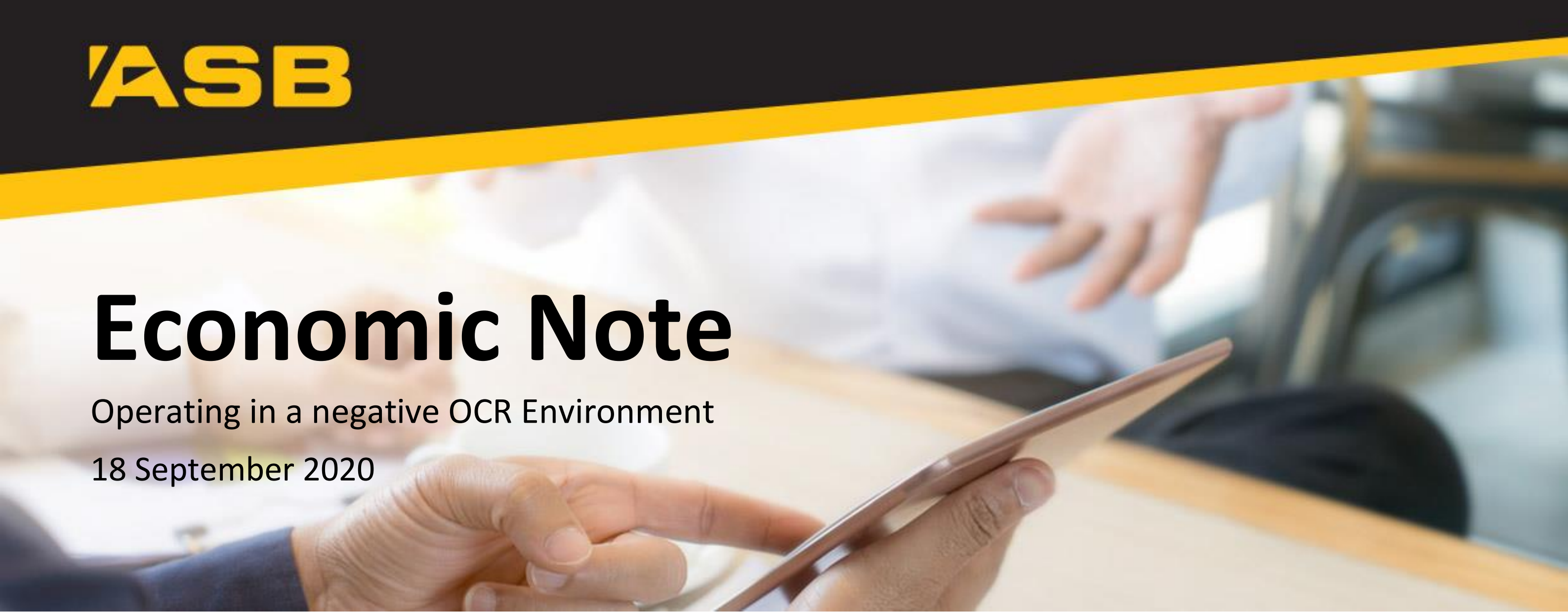

Economic Note

Operating in a negative OCR Environment

18 September 2020

Potential impacts of a negative OCR

- There are various pro's and con's behind the RBNZ potentially going down the negative interest rate path.
- Here we try to highlight some of the wider issues involved with the RBNZ adopting a negative OCR.
- Tying a negative OCR with a funding for lending programme increases the odds of a negative OCR being implemented successfully in NZ and providing further interest rate relief for borrowers. The RBNZ should consider introducing a funding for lending programme before cutting the OCR in early 2021.

Extraordinary times call for extraordinary measures. The steps the RBNZ has taken thus far have undoubtedly helped to support the economy, but the scale of the economic hit posed by COVID-19 requires even more policy support. The **RBNZ has plenty of options, but the most effective looks to be via cutting the 0.25% OCR. The ultimate aim of pushing the OCR below zero would be to lower borrowing costs for households and businesses and to encourage economic activity to be brought forward. The NZD would also be lower than it would otherwise be.**

This step is not without risk and **there are potentially some large drawbacks. Chief among these is the risk that a negative policy interest rate would interfere with the provision of credit**, the lifeblood of a modern economy.

The RBNZ is aware of the potential pitfalls and has signalled it **will tag-team a negative OCR with a Funding for Lending Programme (FLP) that will help provide low cost and stable funding for banks**. The specifics of such a scheme are yet to be announced and getting this right would bolster the effectiveness of a negative OCR. It will take time for the FLP to translate into lower borrowing costs as banks will take time to gradually roll off more expensive funding sources. A clearly-signalled approach would help banks prepare for changes, such that the benefits to borrowers from the lower OCR can be realised sooner. If the RBNZ is concerned about promptly lowering borrowing costs to households and businesses, it should consider introducing the scheme prior to cutting the OCR, rather than waiting until its commitment to hold the OCR at 0.25% ends in March 2021.

Providing operational hurdles are cleared and an effective Funding for Lending Programme (FLP) is developed, **our view is that the benefits of pushing the OCR below zero outweigh the potential costs.** We expect the RBNZ will move the OCR lower after its forward guidance to hold it at 0.25% until March 2021 ends. We expect a front-loaded 75bps OCR cut in April 2021 (or potentially sooner) taking the OCR to -0.50%, roughly at our estimated -0.50% to -0.75% floor for the OCR.

Towards the end of this note we sketch out some potential impacts for **retail, commercial, corporate, and institutional customers. Suffice to say the message is to prepare for the probability of lower wholesale and retail interest rates and manage your exposures accordingly.** The summary table at the end of this note highlights some potential pros and cons from both a negative OCR and a Funding for Lending Programme.

Why is a negative OCR being considered?

The major reason why a negative OCR is hitting the headlines is that COVID-19 struck at a time of already historically-low nominal interest rates (see chart). Just before COVID-19 hit, the OCR was at a record low 1%, and 10-year NZ Government bond yields were around 1.5%. **The onset of a major negative shock like COVID-19 would**

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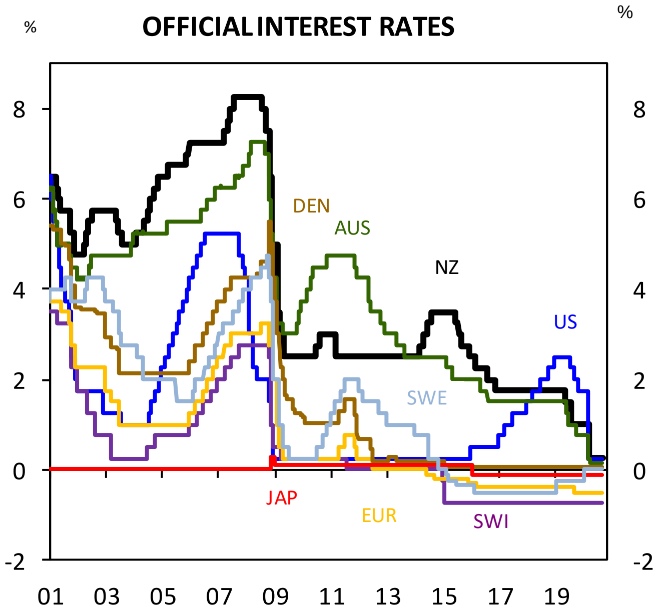
typically necessitate a significant easing in the OCR. For example, at the time of the Global Financial Crisis (GFC) the OCR was cut by close to 600bps. The low starting point for interest rates this time around means that a negative interest rate is a much more likely proposition than it was at the time of the GFC.

The RBNZ has also flagged the likelihood of the OCR moving below zero, with the RBNZ in "active preparation" for a negative OCR. If it were not for some operational concerns the OCR would likely already be below zero, with the RBNZ's unconstrained OCR (i.e. what setting would be needed to fully meet its targets) troughing at -2.4% in mid-2021 and remaining below zero until mid-2023. The RBNZ has expanded its policy toolkit and instigated a quantitative easing programme, which has helped dampen yields and to flatten the yield curve. Ultimately, however, the OCR remains the most effective policy monetary policy instrument for impacting short-term interest rates within the economy and influencing economic activity in general.

The RBNZ is not the only central bank that is either considering adopting negative rates or has actually used them. The deposit rate at the European Central Bank (ECB) has been below zero since June 2014 and is currently -0.50%, with the ECB's current policy rates in a -0.5% (deposit rate) to 0.25% (marginal lending facility) range. Policy interest rates in Sweden, Japan and Switzerland have all spent some time below zero over the last few years, with the -0.75% policy rate in place at the Swiss National Bank the lowest on record. Moreover, the Bank of England (BOE) is "currently considering" whether the effective lower bound for the policy rate could be below zero. Last night the BOE announced that they and the UK Prudential Regulation Authority will shortly begin work on operational considerations around a negative policy interest rate, building on August comments by BOE Governor Bailey that negative rates were "in the toolbox".



Source: Bloomberg, ASB

However, the move to a negative policy rate is still contentious, with the Reserve Bank of Australia (RBA) and US Federal Reserve appearing reluctant to join the negative interest rate club given concerns the costs from negative interest rate settings will outweigh potential benefits.

Why delay if more support is needed now?

In short, the RBNZ needs more time to be confident that financial institutions are ready to operate in a negative interest rate environment. By rushing through a negative OCR, the RBNZ could potentially do more harm than good (see section below on potential pitfalls) and the NZ economy could be worse off as a result. In early May this year the RBNZ signalled that the NZ banking sector will need to ensure by the 1st of December that banking systems and processes will be able to function if the OCR was zero or negative. Providing the RBNZ is confident these operational challenges have been met, the inference was that the OCR could be cut in 2021. Consistent with this was the forward guidance adopted by the RBNZ, which back in March pledged to hold the OCR at 0.25% for a further 12 months.

The OCR has remained at 0.25% since March, but the RBNZ has managed to engineer sizeable falls in NZ wholesale and retail interest rates, via a combination of forward signalling (which flagged the prospect of a negative OCR) and a $100bn Quantitative Easing programme which has been effective in boosting liquidity, flattening the yield curve and lowering wholesale and retail interest rates.

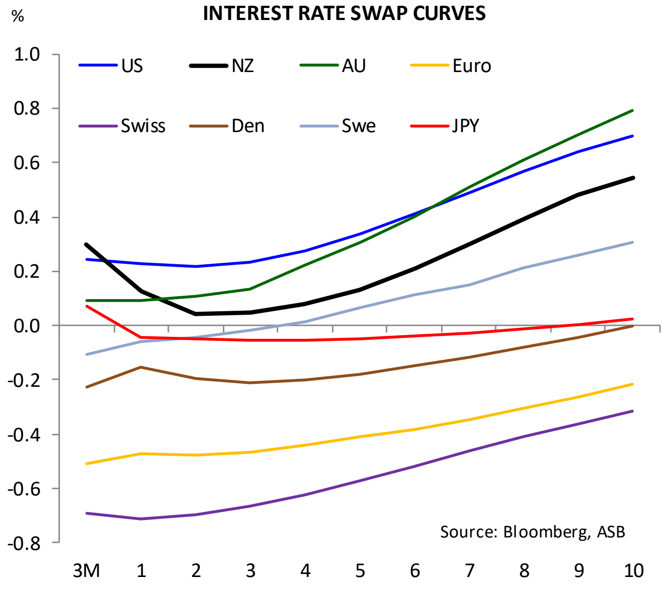
What is the aim of a negative OCR?

The whole point of reducing interest rates is to make consuming/investing right now less costly in terms of what is given up in the future. In principle, adopting a negative policy interest rate would not change the way in which monetary policy works, which is to encourage spending over saving and to encourage economic activity to be brought forward. The NZD would also be lower than it would otherwise be, which would support the export sector.

What really matters to the economy is the impact on interest rates throughout the economy**. There tends to be a reasonable flow-through from policy interest rates to wholesale interest rates, with the influence less marked for longer-term interest rates (see chart in the following section).** Our forecasts suggest that the move to a negative OCR will likely trigger a shift lower in wholesale interest rates, pushing them below zero. We also expect retail interest rates to fall, albeit to a lesser extent, providing further interest rate relief for borrowers. However, we do not expect retail deposit or borrowing rates to fall below zero.

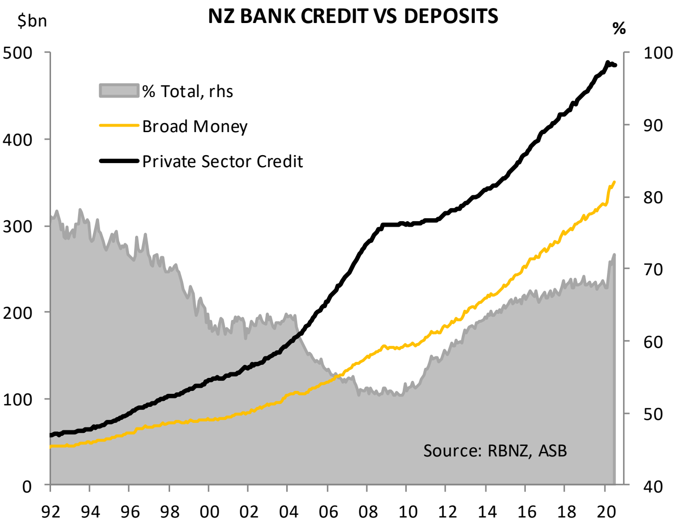
What is the OCR effective lower bound?

The effective lower bound (ELB) of the OCR is the level at which the OCR stops providing a net boost to inflation outcomes/expectations and economic activity in general. All else equal, the lower the ELB the greater the scope for the central bank to lower policy interest rates to support the economy. By contrast, the higher the ELB, the less scope there is for low policy interest rates to support the economy during adverse economic shocks and the more difficult it is to boost inflation. **Unfortunately, the ELB is unobserved**, like potential output or the neutral interest rate. Like the latter, we suspect the level of the ELB is not constant and is now lower than what it was a decade or so ago.



Given the massive economic hit posed by COVID-19, policy interest rates of major central banks are currently as low as central banks feel they can set them while still providing a net boost to the economy (i.e. policy interest rates are at their effective lower bounds). The RBA cash rate is currently 0.25% as compared to 0.0% to 0.25% for the US Federal Reserve and 0.1% for the Bank of England (BoE). Negative policy rates in place in parts of Europe and Japan suggest their respective central banks believe their ELB is below zero. At present the RBNZ has the OCR at 0.25%, but its willingness to consider a negative OCR suggests it thinks that ELB in NZ could be below zero, with a negative OCR.

How low could the ELB potentially be in NZ? One of the limits we have identified has been the level at which banks will still be able to attract funding. There are two major sources of funding for banks. The first is wholesale funding, where banks obtain funding via a number of wholesale market sources. The second, and much larger source in NZ is deposit funding, constituting largely retail deposits in financial institutions that can be subsequently lent out. In NZ, deposits from all sources are equivalent to about 80% of the value of total bank lending. Of the roughly $390bn in total bank deposits, just under a half are term deposits, with transactional and savings accounts accounting for one-quarter each.

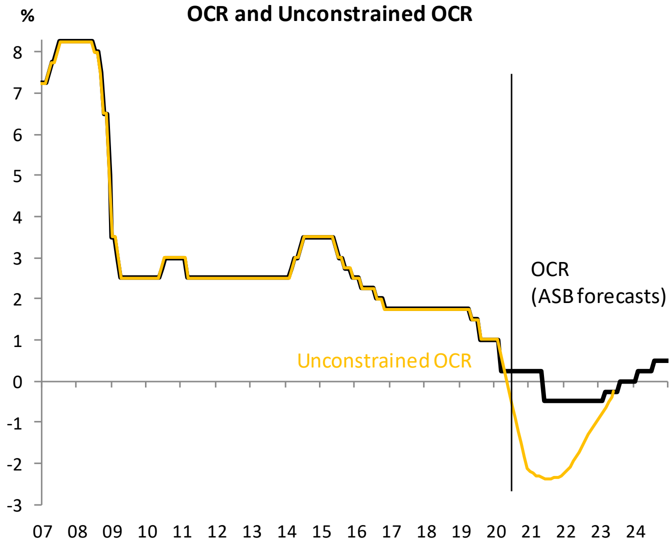


It would be possible for banks to obtain funding from wholesale interest rate markets at negative interest rates, particularly if the policy interest rate was expected to remain negative. The relaxation in the core funding ratio by the RBNZ means that locally-incorporated banks could potentially obtain more funding from this source and reduce their reliance on deposits.

However, deposit funding remains an important means for banks to obtain funding and it seems unlikely that banks will be able to maintain current levels of funding – let alone increase their funding base – by charging depositors. Our observation is that across the globe, retail deposit rates don't tend to fall below zero when wholesale rates are negative. A limit we had earlier identified for the OCR was -0.75%, as this was the level that would likely keep term deposit rates positive. Updating this to reflect current interest rate pricing suggests an even lower OCR floor could be possible of around -0.75%. However, this is likely to constitute the lower bound of a potential range given transactional and savings accounts are much closer to or at zero. **Taking all this into consideration our assessment of the OCR floor is expected to be in a -0.50% to -0.75% range.**

How long will the OCR remain negative?

This is difficult to know and will likely depend on how long lasting the impact of COVID-19 is. We believe that the OCR will remain negative until the NZ economic outlook had sufficiently brightened so as to warrant OCR hikes. This is assumed to be until at least late 2022, with the RBNZ erring on the side of caution to make sure the recovery is well established before slowly raising the OCR. From a least-regrets analysis point of view, it would be better to overstimulate the economy and tolerate a period of high inflation rather than to undercook the policy support and run the risk of deepening the downturn. This is the route that the US Federal Reserve and other major global central banks seem to be taking. The failure of inflationary pressure to ignite despite considerable policy stimulus to boost the economy could see interest rates marooned around record lows.



Source: RBNZ, ASB

Our gut feeling is that if the OCR does go negative it will stay there for a while. Typically, the longer the period in which low OCR settings are help, the stronger the subsequent rebound, and the more likely interest rate settings will normalise. However, in looking at the experience in Europe and Japan, the reality is that once an economy has started the journey down the negative interest rate path it is extremely difficult to return to an environment where interest rates are north of zero.

Potential pitfalls of a negative OCR

We have remained guarded on whether the benefits of a negative OCR outweigh the costs, given the international central banking community is not fully convinced of the benefits.

The major concern is that negative interest rates can interfere with the functioning of banking systems reliant on deposit funding and impair the ability of some banks to supply credit and general financial stability – the opposite of what monetary easing aims to do. Negative interest rates could also create distortions in the financial system, because retail deposit rates would tend to be effectively bounded at zero whereas yields on interest rate swaps could fall below zero. The presence of zero interest rate floor clauses in some loan documentation agreements can potentially limit the effectiveness of a negative OCR and could create some mismatches in interest rate swaps (which do not tend to have such zero-floor clauses).

Banks can also be adversely impacted by negative interest rates: they themselves have to pay interest on excess reserves held at the central bank and pay to hold government bonds used as stores of liquidity. Consequently, banks may actually increase their lending rates in order to recoup the cost of holding reserves at negative interest rates.

There is also a considerable body of evidence suggesting that the effectiveness of interest rate cuts tends to diminish the lower rates go. It may not even be necessary to run the risk of a negative OCR, as some evidence suggests that zero interest rates may be more effective than negative rates in bringing forward economic activity. There is increased concern that lower interest rates encourage people to save more rather than spend, so as to boost their retirement savings. The presence of negative interest rates can also weaken confidence and curb borrower appetites.

Monetary policy is a blunt instrument. Lower interest rates reward those able and willing to borrow and penalise those who save. They also tend to boost asset prices and the wealth of the 'haves' relative to the 'have nots'. From a longer-term perspective such impacts could actually create wider inequality within society, even as those same low interest rates support employment amongst those most vulnerable in an economic downturn.

It is also unclear how easy it will be for an economy to extricate itself from a negative policy interest rate environment. 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.

Why team a negative OCR with other tools?

As Governor Orr noted in a recent speech, the RBNZ will only implement monetary policy in a way that succeeds in supporting its monetary and financial stability goals. More than one specific objective usually requires more than one tool, which is why the RBNZ is looking at a package that can best achieve its broad policy outcomes. **Relying on any one single tool (such as the OCR) could potentially result in sub-optimal outcomes as opposed to using a combination of measures.**

Crucially, the effectiveness of a negative OCR will depend on this resulting in interest rate cuts for borrowers in the economy. **To circumvent the potential pitfalls of a negative OCR on the provision of credit, the RBNZ has signalled that a Funding for Lending Programme (FLP) will be launched around the time the OCR is cut.** The specifics of such a scheme are yet to be announced but will likely involve the RBNZ providing banks with low-interest longer-term funding that can be used to help lower borrowing costs for households and businesses and to bolster credit provision. The RBA has recently expanded a similar scheme in Australia, known as the Term Funding Facility (TFF), providing deposit-taking institutions with low-cost (set at the 0.25% cash rate), significant (the size of the fund raise been raised to AUD200bn, roughly 10% of Australian GDP) and longer-term funding (3-year long-term funding).

The devil is in the detail. Getting the design of the FLP right is crucial and it will need to be linked to increasing credit provision. It will take time for the FLP to translate into lower borrowing costs as banks gradually roll off more expensive funding sources. For example, of the $483bn of bank funding in July 2020, about one quarter is for longer than 6 months. This includes about $20bn of domestic funding. As such, a clearly-signalled approach would also ensure that banks can get their systems in place, so that the benefits to borrowers from the lower OCR can be realised sooner. The sooner that banks know about the scheme, the better.

A poorly designed system that gets very little buy-in from financial institutions would significantly diminish the potency of a negative OCR. In particular, the more conditions that are put in place, the less take-up there is likely to be, a lesson from the initial design of the Business Finance Guarantee Scheme. If, for example, the FLP is highly conditional on setting lending targets in sectors where the cause of weak credit demand is not a lack of low cost-credit provision, the scheme's uptake and impacts in driving lower-cost lending would be muted. Moreover, the RBNZ will need to manage its risk exposures carefully.

In short, time is of the essence. If the RBNZ is concerned about promptly lowering borrowing costs to households and businesses, it should consider introducing the FLP prior to cutting the OCR in early 2021. Banks can employ hedging strategies to address the interest rate risk of any future reductions in FLP interest rates.

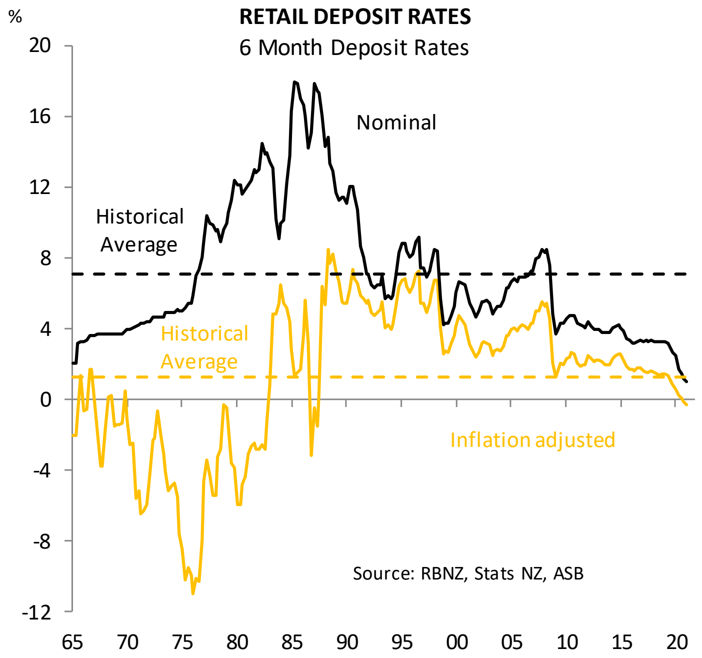
Even if the RBNZ managed to get the new scheme off the ground and borrowing costs do fall, we expect that the RBNZ will continue to maintain an extensive policy toolkit and to seek considerable support from its other policy tools. **Still, there are limits to what the RBNZ can do.** Much of the onus of policy support will fall on fiscal policy, with monetary policy basically playing a supporting role.

Implications for customers

For **retail customers**, the message is simple. Our observation across the globe is that retail deposit and borrowing rates don't tend to fall below zero when wholesale rates are negative. We expect the same for NZ interest rates. **For borrowers**, rates are expected to approach (or set) record lows, but don't expect the bank to pay you to take out a loan. Our latest Home Loan Rate Report sets out our forecast view for mortgage interest rates, in which fixed mortgage rates are expected to plateau at slightly under 2% next year.

For savers, retail deposit interest rates will likely continue to grind lower but are unlikely to fall below zero. Our Term Deposit Report notes that deposit interest rates are now at the lowest on records going back to the 1960s and that interest rates are expected to decline even further and stay low for several years. This will not be good news to some savers who have seen their interest rate income erode with the drift lower in nominal interest rates and some. difficult decisions may lie ahead. It may not feel like it to some, but we live in a low-inflation environment which means the purchasing power of hard-earned savings will not erode with time as they did in the 1970s and 1980s.

For **commercial, corporate and large institutions**, the move to a low OCR may create challenges for financing, hedging and other risk management practices (see our latest Corporate Hedging Toolbox for a further details). Deposit rates, particularly for large amounts, could go negative if the OCR and other wholesale rates do. The alternatives for businesses with large deposit balances are limited if they want to continue holding liquid assets. Holding large volumes of physical cash carries its own costs and risks. Alternative liquid assets such as bank bills and bonds would similarly be trading at negative yields. In a way, a negative deposit interest rate acts a bit like a custodial fee for having cash kept safe, rather than paying for storage space, insurance, and security staff. Lending interest rates, however, are far less likely to go negative. There still needs to be some margin above banks' funding costs. And, while some lending products are priced at direct margins over wholesale benchmark rates, the OCR would have to go substantially more negative than we see as feasible to result in a negative lending interest rate.



Pros and cons of the negative OCR and Funding for Lending Programme

Policy measure	Pros	Cons
Negative OCR	Provides modest additional interest rate stimulus. Brings economic activity forward. Discourages bank cash hoarding and encourages lending. Helps dampen NZD.	Unlikely to provide all the needed stimulus on its own. Global central banks have mixed views on the effectiveness and efficacy. Could impair market functioning, bank profitability and credit provision. Could potentially boost asset prices and exacerbate inequality. Can be difficult to exit policy.
Funding for Lending Programme	Would assist directly in helping to dampen bank interest rates lower. Increases funding options available for financial sector and can bolster credit provision.	Could be of limited effectiveness if there is significant credit provision. Will have to be tied to credit provision to prevent banks using this as a cheaper funding source to cover non-lending related costs. Balance sheet risks for the RBNZ. Increased financial sector reliance on RBNZ.

Source: ASB

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