COLCHESTER®
GLOBAL INVESTORS

Discussion Paper:

Overnight Cash Rates in New Zealand

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Over the last couple of weeks there has been speculation in the media and amongst certain financial commentators that the Reserve Bank of New Zealand might lower the OCR into negative territory. At Colchester we do not try to predict where central bank activity is going and what future rates, in this case the OCR, are going to be. In line with our process, we only try to predict inflation rates two years forward to feed into our real yield forecasts. However, we can offer some comments on why the OCR could go negative and what that might mean.

Our two-year inflation forecast for New Zealand is currently just 1.4%. This is below the RBNZ target of 2%. If our forecast is realised, then this suggests that the RBNZ may try further measures to hit the target. One of the reasons that we believe the RBNZ may not achieve its inflation target is because of the severe economic slowdown that the country is likely to face owing to the impact of the coronavirus. Other commentators have also examined this possible slowdown and believe that to further alleviate the situation the Reserve Bank and Government would need to take more vigorous action to stimulate the economy. For some this would include cutting the OCR into negative territory.

This may turn out to be correct, but we believe that central banks are increasingly reluctant to take rates into negative territory. The US Federal Reserve, the Bank of England and the Reserve Bank of Australia have all recently kept rates positive when faced with a similar situation to that of New Zealand. When we look at some of the major central banks who have taken the step into negative rates, Japan, the Euro Zone, and Switzerland, it is far from clear that they have had major success with the policy. Inflation in these countries has remained subdued and growth has been tepid.

There is also increasing academic literature that is critical of negative interest rates.[1] Of particular note, a very recent paper by Eggerstsson, Juelsrud, Summers and Wold (2019) concluded that the drop into negative rates in Sweden actually increased borrowing rates there. Normally when interest rates are reduced, banks reduce the rates they pay on deposits, thereby reducing bank funding costs in parallel (give or take). This then enables banks to reduce lending rates accordingly. However, when interest rates went negative in Sweden, deposit rates did not fall into negative territory. This was the same in Japan, Denmark and the Euro-area. With most banks sourcing the majority of their funding from deposits, once negative rates were introduced, bank profitability declined, forcing them to raise borrowing costs to offset the lower lending spread. This starts to undermine the traditional monetary transmission mechanism.

Of course, there is no theoretical reason why deposit rates could not be negative, but it is easy to think of practical reasons why this would not work. Often depositors are putting their money in the bank at negative real interest rates, with inflation being above the deposit rate. However, they are seeing a nominal increase in their money, or at worst, are not seeing a nominal decrease in their money. This so called "money illusion" results in deposits remaining "sticky" in this scenario, even though the real value is declining. However, once they are being charged, with a negative interest rate to hold cash deposits, the traditional "store of value" concept of holding cash is broken, and depositors are less likely to leave their money in the bank. It is possible that the vast majority of people would still keep their money in the bank at negative rates, but so far banks have not taken the risk of finding out.

[1] For example Gauti B Eggertsson, Ragnar E. Juelsrud, Lawrence H. Summers, Ella Getz Wold (2019) Negative Nominal Interest Rates and the Bank Lending Channel, National Bureau of Economic Research Working Paper 25416

Markus K. Brunnermeier, and Koby Yann (2017) The Reversal Interest Rate: An Effective Lower Bound on Monetary Policy, Princeton

What this has meant is that deposit rates have not generally moved into negative territory, so the cost of bank funding has remained unchanged, making it harder to reduce lending rates. If anything, bank profitability has reduced because of negative rates making them less likely to lend. It is worth pointing out that the Riksbank disagreed with the findings of the paper just discussed.

In New Zealand, banks rely on deposits for around 40% of their funding and in past Financial Stability reports the RBNZ has expressed concern that this might fall, increasing the reliance of banks on offshore funding. This would then increase their exposure to offshore risks that could adversely affect the cost and availability of this funding. In the most recent Financial Stability report, from November 2019, the RBNZ discusses the issue of bank profitability in light of low interest rates whilst banks are competing to attract deposits.

Notwithstanding these concerns about the effectiveness of such a policy, it is perfectly possible that the RBNZ will take rates negative. As such it is sensible to consider some of the impacts this may have on offshore global bond investments, like the portfolios we run at Colchester.

In short, while a move to push interest rates into negative territory in New Zealand will have little to no impact on global interest rates and currencies, it is likely to increase the attractiveness of global bond and currency portfolio's relative to domestic New Zealand bonds and the Kiwi dollar.

On the bond side, the reduction in the OCR may bring down nominal rates across the curve. Assuming no significant deterioration in the inflation outlook relative to the rest of the world, this is likely to reduce the attractiveness of holding NZ bonds. Given the already negative real yields on offer in the NZ bond market, we at Colchester have not been invested in any NZ bonds. As their relative attractiveness would continue to deteriorate under this scenario, that is unlikely to change. While we can't speak for other managers, it is reasonable to assume that a decline in nominal yields under these circumstances will make NZ bonds less attractive to them as well, if at all. Decreasing foreign participation in the domestic bond market at a time of increasing Government funding needs increases the dependency on the RBNZ bond buying program, potentially increasing vulnerabilities.

The effect of the additional monetary easing on the New Zealand dollar is likely to be negative, assuming the move to negative rates was not already "fully priced" by the market. Although the main driver of Colchester's FX valuation process is an assessment of the real exchange rate (or Purchasing Power Parity - PPP) we do include an element of short term real carry within the valuation framework along with an assessment of the strength of a country's overall financial balance sheet. Despite the fall against the US dollar over the past couple of years, the Kiwi dollar remains meaningfully overvalued against most global currencies on our valuation metrics. As a result, we are currently underweight or "short" the Kiwi in those portfolio's where permissible. A cut to negative interest rates is likely to drive down real carry and further reduce our valuation of the currency. All else being equal, this would further reduce the attractiveness of the NZ dollar relative to other currencies. As a number of other investment houses appear to focus on nominal carry, negative nominal rates are likely to be unattractive to them as well, potentially exacerbating the decline in the currency.

Finally, as most New Zealand based investors tend to hedge their foreign asset holdings, including their global bond exposure, a negative domestic rate is likely to increase those hedging costs. However, as most major economies also have very low nominal interest rates, or already negative, the potential rise in hedging costs is likely to be small.

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