Abel Tasman National Park, New Zealand

Weekly Economic Commentary.

New tricks.

The Reserve Bank continues to favour a negative Official Cash Rate as the next tool in its policy arsenal, and there is a growing acceptance that this will be implemented next year. The RBNZ also said that it might combine a negative OCR with cheap long-term funding for banks. Here we take a closer look at how these measures might work in practice.

Last year the Reserve Bank announced that it would review its 'unconventional' monetary policy toolkit – that is, the range of options that would be available if the OCR had already fallen to zero. At the time, the RBNZ's preferred option was to take the OCR below zero; other options included large-scale government bond purchases and direct lending to banks.

The Covid-19 pandemic tipped New Zealand into the world of unconventional monetary policy much sooner than expected. After cutting the OCR to just 0.25% and pledging to hold it there for the next year, the RBNZ's next step was actually a Large-Scale Asset Purchase (LSAP) programme. That was partly because this was felt to be more effective in calming the turmoil in financial markets at the time, but also because the banking system was not yet operationally ready to handle negative interest rates. However, the ability to take the OCR negative remains a priority for the RBNZ, and it has directed the banks to get their systems ready for it by December 1 this year.

Once operationally ready, the RBNZ has said that a negative OCR remains an option "if needed". However, we have argued for some time that a negative OCR is more likely than not, and a growing number of forecasters now share this view.

The RBNZ estimates that in order to meet its inflation and employment goals, it will need to deliver monetary stimulus equivalent to an OCR of -2% over a period of two years. To date it has achieved this through its LSAP programme, buying Government bonds to drive their yields down, in turn pushing other market interest rates lower.

However, we don't believe that the RBNZ can rely solely on this tool. At the August *Monetary Policy Statement* the RBNZ increased the total size and duration of the LSAP, so that it now plans to buy up to $100bn of bonds by June 2022. We regard that as the maximum for this programme. At that point it would own about 60% of the Government bonds on issue;

holding any more than this could hinder the functioning of the bond market, and may have no further impact on driving interest rates lower.

Moreover, a cap of $100bn means that the RBNZ will at some point have to slow its rate of bond purchases, from the current pace of over $1bn per week. Clearly, the RBNZ will need an additional policy tool at some point next year. We have long been of the view that the RBNZ will cut the OCR to -0.5% next April, which is the first scheduled opportunity after its 12-month commitment to keep the OCR unchanged expires.

No retail rates to go negative.

To be clear, we do not expect any of the interest rates paid or received by New Zealand households and businesses to go below zero when the OCR does. In overseas jurisdictions with negative policy rates, retail interest rates have almost always remained at or above zero. Banks have generally been reluctant to charge customers for their deposits.

Taking the OCR below zero would work in much the same way as a ‘conventional’ OCR cut. However, we don’t expect that it would transfer through to retail rates one-for-one. The lower the OCR goes, the less additional impact it has on retail lending rates. That’s because a growing share of bank deposits already earn zero interest, or close to it. For example, the interest rate on transactional accounts, which now make up about a quarter of bank deposits, dropped to zero years ago.

When the OCR is already low, further cuts reduce only a portion of banks’ overall funding costs, and therefore banks reduce lending rates less than one-for-one with the OCR. We estimate that an OCR cut from 0.25% to -0.5% would probably reduce mortgage rates by only about 30-40 basis points, and OCR cuts below about -1% would have no effect at all.

The RBNZ has raised the possibility that a negative OCR could be combined with a Term Lending Facility (TLF). This would involve the RBNZ directly providing long-term funding to banks at an interest rate close to the OCR, lowering banks’ overall funding costs. It would also indirectly reduce funding costs by lowering bank demand for term deposits and wholesale funding, thereby reducing the interest rates on these products. However, we note that the TLF would face a similar constraint to a negative OCR – around a third of bank funding is sourced from deposits that already pay zero interest or close to it.

By reducing the average interest rate that banks pay on money coming in the door, the TLF would lead to a reduction in the interest rate on money going out the door, such as mortgage rates (assuming that banks would maintain the same overall net interest margin). The effectiveness of the TLF, and the extent of any reduction in retail interest rates, depends on the detail of the scheme’s design.

It could be useful to introduce a TLF at the same time as reducing the OCR below zero. As the OCR gets lower, it tends to have a diminishing marginal impact on retail interest rates, so the spread between the OCR and mortgage rates tends to widen. A TLF could partially offset that. However, the TLF is a separate policy from a negative OCR, and could just as easily be used without lowering the OCR.

NZD to strengthen over 2021

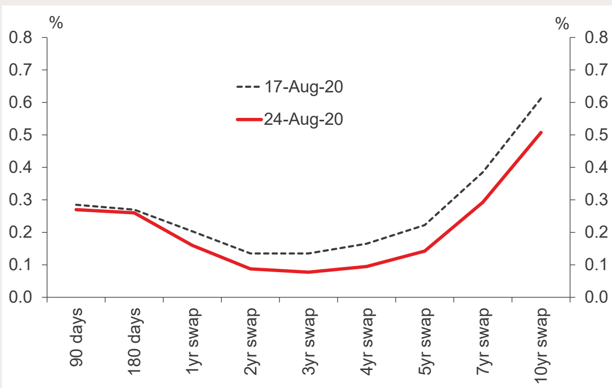
We have upgraded our forecasts of the New Zealand dollar over the next couple of years. The US dollar’s weakness is expected to persist for longer, as global markets look towards the end of the pandemic and a less risk-averse economic environment. We are forecasting the NZD to hold at around 0.66 against the US dollar this year, rising to 0.70 by the end of 2021. However, we expect the NZD to underperform the Australian dollar, given that a move to a negative OCR in Australia seems unlikely.

Fixed vs Floating for mortgages.

Fixed mortgage rates fell sharply over May and June, and have been stable since. There is perhaps some scope for a further decline in fixed mortgage rates, but it isn’t guaranteed and it isn’t large.

We are forecasting fairly stable interest rates this year, but early next year we expect that the RBNZ will lower the OCR to -0.5%. If that is correct, then both fixed and floating rates will fall next year.

NZ interest rates



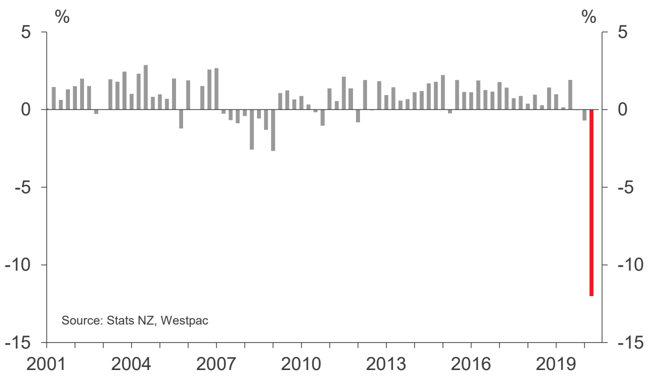
The week ahead.

NZ Q2 retail spending

Aug 24, Last: –0.7%, WBC f/c: –12%
Mkt f/c: –16.3%, Range: –20.3% to -5.0%

- Retail spending fell by 0.7% in the March quarter with the impacts of COVID-19 starting to become evident late in the quarter. Spending on grocery foods rose strongly as people stocked up and dined out less. However, there were sharp declines in spending in areas like hospitality.
- We're forecasting a 12% drop in retail volumes in the June quarter, with nominal spending down by more. New Zealand was in Alert Level 4 lockdown through the early part of the quarter, which prevented a number of businesses from trading and limited travel. The Alert Level was dialled back over time and spending has rebounded. However, that hasn't offset the loss of sales in April. In addition, social distancing requirements were in place for much of the quarter and the closure of the borders resulted in the loss of international tourists.

NZ quarterly real retail sales

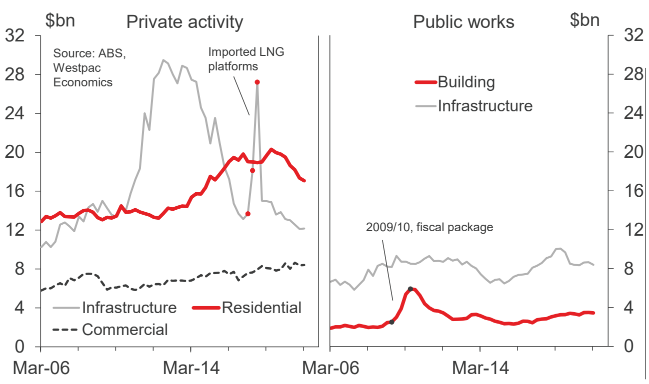


Aus Q2 construction work

Aug 26, Last: –1.0%, WBC f/c: –3.4%
Mkt f/c: -5.8%, Range: -11.7% to -3.4%

- The construction sector downturn likely accelerated in the June quarter, with the impacts of COVID-19 reinforcing existing underlying weakness.
- In March, work fell by 1% to be 6.5% lower over the year and down 12.6% from mid-2018, when the housing cycle peaked.
- For June, we anticipate a 3.4% decline in activity.
- Private sector work is forecast to fall by a sharp 5%, with weakness broadly based across residential and non-residential. The exception is mining infrastructure projects, where gains are likely.
- Public works (25% of the total) are expected to lift modestly, up by around 2%. Governments were fast tracking some works - taking advantage of the reduced congestion on our roads during this period.

Aus construction work: by segment

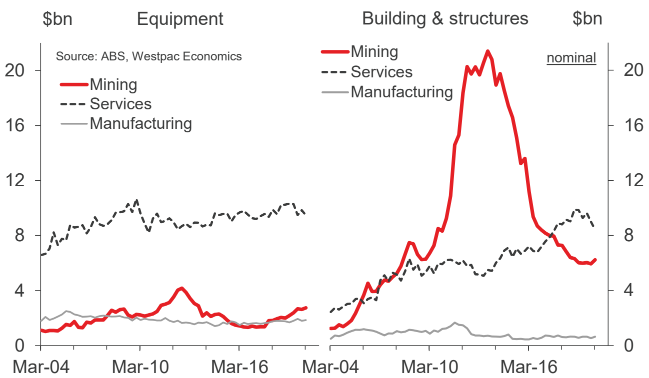


Aus Q2 private business capex

Aug 27, Last: –1.6%, WBC f/c: –8.2%
Mkt f/c: –7.9%, Range: –15.0% to –5.0%

- Private business capex will contract sharply as a result of the COVID-19 recession - a trend that emerged in the June quarter.
- In March, capex fell by 1.6%, including a -1.1% for building & structures and a -2.3% for equipment.
- For the June quarter, we expect capex to slump by -8.2%, the 2nd largest quarterly decline in the history of the series (only exceeded by a -8.6% in 2015 Q3).
- With businesses in survival mode, as well as many being in a partial shut-down, equipment spending most likely fell precipitously in the quarter. Our forecast is a -14%, the largest fall on record (next is a -8.8% for 1988Q3).
- Building & structures is forecast to decline by around 3% to be 7% lower over the year. Weakness is anticipated in commercial building and non-mining infrastructure projects.

Aus CAPEX: by industry by asset



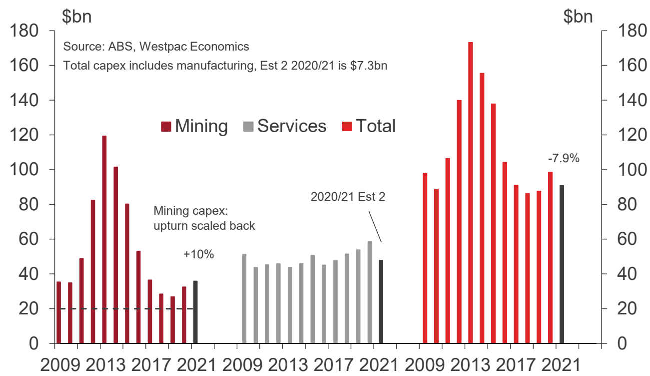
The week ahead.

Aus 2020/21 capex plans

Aug 27, Last: Est 2 2020/21: $90.9bn, -7.9% vs Est 2 a yr ago

- This survey, conducted in July and August, will provide an update on capex plans for 2020/21, as well as the outcome for 2019/20 (Est 7).
- The COVID–19 recession will see businesses cut non–essential capex – particularly equipment in the non–mining sectors. The focus is survival and firms are looking to preserve cash flows.
- The downgrading of investment plans will be evident in this update and potentially in following survey updates as well.
- Est 2 for 2020/21 was $90.9bn, -7.9% below Est 2 a year ago.
- Est 3 for 2020/21 may potentially print around $95bn, -16% below Est 3 a year ago.
- We will be interested in the industry detail - likely to show strength in mining and considerable weakness in non-mining. The outlook for mining capex is still positive, albeit COVID-19 has had some impacts, with LNG projects to be delayed in response to lower prices.

Aus capex plans, by industry: Estimate 2

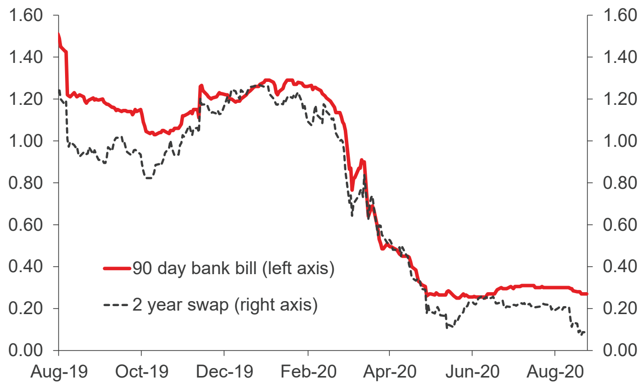


New Zealand forecasts.

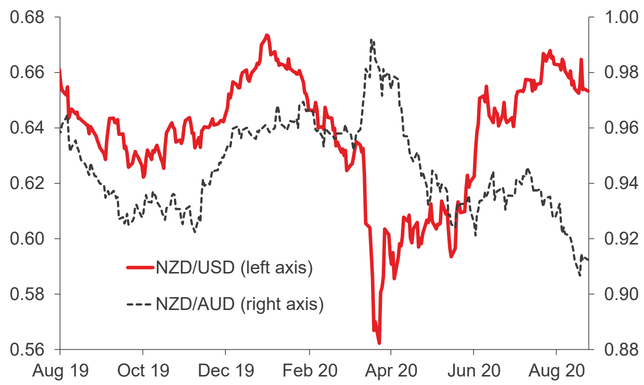
Economic forecasts	Quarterly				Annual			
	2020							
% change	Mar (a)	Jun	Sep	Dec	2018	2019	2020f	2021f
GDP (Production)	-1.6	-13.0	12.3	1.7	3.2	2.3	-4.7	5.9
Employment	1.0	-0.4	-3.8	-0.8	1.9	1.0	-4.0	2.8
Unemployment Rate % s.a.	4.2	4.0	6.5	7.0	4.3	4.1	7.0	6.4
CPI	0.8	-0.5	0.6	0.0	1.9	1.9	0.9	0.5
Current Account Balance % of GDP	-2.7	-2.3	-2.0	-2.1	-3.8	-3.0	-2.1	-3.5

Financial forecasts	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21
Cash	0.25	0.25	0.25	-0.50	-0.50	-0.50
90 Day bill	0.30	0.30	-0.10	-0.20	-0.20	-0.20
2 Year Swap	0.20	0.10	0.00	-0.10	-0.10	-0.10
5 Year Swap	0.30	0.25	0.25	0.25	0.25	0.35
10 Year Bond	0.70	0.75	0.75	0.75	0.80	0.80
NZD/USD	0.66	0.67	0.66	0.66	0.68	0.70
NZD/AUD	0.90	0.89	0.87	0.87	0.87	0.88
NZD/JPY	69.3	71.0	70.6	70.6	73.4	75.6
NZD/EUR	0.56	0.56	0.55	0.55	0.56	0.57
NZD/GBP	0.51	0.52	0.51	0.50	0.52	0.53
TWI	71.5	71.9	70.3	69.9	71.4	72.8

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 24 August 2020

Interest rates	Current	Two weeks ago	One month ago
Cash	0.25%	0.25%	0.25%
30 Days	0.27%	0.27%	0.27%
60 Days	0.27%	0.28%	0.30%
90 Days	0.27%	0.30%	0.30%
2 Year Swap	0.09%	0.21%	0.22%
5 Year Swap	0.14%	0.30%	0.33%

NZ foreign currency mid-rates as at 24 August 2020

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6533	0.6607	0.6639
NZD/EUR	0.5540	0.5605	0.5695
NZD/GBP	0.4995	0.5061	0.5188
NZD/JPY	69.12	69.93	70.49
NZD/AUD	0.9124	0.9230	0.9344
TWI	71.03	71.91	72.75

Data calendar.

		Last	Market median	Westpac forecast	Risk/Comment
Mon 24					
NZ	Q2 real retail sales	–0.7%	–16.3%	–12.0%	Spending dropped sharply during the COVID-19 lockdown.
Aus	Jun household impacts of COVID–19	–	–	–	Monthly update on COVID-19's impacts.
US	Jul Chicago Fed activity index	4.11	3.69	–	Rose to record high as states reopened.
Tue 25					
Aus	8 Aug weekly payroll jobs	–	–	–	An emerging loss of momentum. Hit from Melbourne lock–down.
	Jul merchandise trade, prelim	–	–	–	Surplus elevated. This series – not in a user friendly form.
US	Jun FHFA house prices	–0.3%	0.3%	–	May – contracts signed under stay–at–home orders Mar/Apr.
	Jun S&P/CS home price index	0.04%	0.10%	–	Last month missed market expectations.
	Aug consumer confidence index	92.6	93.0	–	Improving but policy gridlock remains a material risk.
	Jul new home sales	776k	775k	–	Housing on recovery route, aided by low rates.
	Aug Richmond Fed index	10	10	–	Shipments and new orders data suggest expansion ahead.
	Fedspeak	–	–	–	FOMC Daly speaks on inequity and COVID–19.
Wed 26					
NZ	Jul trade balance $mn	426	282	280	Returning to surplus as import demand remains weak.
Aus	Q2 construction work done	–1.0%	–5.8%	–3.4%	Broad based weakness across private sector, non–mining.
US	Jul durable goods orders	7.6%	4.0%	–	Gain led by transportation equip (+20%), esp. motor vehicles.
Thu 27					
Aus	Q2 private new capital expenditure	–1.6%	–7.9%	–8.2%	Falls to be led by likely sharp slump in equipment spending.
	2020/21 capex plans (Est 3) AUDbn	90.9	–	95	Plans to be "downgraded" in response to recession.
	Aug business impacts of COVID	–	–	–	Revenue down for many businesses. Melbourne lock–down to bite.
Chn	Jul industrial profits %yr	11.5%	–	–	Pick up in profits driven by gov–led infrastructure investm.
Eur	Jul M3 money supply %yr	9.2%	–	–	Stimulus to continue supporting money supply.
US	Q2 GDP	–32.9%	–32.5%	–32.9%	Second est. to confirm pandemics substantial hit to growth.
	Initial jobless claims, '000	1,106	–	–	Unable to make the downtrend stick, claims edged up again.
	Jul pending home sales	16.6%	5.5%	–	Beating f/cs as borrowing costs fall; bright spot in pandemic.
	Aug Kansas City Fed index	3	–	–	Activity driven by non–durable goods, still positive in YoY terms.
	FOMC Chair Powell	–	–	–	Speaking on policy framework.
Fri 28					
NZ	Aug ANZ consumer confidence	104.3	–	–	Renewed COVID concerns are likely to dent confidence.
Eur	Aug economic confidence	82.3	85.0	–	Sentiment across the economy rises as summer rolls on, but...
	Aug consumer confidence	–	–	–	...continued growth will depend on keeping new cases down.
UK	Aug Nationwide house prices	1.7%	0.5%	–	Bounce back reflects unexpected recovery in housing.
US	Jul personal income	–1.1%	–0.3%	–	Gov's one–time stimulus checks dissipate, incomes fall.
	Jul wholesale inventories	–1.4%	–1.0%	–	Durable goods stocks fell, prof. equip and metals fell most.
	Jul personal spending	5.6%	1.5%	1.2%	Services weakness to moderate boost from retail.
	Jul PCE deflator	0.4%	0.4%	–	CPI surprised to the upside in Jul on headline and core...
	Jul core PCE deflator	0.2%	0.5%	–	... but it was due to supply one-offs not demand.
	Aug Chicago PMI	51.9	51.0	–	Rose 15.3pts as businesses resume operations.
	Aug Uni. of Michigan sentiment	–	–	–	Regional surveys moving in positive direction.

International forecasts.

Economic forecasts (Calendar years)	2016	2017	2018	2019	2020f	2021f
Australia						
Real GDP % yr	2.8	2.5	2.8	1.8	-4.1	2.3
CPI inflation % annual	1.5	1.9	1.8	1.8	0.7	2.1
Unemployment %	5.7	5.5	5.0	5.2	8.6	7.4
Current Account % GDP	-3.1	-2.6	-2.0	0.6	2.4	0.8
United States						
Real GDP %yr	1.6	2.4	2.9	2.3	-6.8	2.9
Consumer Prices %yr	1.4	2.1	2.4	1.9	0.7	1.4
Unemployment Rate %	4.9	4.4	3.8	3.7	9.7	7.3
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
Japan						
Real GDP %yr	0.5	2.2	0.3	0.7	-5.0	1.0
Euro zone						
Real GDP %yr	1.9	2.5	1.9	1.2	-8.5	4.1
United Kingdom						
Real GDP %yr	1.9	1.9	1.3	1.4	-7.0	2.5
China						
Real GDP %yr	6.8	6.9	6.8	6.1	1.3	9.5
East Asia ex China						
Real GDP %yr	4.1	4.6	4.4	3.7	-2.0	5.4
World						
Real GDP %yr	3.4	3.9	3.6	2.8	-4.3	5.0
Forecasts finalised 7 August 2020						

Interest rate forecasts	Latest	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21
Australia							
Cash	0.25	0.25	0.25	0.25	0.25	0.25	0.25
90 Day BBSW	0.10	0.10	0.15	0.20	0.25	0.30	0.35
10 Year Bond	0.89	0.90	0.90	0.95	1.05	1.20	1.35
International							
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	0.65	0.60	0.60	0.65	0.75	0.85	0.95

Exchange rate forecasts	Latest	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Jun-22
AUD/USD	0.7203	0.73	0.75	0.76	0.76	0.78	0.80	0.80
USD/JPY	105.70	105	105	105	106	106	106	107
EUR/USD	1.1866	1.19	1.21	1.22	1.23	1.24	1.25	1.25
GBP/USD	1.3229	1.32	1.33	1.34	1.35	1.37	1.39	1.40
AUD/NZD	1.1015	1.11	1.12	1.15	1.15	1.15	1.14	1.14

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