Economic Note

QE and retail interest rates

17 June 2020

Retail interest rates on the RBNZ watchlist

- The RBNZ has not ruled out the possibility of a negative OCR and has introduced a Quantitative Easing (QE) programme.
- This looks to have been effective so far. Wholesale and retail interest rates have fallen and could move lower still.
- The test will be how effective QE will be as markets contemplate moving past the emergency stage of COVID-19 and focus on the path ahead for the economy and interest rate settings.

Summary

COVID-19 represents a substantial negative shock to the NZ and global economy, arguably of greater severity than the Global Financial Crisis (GFC). Back then, the OCR was cut by just shy of 600bps, but with the OCR sitting at just 1% prior to the onset of COVID-19, the leeway for conventional OCR stimulus is much reduced.

The RBNZ had the choice of adopting a negative OCR or using its wider tool kit. It has chosen the latter. QE, forward guidance, and monetary policy implementation actions by the RBNZ and global central banks have been effective in helping to calm markets, lowering yields, narrowing spreads and have delivered lower retail deposit and mortgage interest rates.

RBNZ QE has worked well so far, but the true test will be how long-lasting its impacts will be. NZ Retail lending and deposit interest rates remain on the RBNZ's watchlist and ours as well.

More stimulus needed and promptly

COVID-19 represents a larger negative shock to the global economy than the Global Financial Crisis. Our forecasts have a 6% decline in NZ GDP over 2020, around twice the cumulative fall in GDP during the GFC. **We also need to take into account the weaker outlook for inflation and inflation expectations**. Both real and nominal short-term interest rates dropped by more than 500bps during the GFC. Our estimates suggest real 90-day interest rates have only dropped 50bps so far in 2020 (see chart overleaf, with Appendix 1 having some additional charts).

Admittedly the fiscal policy easing this time around is more front-loaded compared to the GFC. However, the magnitude of planned fiscal easing over the next 3 fiscal years is broadly comparable to the fiscal stimulus put in place over the 209/11 period according to the Treasury Fiscal Impulse in Budget 2020 (6.5% of GDP over 2020/21 versus 5% of GDP over 2009/11).

Monetary policy works with a lag and the sooner the support is provided, the better. Our forecasts suggest that the level of NZ economic activity has already troughed but that more support will be needed as the economy struggles to transition from the crisis stage**. Climbing out of a deep hole is much harder than falling into it**.

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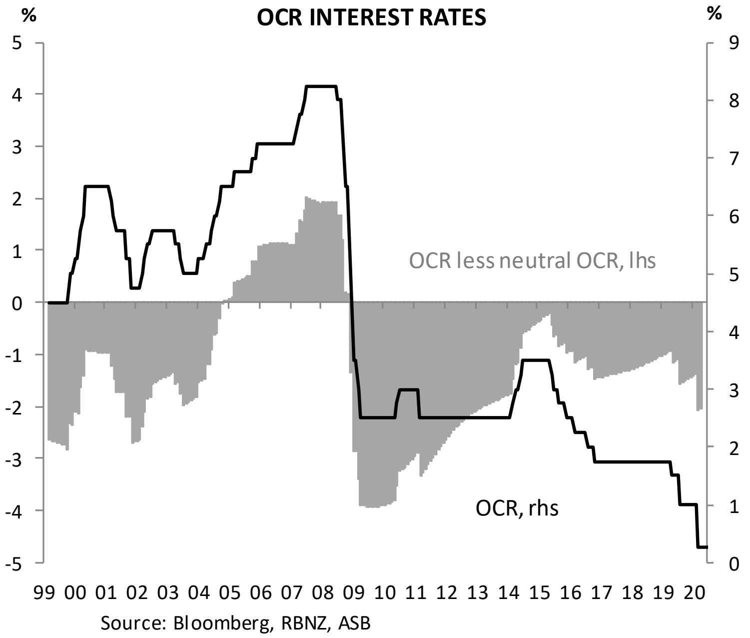
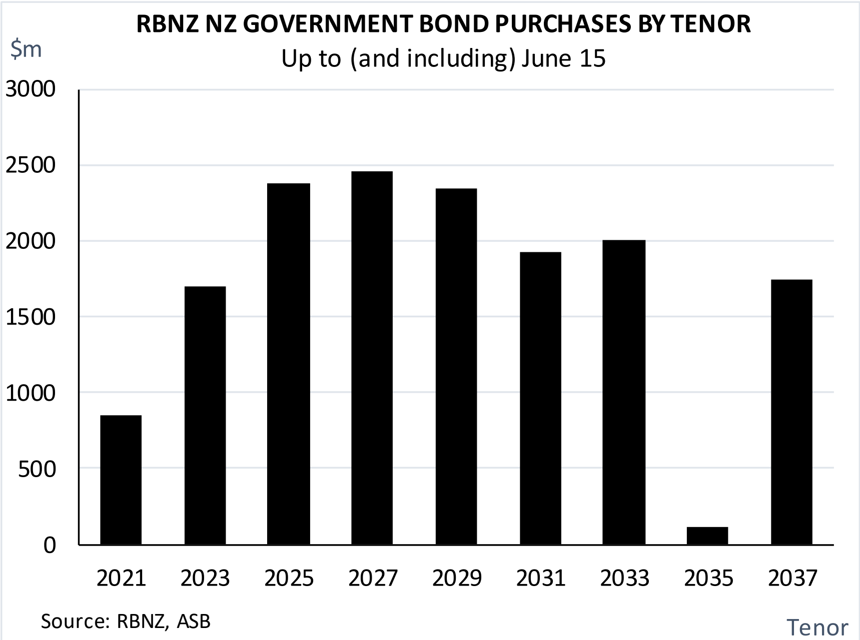
RBNZ has a number of options available and the pecking order can change

We have seen an evolution in the RBNZ's way of thinking over the last few months. Back in early March, the RBNZ flagged some principles for unconventional monetary policy. It flagged a rough pecking order for the provision of additional stimulus – lowering the OCR, forward guidance, using mildly negative interest rates, consider the use of interest rate swaps to reduce interest rates and finally asset purchases – but reiterated that the appropriate tool would depend on the situation facing the economy. Important considerations include their efficiency, effectiveness, impact on financial system soundness, operational readiness and Crown balance sheet risk.



The OCR has subsequently been cut to record lows and forward guidance employed, but the speed and severity of the COVID-19 outbreak on the economy has facilitated a swift re-prioritisation. On March 23, we saw the RBNZ introduce a $30bn Large Scale Asset Purchase programme (LSAP), buying NZ Government bonds in the secondary market. It added a further $3bn in Local Government Funding Agency (LGFA) debt to its programme on April 7. In the May MPS, the RBNZ announced a signalled ramping up in Large Scale Asset purchases (or Quantitative Easing (QE)) from $33bn to $60bn, via buying predominantly buying more Government bonds in the secondary market. RBNZ asset purchases to date have totalled close to $16.5bn. Of this, around $15.7bn have been purchases of NZ Government bonds, with an average maturity of 8.7 years (see chart).



It also signalled the preparedness to look at additional tools if and when needed. Two other options (in addition to not ruling out OCR cuts) included expanding the coverage of the LSAP, although the Crown Indemnity caps the proportion of RBNZ purchase for different asset classes, and providing fixed-term loans to banks. The latter would likely provide cheaper longer-term funding to banks but it creates a significant risk exposure to the RBNZ and may conflict with broader monetary policy and financial stability objectives.

Interest in a negative OCR may be waning, but it remains an option

The RBNZ has continued to flag the possibility of a negative OCR, but not just yet, having stuck to its forward guidance that the OCR will remain at 0.25% until early 2021. The lack of operational readiness of financial institutions and the RBNZ's lack of conviction whether this would actually lower borrowing costs at present were cited as reasons for not cutting the OCR this year.

Adopting negative interest rates would not change the way in which monetary policy works, which is to tilt the balance more in favour of investment/borrowing over saving and to encourage activity to be bought forward. The NZD would also be lower than it would otherwise be.

However, the jury remains out over whether it is advisable for a central bank to set negative interest rates. The experience offshore with negative interest rates had been decidedly mixed. Exiting out of a negative policy interest rate environment is easier said than done, with neither the Bank of Japan nor the European Central Bank able to move rates back into positive territory as yet. Two of the best global central banks in our view – the US Federal Reserve and the Reserve Bank of Australia – have ruled out negative policy interest rates for the time being.

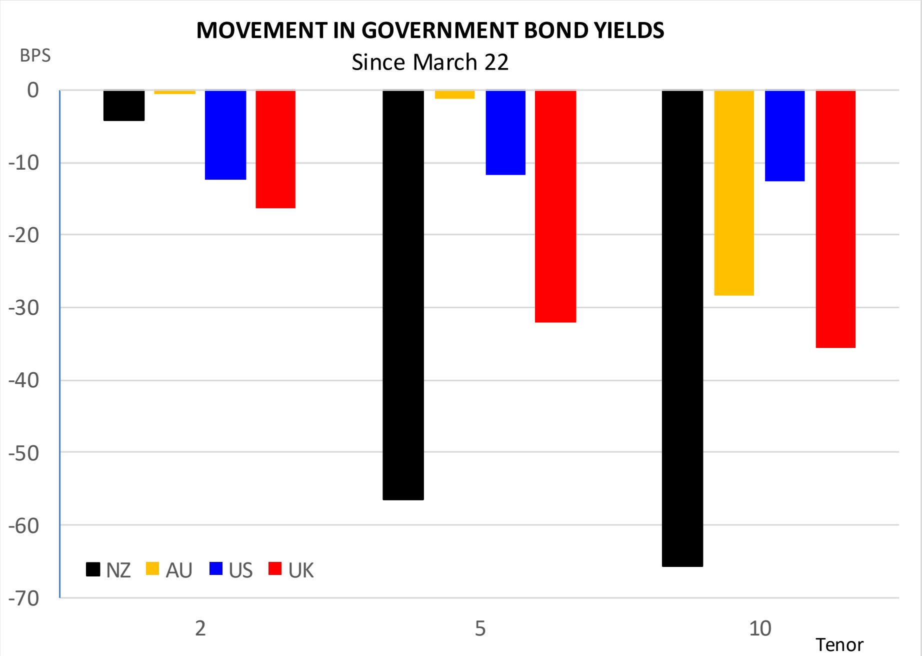
There is a considerable body of evidence suggesting that the effectiveness of interest rate settings tends to diminish for lower (and negative interest rates). Negative interest rates could interfere with the functioning for banking systems reliant on deposit funding and impair the ability of some banks to supply credit, the opposite of what monetary easing would aim to do. Banks may actually increase their mortgage interest rates in order to recoup the cost of holding reserves at negative interest rates. Even, here, however, evidence is still inconclusive.

Credit where credit is due

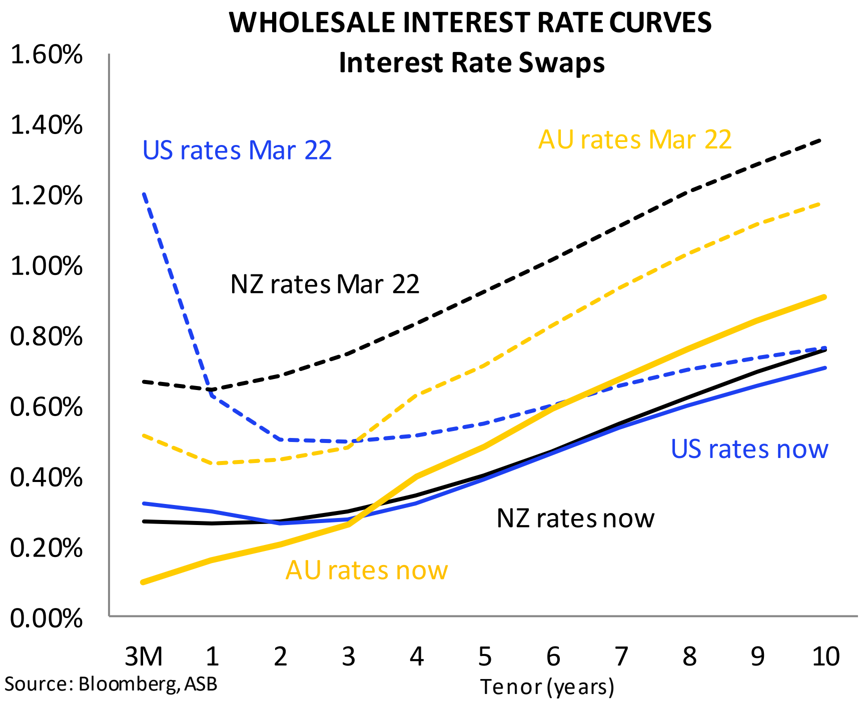
The aims of QE and a negative OCR and policy signalling are similar. They both work by conditioning expectations and flattening the term structure of interest rates and the NZD would likely be lower than otherwise. QE should also help to improve market liquidity via boosting the amount of settlement cash and facilitate more bank lending via increasing the quantity of money in the broader banking system (when the RBNZ purchases assets it prints more money to pay for it).

So far, the RBNZ QE programme has been sufficiently large and credible so as to keep interest rates low across the yield curve. Around 95% of RBNZ QE purchases to date have been NZ Government bonds. The bulk of the RBNZ asset purchases have been concentrated in the 5- to 10-year part of the curve and this is where falls in NZ yields have tended to considerably outpace global counterparts, acting to flatten the NZ yield curve, both in absolute terms and relative to global peers (see chart). An added bonus is that RBNZ bond purchases will likely help to support fiscal policy by lowering funding costs for NZ Government borrowing.

By contrast, the yield curve control (YCC) programme instigated by the RBA on March 19, has generally kept the Australian 3-year bond close to its 0.25% target, although the fall in longer-term bond yields has been more modest since late March.



Source: Bloomberg

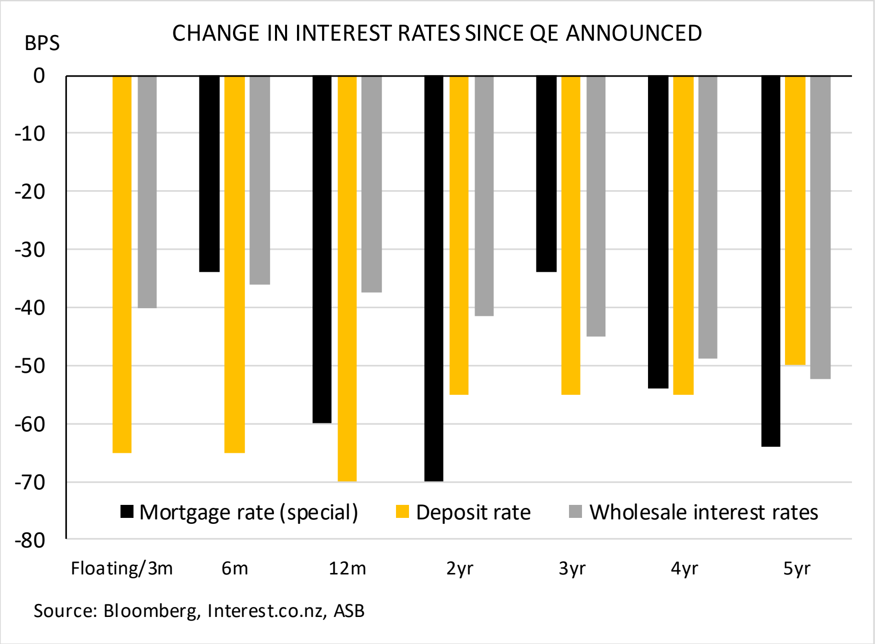


Source: Bloomberg, ASB

By lowering yields on NZ Government bonds, there are flow-on effects to other NZ yields. QE makes it relatively more attractive for would-be bond purchasers to buy bonds from other borrowers. It has also lowered interest rates throughout the economy in general. Yields on NZ interest rate swaps touched fresh lows at around the time the RBNZ signalled an increase in its QE programme in mid-May. NZ and global yields have firmed of late, but NZ yields remain about 40-60bps lower than on the day following the 75bp OCR cut on March 16. The fall in NZ swap yields has outpaced those in Australia and US over that period**.**

Retail deposit and lending rates are on our watchlist

One of the major objectives of QE is to increase liquidity (cash) in the banking system and provide a source of lower cost funding to facilitate borrowing compared to domestic deposits or even wholesale funding. This has reduced the demand for wholesale funding. Bank bills to OIS spreads have narrowed significantly, with the 90-day bank bill down about 40bps since RBNZ QE was launched. **RBNZ QE, combined with a flood of household and non-household deposits, has helped lower retail deposit rates by more than wholesale interest rates (see chart).** NZ retail deposit and mortgage interest rates have fallen (see chart).

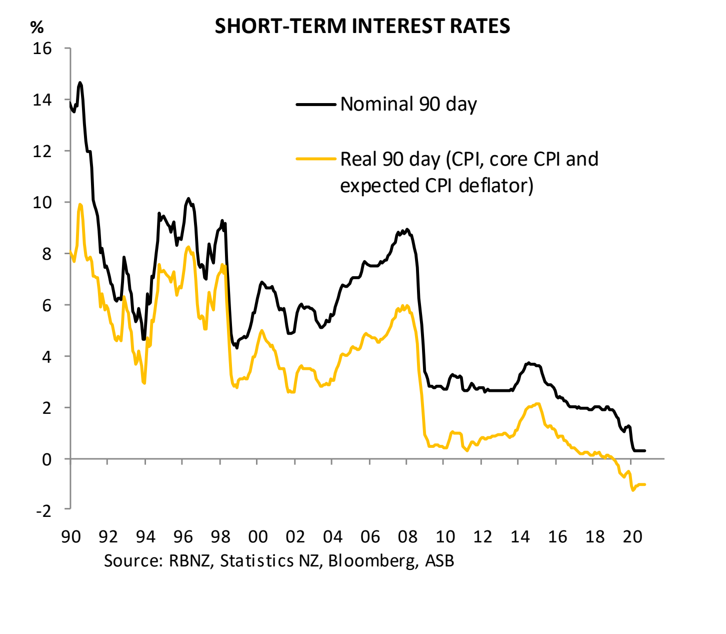


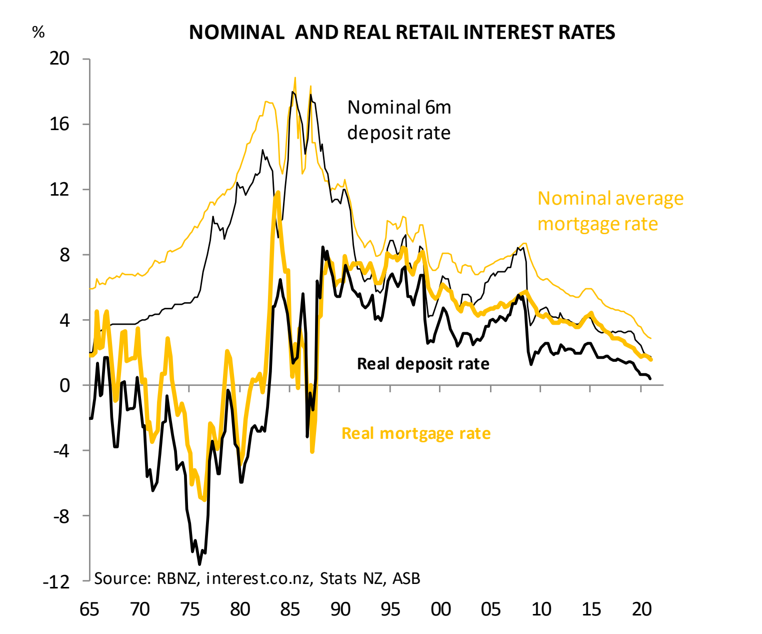
Further falls in retail interest rates are possible. RBNZ QE is still in its infancy, and further increase in liquidity generated by RBNZ QE may act to lower retail deposit interest rates. Mortgage interest could well follow. We acknowledge the prospect of lower retail interest rates won't be greeted with much enthusiasm by savers, but it could prove to be a saving grace for borrowers.

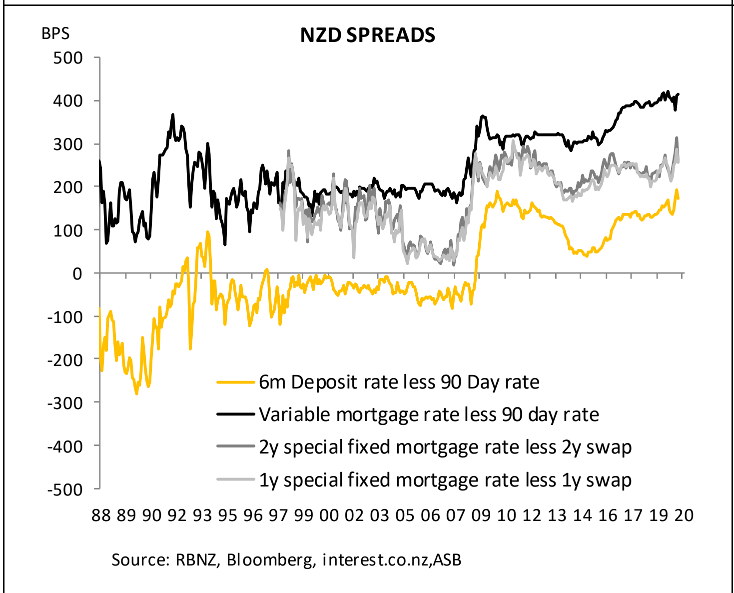
However, much will depend on how flush the system is for funding. The flood of deposit funding could slow to a trickle if households and corporates run down their deposit balances. Borrowing could also pick up. This could act to slow the decline in retail interest rates.

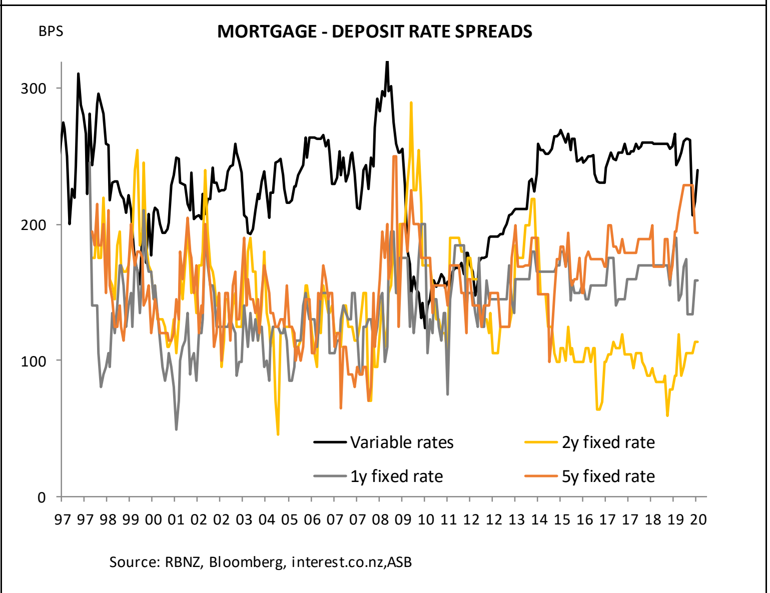
QE in NZ is still in its infancy. The test will be how effective QE will be in capping yields and flattening the yield curve as markets contemplate moving past the emergency stage of COVID-19 and focus on the path ahead for the economy and interest rate settings. NZ Retail lending and deposit interest rates remain on the RBNZ's watchlist, and ours too.

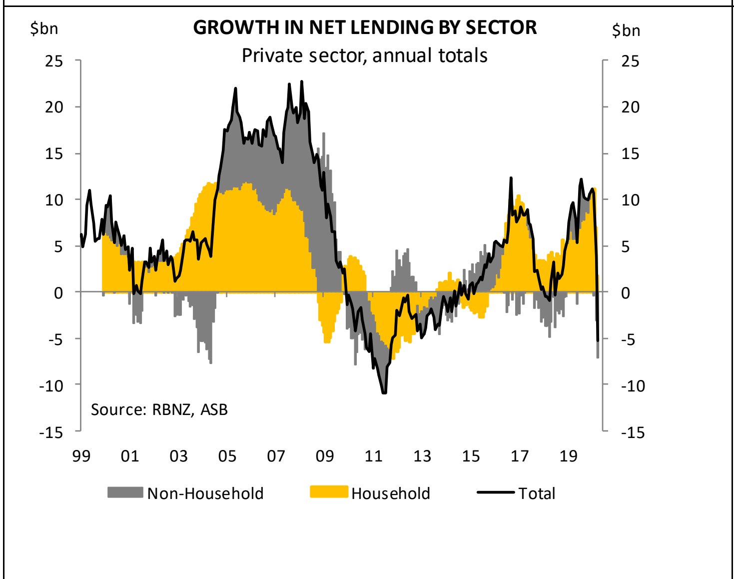
Appendix 1: Selected Charts

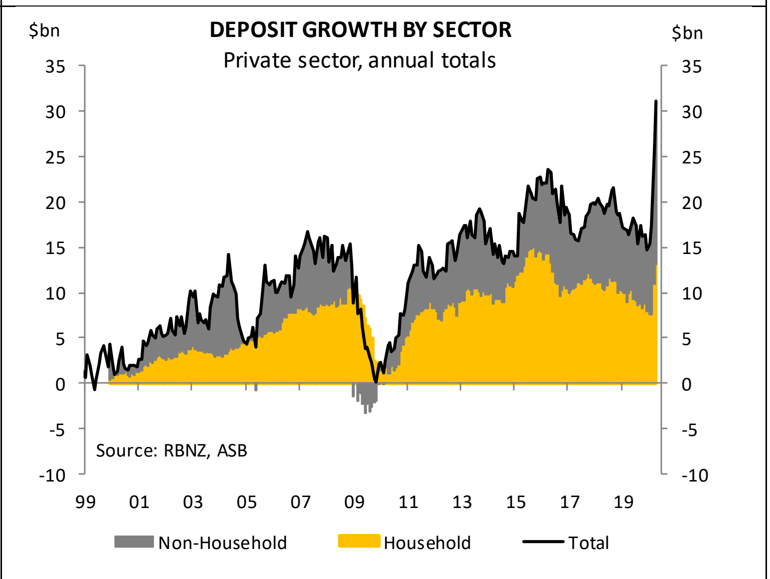












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