Economic Note

Changes to ASB's interest rate outlook for New Zealand

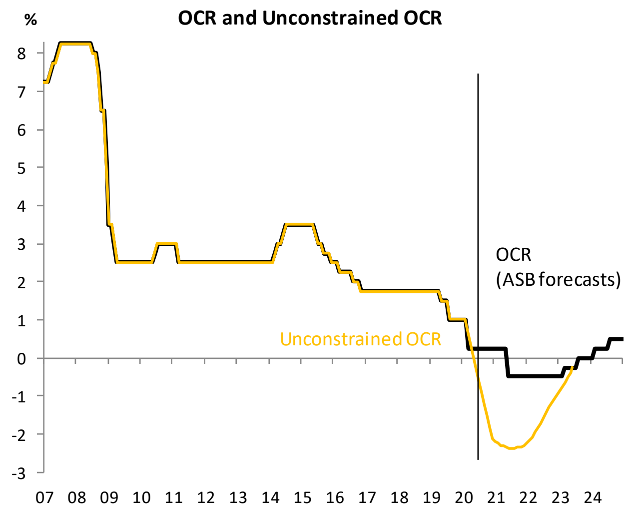
18 August 2020

Negative OCR and Funding for Lending tag team in action from 2021

- We have formally changed our OCR forecast view and now expect the RBNZ to cut the OCR to -0.50% in early 2021, with the OCR to remain at this level before the COVID-19 storm passes (potentially as long as late 2022). The interest rate outlook is highly uncertain and OCR settings will be conditional on a number of factors.
- The negative OCR will be launched in conjunction with a Funding for Lending Programme (FLP) that will provide stable, low-cost funding to banks that can be lent out, mitigating some of the adverse impacts of a negative policy interest rate. We expect further details of this scheme to emerge in the coming months.
- In the interim, we expect the RBNZ to continue to use forward guidance and its expanded $100bn Large Scale Asset Purchase programme to push yields lower.
- Retail deposit and lending interest rates look set to decline further but we do not expect rates to fall below zero.

The OCR to move below zero from early 2021

As we have warned for some time, a 0.25% OCR was unlikely to provide sufficient support to the economy given the sizeable economic hit posed by COVID-19. We had been encouraged that the RBNZ appeared to share a similar view and had rolled out additional policy support measures, including its Large-Scale Asset Purchase programme (LSAP), which has been highly effective in boosting liquidity and lowering interest rates in NZ. Even with more RBNZ QE and a number of monetary implementation measures relaxed, our view was that the RBNZ would need to do more. A week or so before the August MPS we provided a list of additional measures the RBNZ could do to support the economy. In August, the RBNZ duly increased the LSAP programme to $100bn by June 2022 and raised the Crown Indemnity to allow the RBNZ to purchase 60% of conventional NZ Government bonds. The RBNZ also flagged further easing would come from a negative OCR from early next year (the RBNZ is in "active preparation") that was linked to a Funding for Lending Programme for banks as well as potential foreign asset purchases.



Source: RBNZ, ASB

What pushed us over the line into changing our OCR call was our conviction that the NZ economic outlook will remain weaker than the RBNZ had assumed even if the recent community outbreak of COVID-19 in NZ has a modest and short-lived impact. Part of the reason why the RBNZ's economic projections were more upbeat than our own was that they had assumed the economy would be the recipient of a greater degree of interest rate stimulus, with the RBNZ's unconstrained OCR (see chart) into deeply negative territory over the next few years. It was always likely to be preferable for the RBNZ to make use of its major and most effective policy instrument after making sure implementation issues were resolved.

The RBNZ's announcement that it would link the lower OCR with a Funding for Lending Programme (FLP) also removed some of the concerns we had over a negative OCR. Exact details of the FLP need to be worked out, but a similar programme looks to be operating

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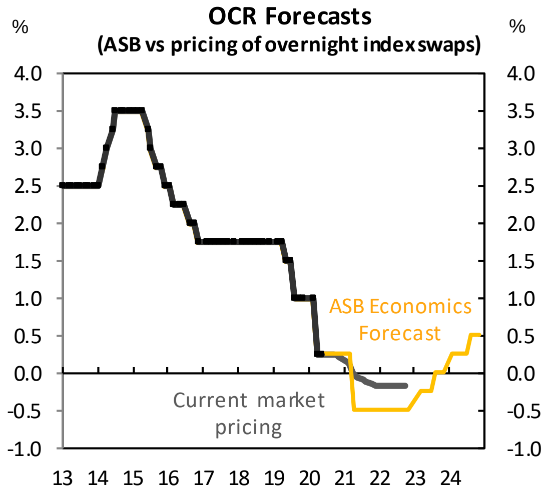
effectively across the Tasman. Banks will be able to obtain stable, low cost and long-term funding by borrowing directly from the RBNZ that can be efficiently directed throughout the economy.

When will the RBNZ move the OCR? This is still highly uncertain, but typically the sooner the better. The RBNZ's regrets analysis would likely opt for imminent and front-loaded policy stimulus so as to prevent the economy going into an even deeper hole. Operational details still need to be worked through but, provided the RBNZ do not shift its earlier guidance on leaving the OCR at 0.25% until next March, the April 15th Monetary Policy Review looks to be the most likely date. This is on the proviso that:

- COVID-19 continues to remain a strong headwind to NZ and global economies;
- Operational hurdles around a negative OCR are cleared;
- The RBNZ do not shift its earlier guidance on not changing the OCR till early next year, and;
- The lower OCR will be in conjunction with a Funding for Lending Programme that will provide stable, low-cost funding to banks that can be lent out.

We have pencilled in an April 2021 OCR cut, but note that the RBNZ could tweak its forward guidance. In the interim, we expect RBNZ signalling and potentially an upsizing of its weekly asset purchases to dampen NZ yields.

To how low, and for how long? The RBNZ is unlikely to drop the OCR in 25bp increments; we expect instead a large one-off cut of 75bps, similar to that delivered in March this year. The OCR would remain at -0.50% until the 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. We do not expect the OCR to move above 0% until 2024. Our full interest rate projections are summarised in the table at the end of this note.



Source: RBNZ, ASB

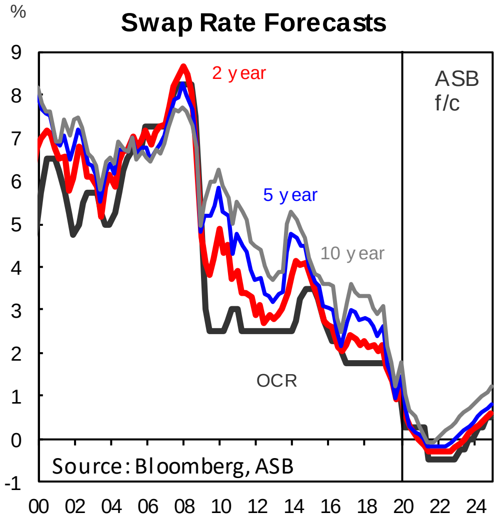
The extent the OCR could fall and how long it would remain there would depend on the economic outlook, the effectiveness of other policy options (particularly the LSAP programme), and the ability of banks to continue to attract funding from depositors. Our observation is that across the globe, retail deposit rates don't tend to fall below zero when wholesale rates are negative. A limit we currently identify for the OCR was around -1%, as this was the level that would likely keep deposit rates positive. Even at -1%, however, the OCR will need mates, with the amount interest rate stimulus to pull the economy out of its slump. We are hopeful that the FLP and LSAP will provide further support needed, but much of the onus of policy support will fall on fiscal policy, with fiscal settings remaining highly supportive over the next few years.

Will a negative OCR work? This remains the $64,000 question. We have remained guarded on whether the benefits of a negative OCR outweigh the costs, given the international central banking community appears to be split. Our concern was 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 – the opposite of what monetary easing aims to do. The effectiveness of a negative OCR crucially depends on the successful rolling out of a FLP. A poorly designed FLP would significantly diminish the potency of a negative OCR. It is also unclear how easy it will be for an economy to extricate itself from a negative policy interest rate environment. The experience in Europe does not inspire a lot of confidence.

Is a negative OCR a sure thing? Nothing is a sure bet in life, even more so with a global pandemic lurking. The RBNZ has made the right noises, but operational hurdles still need to be cleared. The global and domestic outlook could dramatically improve, the NZ labour market could spring into life and medium-term inflationary pressure could stir.

What about other NZ yields? To some extent they are linked to our OCR call. A -0.50% OCR will act to substantially dampen yields across the curve and our forecasts are for bank bill interest rates and swap yields to move below zero from late 2020/early 2021. We expect yield curves to be upward sloping, with longer-term rates less tied to domestic short-term interest rate settings and more sensitive to global influences. Nevertheless, outright NZ yields are expected to be a considerably below US/Australian counterparts and at around record lows over the next few years.

We eventually expect that the improving NZ economic outlook and brighter signs abroad will eventually push term rates higher, with the yield curve steepening. Nevertheless, we expect NZ yields to remain below US and Australian counterparts for a number of years.



What is the outlook for retail deposit and borrowing rates?

Lower, but not sub 0% despite the outlook for the OCR and wholesale interest rates. Exactly how low will likely depend on the (still unknown) mechanics of the Funding for Lending Programme. The Funding for Lending Programme will provide banks with another avenue of low-cost funding, but banks will still need to attract funding from deposits. The experience overseas suggests it is very rare for retail deposit rates to fall below zero. Prior to negative rates being introduced we would expect retail and mortgage interest rates to continue to decline as wholesale interest rates decline. The RBNZ LSAP programme is also expected to bolster liquidity and place downward pressure on retail borrowing and deposit rates. We will provide more thoughts on the outlook for retail interest rates over the next few weeks.

ASB INTEREST RATE FORECASTS

	OCR	90 day	1 yr swap	2 yr swap	3 yr swap	4 yr swap	5 yr swap	10 yr swap	10 yr bond	Slope	10y swaps less bonds
Jun-20	0.25	0.30	0.25	0.25	0.25	0.25	0.30	0.65	0.91	0.40	-0.26
Sep-20	0.25	0.25	0.15	0.15	0.10	0.10	0.15	0.50	0.55	0.35	-0.05
Dec-20	0.25	0.15	0.10	0.10	0.10	0.15	0.10	0.30	0.45	0.20	-0.15
Mar-21	0.25	0.00	0.05	0.05	-0.10	-0.10	0.00	0.10	0.25	0.05	-0.15
Jun-21	-0.50	-0.50	-0.35	-0.30	-0.25	-0.20	-0.20	-0.10	0.00	0.20	-0.10
Sep-21	-0.50	-0.50	-0.35	-0.30	-0.25	-0.20	-0.20	-0.10	0.00	0.20	-0.10
Dec-21	-0.50	-0.50	-0.35	-0.30	-0.25	-0.20	-0.20	0.00	0.10	0.30	-0.10
Mar-22	-0.50	-0.50	-0.35	-0.30	-0.25	-0.20	-0.20	0.10	0.20	0.40	-0.10
Jun-22	-0.50	-0.50	-0.35	-0.30	-0.25	-0.20	-0.20	0.20	0.30	0.50	-0.10
Sep-22	-0.50	-0.50	-0.25	-0.30	-0.25	-0.20	-0.10	0.30	0.40	0.60	-0.10
Dec-22	-0.50	-0.35	-0.15	-0.20	-0.15	-0.10	0.00	0.40	0.50	0.60	-0.10
Mar-23	-0.25	-0.20	-0.05	-0.10	-0.05	0.00	0.10	0.50	0.55	0.60	-0.05
Jun-23	-0.25	-0.10	0.05	0.00	0.05	0.10	0.20	0.60	0.65	0.60	-0.05
Sep-23	0.00	0.05	0.15	0.10	0.15	0.20	0.30	0.70	0.75	0.60	-0.05
Dec-23	0.00	0.15	0.25	0.20	0.25	0.30	0.40	0.80	0.85	0.60	-0.05
Mar-24	0.25	0.30	0.35	0.30	0.35	0.40	0.50	0.90	0.95	0.60	-0.05
Jun-24	0.25	0.45	0.45	0.40	0.45	0.50	0.60	1.00	1.05	0.60	-0.05
Sep-24	0.50	0.60	0.55	0.50	0.55	0.60	0.70	1.10	1.15	0.60	-0.05
Dec-24	0.50	0.60	0.65	0.60	0.65	0.70	0.80	1.20	1.25	0.60	-0.05

Source: ASB

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