

RBNZ: Keeping it positive

Markets seem to be getting ahead of themselves, as expectations have risen for a move to zero or even negative rates at the Reserve Bank of New Zealand's 13 May meeting. While Governor Adrian Orr is ruling nothing out (possibly to keep the New Zealand dollar capped), there is more danger from doing too much right now, than too little



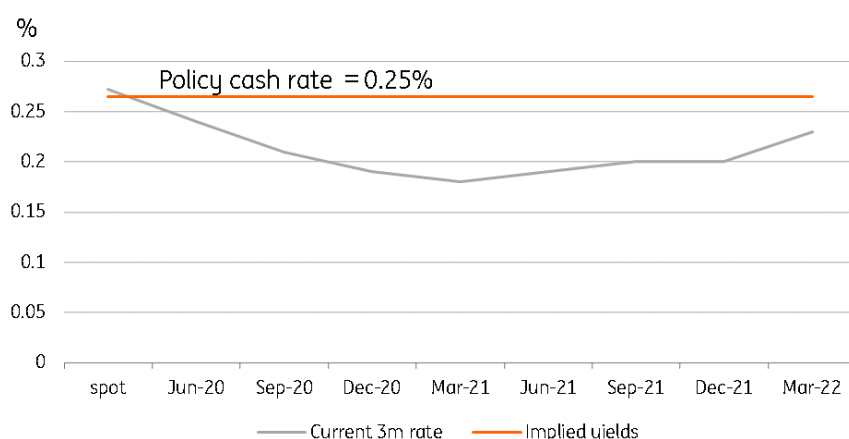
RBNZ Governor, Adrian Orr

Markets don't like inaction

Bank bill futures in New Zealand have dropped precipitously in the last month, taking them well below the 25 basis point official cash rate set by the RBNZ at their 16 March meeting, when they cut rates by 75bp. Back then, the end of year implied rate from bank bill futures was 0.77%, so not much term premium over the official cash rate, but basically in line with it, plus a small spread of a few basis points.

Today, the end of year implied rate is 19bp, fully 6bp below the official cash rate. Should we be pricing in a cut in rates to zero or even negative rates?

Implied rates and current 3m rates



Source: Bloomberg, ING

Maybe, but probably not

The arguments in favour of such a change in policy boil down to Governor Adrian Orr's open-minded attitude to all manner of policy responses.

He has said that he will not rule out negative rates. He has also said that he would not totally dismiss direct monetisation of the deficit. Markets seem to be viewing this as a signal of policy direction.

But it looks to us as if, and not for the first time, the market is caught up with its own momentum, and has lost sight of the drivers of RBNZ policy.

NZ outlook is one of the best in APAC

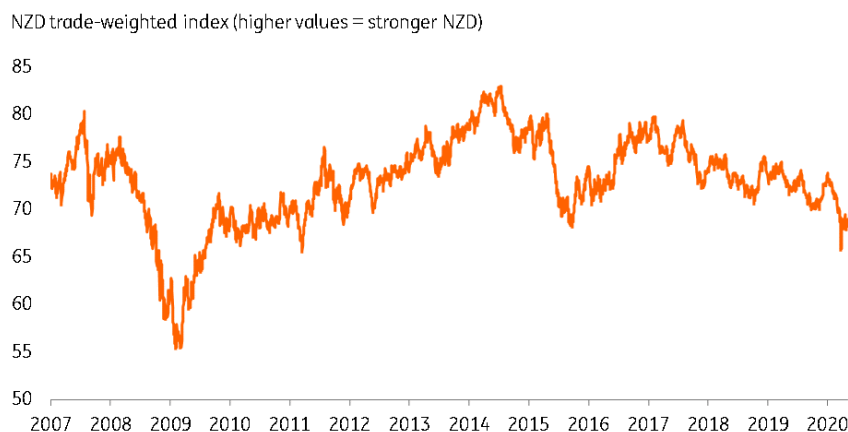
Recent RBNZ policy has been all about responding to the Covid-19 outbreak. Certainly, the NZ lockdown will have hurt economic activity, but as of 28 April, the lockdown ended. New cases are very low and their sources well understood. This isn't to rule out a second wave, but for now, it does look as if the country has managed to deliver a way out of lockdown with minimum economic disruption, and a return to growth in 2Q now looks very likely.

So given that the macro outlook has clearly improved, the macroeconomic rationale for adopting either negative rates or direct monetisation looks extremely weak. But could there be a currency argument?

NZD: Weak, but not weak enough

The RBNZ does not openly mention the exchange rate as part of its objectives. Indeed, as the currency normally depreciates during global economic downturns, it works as an automatic shock-absorber to the export-oriented economy.

This time, however, things are a bit different. While it is true that the NZD has lost around 5% on a trade-weighted basis (chart below) since the Covid-19 outbreak became public (late January), the RBNZ may be worrying about the faster than expected rebound in its currency. In 2008, the NZD depreciated by some 30% on a trade-weighted basis and did not rebound until early 2009.



Source: RBNZ, ING

The Bank may not be comfortable with a recovery in the NZD just yet, as they recognise its role in keeping exports attractive in global markets, as the New Zealand economy tries to work its way out of the sharp downturn. Whether this currency-related concern (which would still likely remain implicit) will be enough to make a somewhat risky move into negative rates, is a different question. In our view, it is more likely – if anything – that the Bank will maintain some sort of ambiguity about additional easing, hoping it will be enough to slow the recovery in the currency.

Crossing the event horizon

Even if there were a stronger argument for easing policy further, which looks questionable, negative rates or direct monetisation are two policies that come with considerable baggage. As Orr himself remarks, direct monetisation is a good way to lose market credibility. So yes, you might "win" on a weaker currency, but you may well "lose" on your government bond market.

As for negative rates, Europe is perhaps the best advertisement for NOT going down this route. Closer to home, Australia has in fact ruled them out, noting not only that they may do more harm than good, but also how difficult it seems to be to undo them once in place. This "event horizon" feature of negative rates seems as good a reason as any for not doing something which a) seems patently unnecessary at this time, especially when b) other alternatives remain available.

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