

Paying a negative interest rate on settlement balances is costly for financial institutions. To mitigate the costs imposed on the banking system and ensure a smoother transmission of a lower OCR to customer lending interest rates, the RBNZ could alter its tiering structures for bank reserves (making a smaller proportion subject to negative rates) and/or implementing term lending facilities at favourable interest rates to promote lending. **Targeted term lending could promote lending by extending loans to banks at favourable rates, conditional on how much those banks lend to the real economy.** Such measures will reduce the likelihood of lenders having to increase borrowing interest rates to cover the costs of additional market disruption. A tier structure is common among other central banks globally who have implemented negative interest rates.

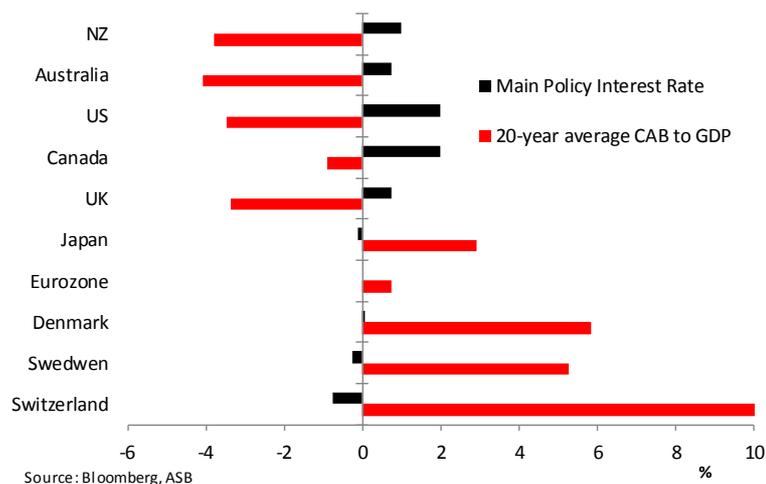
### Our view of the OCR floor

**The effective lower bound for the OCR – in other words the point at which it is no longer stimulatory for near-term activity – could be anywhere between -0.25% and -0.75%.** This would heavily depend at what point credit availability is significantly impacted, the extent to which the flow-through to lending and deposit interest rate ends and the degree to which this impacts on the NZD, and the term structure of interest rates.

### The lower bound for the NZ OCR is likely to vary over time. It will also depend on what is happening globally and will likely vary.

New Zealand's low nationwide savings relative to investment requirements have fostered the reliance on saving from other countries. Australia, the US, UK and Canada are in a similar boat. Economies with high national savings - the Eurozone, Sweden, Switzerland, Denmark and Japan - and who routinely run current account surpluses tend to have lower nominal interest rates on average. The OCR is at a record low 1.00% and from time to time has been below comparable policy interest rates in Australia, the US, UK and Canada. **We could not find any period over the last 20 years where the level of the OCR was below comparable policy interest rates in Denmark, Japan, Sweden and Switzerland.** As such, the lull in the OCR is still likely to be above the lull in policy rates in these economies.

CURRENT ACCOUNT BALANCES AND POLICY RATES



<sup>1</sup> Most agreements are likely to be indexed to BKBM (the bank bill benchmark rate (typically with a maturity date of 30-180 days after issue)). If the BKBM spreads remains 15-20bps, the hedging mismatch could occur at a relatively small negative OCR.

## NZ QE

Quantitative easing<sup>2</sup> (QE) is an unconventional monetary policy in which a central bank purchases government securities or other securities from the market. By increasing the domestic money supply and providing liquidity in the banking sector, QE lowers yields and can make it easier and cheaper for banks to extend loans to customers and stimulate borrowing. QE can also make it cheaper for governments to borrow on financial markets and to help ease financial conditions via lowering interest rates and contribute to a flattening of the yield curve.

**QE has been deployed in various guises** since Bank of Japan adopted it in 2001. From late 2008 to late 2013, the US Federal Open Market Committee undertook three bouts of Quantitative Easing (QE1, QE2 and QE3) constituting a combination of bank debt, Treasury notes, and mortgage-backed security purchases. In late 2013 the FOMC announced it would begin tapering its purchases, although it scaled back its balance sheet reduction last month.

The Bank of England has progressively stepped up government bond purchases from £200bn (2009) to £375bn (2012) and £435bn (2016), also instigating roughly £10bn in corporate bond purchases in August 2016.

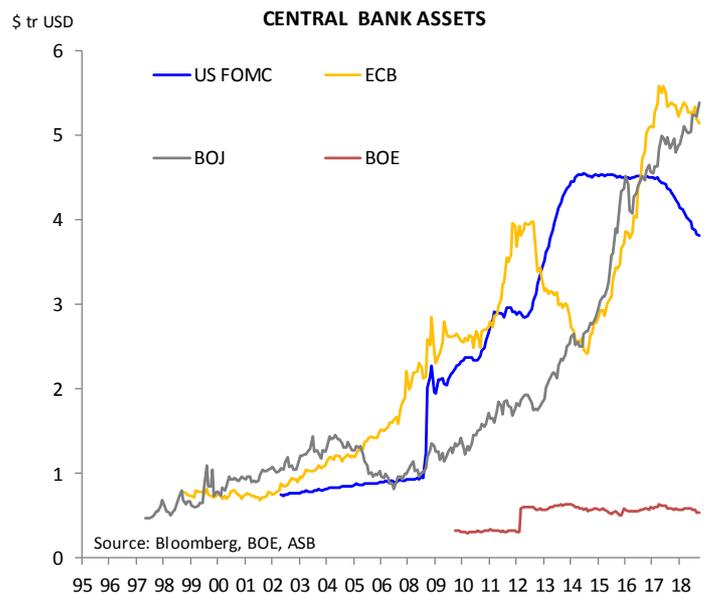
The ECB embarked upon quantitative easing in March 2015, and looks set to restart it in November this year after a pause late last year. Under QE the ECB's balance sheet, mostly government and corporate debt, asset-backed securities and covered bonds, has ballooned to about €4.65 trillion.

**QE has substantially boosted central bank balance sheets.** All up, the Big 4 major central banks hold more than USD15 trillion in assets, which predominantly take the form of government bond holdings. **This is around 25% of global GDP.** Relative to the size of its economy, the BOJ is currently the biggest asset holder among these central banks, holding assets worth around 100% of Japanese GDP. The ECB, BOE and FOMC currently hold assets at around 40%, 25% and 20% of GDP, respectively.

### How would QE work in NZ?

As the [RBNZ](#) notes, New Zealand's debt markets are small and undiversified in structure compared to other advanced economies. Moreover, NZ locally-incorporated banks and the NZ Government bond market have a high proportion of overseas ownership, with just over [half](#) of the NZ equity market owned offshore. This may create limitations on the extent to which unconventional policies can be applied in New Zealand.

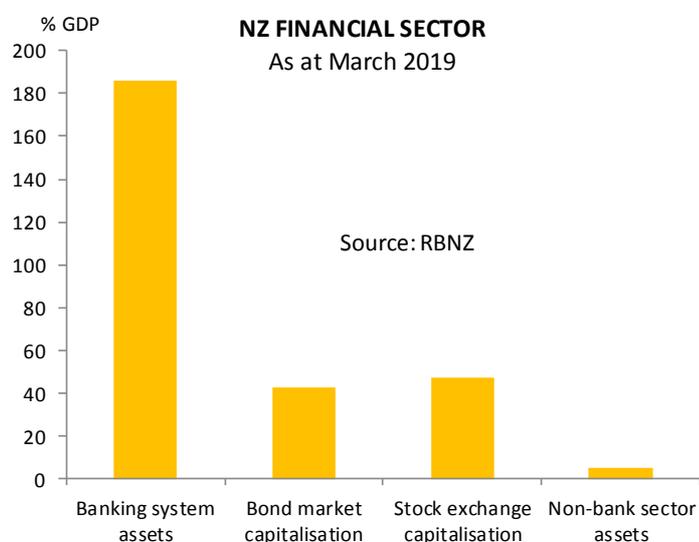
**For NZ asset purchases, the RBNZ is most likely to target NZ Government bonds.** There is around \$78bn of NZ Government bonds on issue (25% of NZ GDP), which are the most accessible asset to purchase, although the size of this market will be a constraint compared to larger economies. There are also non-Government NZ bonds on issue (more than 30% of GDP) that the RBNZ could purchase, but these markets are typically more illiquid. Of relevance for a small open economy, such as NZ, QE tends to depreciate a country's exchange rates relative to other currencies.



<sup>2</sup> This differs from qualitative easing, which holds the size of the central bank balance sheet, but changes the asset mix towards less liquid and riskier assets. Central banks also purchase government securities for liquidity management purposes.

If the RBNZ buys up the available bonds, this may reduce liquidity within the market, which could impair financial functioning and limit falls in wholesale interest rates. Alternatively, by crowding out the demand for NZ bonds, QE may push investors into other investments. These other investments could either be overseas (which will depress the NZD) or in other domestic investments. **By pushing investment to other assets, QE could boost economic activity if those funds were put to good use. Not so good, however, if these investments turn out to be lemons.**

To enhance the market liquidity and to provide investors with more options, the RBNZ is also looking at alternate options. In August the RBNZ, published a summary of [submissions](#) on its consultation proposing a new mortgage bond standard aimed at supporting confidence and liquidity in New Zealand's financial markets. It proposed to introduce a high-grade residential mortgage backed securities framework through Residential Mortgage Obligations (RMO). These would be fully repo-eligible and would be accepted by the RBNZ as regular collateral in its market operations. RBNZ purchases of these assets would likely narrow the spread between mortgage interest rates and government bonds, providing more direct stimulus to the housing market via lower mortgage interest rates.



## Market Intervention

In NZ, the interest rate swaps market is deeper (i.e. more liquid) than the domestic bond market and plays a more important role in the monetary policy transmission mechanism. Swaps are a key component used to price fixed-rate mortgages and are widely used for corporate borrowing/hedging. If the RBNZ was trying to lower borrowing rates, it could transact in interest rate swap markets. To lower swap yields at a particular tenor (e.g. 2 years), it would receive the fixed rate (i.e. buy 2-year swap) and paying a floating interest rate (sell the floating rate leg of the swap). Such a move by the RBNZ would signal the commitment not to raise interest rates as the RBNZ would incur losses if floating rates were to rise. If these transactions are done in sufficient quantities and backed up by a credible commitment, such an action would act to flatten the yield curve and potentially lower interest costs for fixed-rate borrowers. It would also act to lower the NZD via reducing NZ interest rates relative to our trading partners.

## Targeted term lending

This type of facility would provide collateralised term lending to banks at a subsidised rate if banks met specified lending objectives. It would ensure that the low policy rate was being passed on to favoured sectors.

**Targeted term lending for banks can be effective for economies that rely heavily on bank financing, such as NZ.**

Moreover, some form of targeted lending scheme could be particularly useful if banks' funding costs were elevated or if credit supply to particular sectors was impaired, and the benefit of the low OCR was not being passed through to the real economy. This option would have the most direct impact in terms of lowering banks' funding costs, which could then be passed through to lending rates in the wider economy. A number of economies countries have adopted similar measures in the wake of the Global Financial Crisis, and the Bank of England reintroduced it as a pre-emptive measure after the Brexit vote in 2016.

**Such an approach can impose significant credit risk exposure for the RBNZ if the banking sector lowered credit standards to meet the specified target.** There might also be the temptation for financial institutions to replace existing funding sources with this one, if it was considerably cheaper. **Moreover, it would also place the RBNZ in the unenviable position of having to 'pick winners',** by deciding which sector or firm was more deserving of the cheaper funding. This could backfire if the RBNZ backed the wrong 'winner'.

## Foreign Exchange Intervention

To lower the NZD, the RBNZ could also issue NZD reserves and use the proceeds to purchase foreign assets (mostly foreign government bonds). This intervention would be [unsterilised FX intervention](#) in that it would increase the domestic money supply (and dampen domestic interest rates) in addition to boosting the RBNZ's asset holdings. It would generate a net foreign exchange exposure, or a 'long' foreign currency position in the RBNZ's books, financed by NZD borrowing. Typically, the RBNZ actively intervenes at extremes in the exchange rate cycle, with the aim of the intervention to smooth through the peaks and troughs of the NZD.

Such a strategy would have a greater chance of success if it was co-ordinated with other central banks and was consistent with the general direction of policy settings. However, there is no guarantee if this would work given the depth of financial FX markets and the NZD's position of being the 10<sup>th</sup> most traded currency in the world. **FX intervention could cop global political fallout and hasten the move to greater trade protectionism, which would be ultimately self-defeating for a small, open economy like NZ.** A lower NZD is not a panacea, it just redistributes the costs and benefits within the economy. While the export sector would benefit from a lower NZD, consumers and firms would face higher bills.

## Drawbacks of Unconventional Policy

In short, while it is always useful for policy-makers to have a number of potential options in the policy toolkit, unconventional policies are not a panacea and can impose significant costs:

- UP is risky and can undermine policy credibility if unsuccessful.
- Their impacts are uncertain and can add to unpredictability, which could hold back investment activity and impair other crucial decision making.
- Low or negative interest rates create disincentives for saving. UP by its very nature is intended to spur consumer spending and lower saving via encouraging more debt accumulation. More indebtedness would increase the vulnerability of the NZ economy and leave it more vulnerable to adverse economic shocks.
- UP can impose political risks. Fiscal discipline can be significantly eroded if governments believe central banks will finance fiscal deficits via debt monetisation.
- There are not many options available for QE or even UP in NZ, given our small financial system, undiversified structure, and sizeable portion of foreign ownership.
- UP could be used to invest in overseas markets or speculative assets rather than investments that would boost the productive potential of an economy.
- UP can be regressive, boosting asset values and the wealth of asset holders and widening the gap between the haves and have nots. It could potentially pitch one generation against another.
- UP imposes significant risk on central bank balance sheets.
- UP can fail to spur demand if banks are unable to lend money to businesses and households.

## A check-list for the RBNZ

There is no hard and fast rule in terms of the sequence in which unconventional policies should be deployed. Governor Orr has expressed a [preference](#) for the OCR to go negative before the RBNZ contemplates unconventional policy (including quantitative easing, QE). The [view](#) of the Reserve Bank of Australia is somewhat different, with quantitative easing likely preferred before contemplating a negative cash rate.

If the proverbial does hit the fan, a suggested course of action for the RBNZ would be to do the following:

- 1) Cut the OCR to its limit - the floor could be up to -0.75% according to our estimates. Introduce tiered lending to mitigate the impact of the low OCR on financial institutions;
- 2) Provide explicit forward guidance, committing to hold the OCR at the lower bound for either a long period of time or until there are signs that the trend in inflation is above the midpoint of the 1-3% inflation target;
- 3) Direct market intervention via receiving long-term interest rate swaps to hold down long-term interest rates;
- 4) Conduct asset purchases, via purchasing NZ Government bonds;
- 5) Conduct long-term funding operations by providing cheaper lending to particular sectors, via banks; and
- 6) Undertake unsterilised FX intervention to lower the NZD.

For small open economies (like NZ), the exchange rate is an important part of the transmission mechanism. **Most of the actions above would likely lead to a lower NZD.** Even the announcement of the intent to pursue unconventional policies would likely push the NZD lower. A lower NZD reduces the amount of heavy lifting needing to be done by domestic interest rates. There will be distributional consequences from a lower NZD, with consumers bearing much of the brunt, while the export sector would likely benefit.

## The need for policy co-ordination

**If the RBNZ was to go down the unconventional policy route it needs to make sure that its internal policy settings are moving in the same direction.** If the proposed RBNZ capital requirements are imposed, our [work](#) suggests this will widen the margin between deposit and lending interest rates and potentially slow the supply of credit. Both would oppose the impact and effectiveness of UP.

**It is also vital that Number 1 and Number 2 The Terrace sing from the same song sheet.** NZ is in an enviable position, with fiscal policy well-placed to do some of the heavy lifting. NZ's public finances are in a strong position; the Government has continued to run budget surpluses and our net public debt is low relative to our OECD peers. The signalled relaxation of the net public debt ceiling (via moving from a less than 20% of GDP net public debt target to a range of 15-25% of GDP) after the 2020 election signals the willingness to leverage off the Government's balance sheet. In addition to support provided by the automatic fiscal stabilisers, discretionary fiscal policy easing would support the economy. Moreover, with circa 1% 10-year NZ Government bond yields, it is cheap for the Government to borrow, although the focus should be on projects that can be implemented quickly and boost economic activity, will provide benefits to future generations, and will minimise the crowding out of the private sector. This is a tall order and necessary trade-offs will have to be made.

UP for NZ is new, but it is not so novel in various countries who have used it, with varying degrees of success. **Rather than reinvent the wheel in NZ, it is crucial that the RBNZ closely liaises with other central banks around the world to see what has worked, and what hasn't.** New Zealand prides itself of being a pioneer, but there is considerable value in being a good observer and learning from other's successes and failures. Moreover, some policy actions – for example, FX intervention – stand a better chance of success if the action is co-ordinated rather than the RBNZ going it alone.

## A final Warning

Monetary policy is a powerful tool for *cyclical* stabilisation. However, its ability to counter longer-lasting influences – including persistently-weak inflation – is untested. If inappropriately used, it could end up creating a larger mess down the track. **Before opting for the unconventional policy route, policymakers must be confident that propping up the economy with policy stimulus will provide better long-term outcomes for economic welfare than letting things run their natural course.** The adoption of unconventional policy represents another form of 'can kicking', but the conversation needs to turn to whether it is beneficial for economic welfare to keep the can rolling and face the risk of a larger mess to eventually clean-up and with fewer policy options available.

**Table 1: Unconventional Policy options for NZ**

Policy	What is it?	Benefits	Costs
<i>Negative interest rates</i>	OCR could go as low as -0.75% according to RBNZ. Treasury place the lower bound at -0.35%. <i>ASB: Lower bound is in a -0.25% to -0.75% range.</i>	Lower wholesale/retail interest rates. Lower NZD.	Adversely impacts bank profitability and could dampen bank lending. Will hit savers hard and may see pick-up in speculative investment/asset prices May be less effective in low saving economies (NZ).
<i>Explicit forward guidance</i>	RBNZ commits to holding OCR low over lengthy horizon.	Increase traction of OCR settings, holding down longer-term interest rates. Lower NZD.	Reputational/credibility loss or if circumstances change/forward guidance looks to be misleading, or if the RBNZ abandons guidance.
<i>Quantitative Easing</i>	RBNZ purchase NZ Govt bonds, collateralised mortgages.	Lowers long-term lending rates and frees up liquidity. Lower NZD. Could directly lower borrowing costs for mortgages.	Sizeable risks incurred by RBNZ. Could create additional volatility and overheating in asset markets. Small domestic bond market. Could reduce liquidity if purchases too many assets.
<i>Market Intervention</i>	Transaction to flatten domestic swaps curve and kick-start activity.	Lower long-term borrowing costs. Lower NZD.	Subjects RBNZ to considerable risk given their reduced influence on longer-term interest rates.
<i>Term Lending facilities</i>	New cash facility to support banking system liquidity.	Help to increase supply of credit and pass through to customer interest rates. More effective for economies reliant on bank financing. Lower NZD.	Banks may take on more credit risk than they would normally do. Could impede market efficiency.
<i>Purchase private sector assets</i>	RBNZ to fund asset purchases.	Supports asset values. Increases liquidity. Lower NZD.	Sizeable risks to RBNZ's balance sheet. RBNZ would have to pick winners in sectors. Could create overheating in asset markets.
<i>Purchasing foreign currency</i>	Outright foreign asset purchases by the RBNZ.	Holds down NZD and boosts banking system liquidity.	Large financial risks imposed on RBNZ.

Source: ASB

**ASB Economics & Research**

Chief Economist  
 Senior Economist  
 Senior Economist  
 Senior Economist  
 Senior Rural Economist  
 Senior Economist, Wealth  
 Data & Publication Manager  
[www.asb.co.nz/economics](http://www.asb.co.nz/economics)

Nick Tuffley [nick.tuffley@asb.co.nz](mailto:nick.tuffley@asb.co.nz)  
 Mark Smith [mark.smith4@asb.co.nz](mailto:mark.smith4@asb.co.nz)  
 Jane Turner [jane.turner@asb.co.nz](mailto:jane.turner@asb.co.nz)  
 Mike Jones [mike.jones@asb.co.nz](mailto:mike.jones@asb.co.nz)  
 Nathan Penny [nathan.penny@asb.co.nz](mailto:nathan.penny@asb.co.nz)  
 Chris Tennent-Brown [chris.tennent-brown@asb.co.nz](mailto:chris.tennent-brown@asb.co.nz)  
 Judith Pinto [judith.pinto@asb.co.nz](mailto:judith.pinto@asb.co.nz)

**Phone**

(649) 301 5659  
 (649) 301 5957  
 (649) 301 5853  
 (649) 301 5660  
 (649) 448 8778  
 (649) 301 5915  
 (649) 301 5660

**Disclaimer**

This document is published solely for informational purposes. It has been prepared without taking account of your objectives, financial situation, or needs. Before acting on the information in this document, you should consider the appropriateness and suitability of the information, having regard to your objectives, financial situation and needs, and, if necessary seek appropriate professional or financial advice. We believe that the information in this document is correct and any opinions, conclusions or recommendations are reasonably held or made, based on the information available at the time of its compilation, but no representation or warranty, either expressed or implied, is made or provided as to accuracy, reliability or completeness of any statement made in this document. Any opinions, conclusions or recommendations set forth in this document are subject to change without notice and may differ or be contrary to the opinions, conclusions or recommendations expressed elsewhere by ASB Bank Limited. We are under no obligation to, and do not, update or keep current the information contained in this document. Neither ASB nor any person involved in the preparation of this document accepts any liability for any loss or damage arising out of the use of all or any part of this document. Any valuations, projections and forecasts contained in this document are based on a number of assumptions and estimates and are subject to contingencies and uncertainties. Different assumptions and estimates could result in materially different results. ASB does not represent or warrant that any of these valuations, projections or forecasts, or any of the underlying assumptions or estimates, will be met.