17 November 2017

Interest Rate Strategy: Short rates hit record low

- **Short term interest rates have hit a record low. The 90-day bank bill rate traded at 1.905% and some government rates like T-bills and RB bills have recently been bid below the cash rate of 1.75%. Domestic liquidity is gushing, as banks are well ahead of funding targets and credit growth is softer.**
- **As these conditions continue, the 2-year swap rate has a good chance of reaching a fresh low for the year, down towards 2.10%. The top of the range into year-end and early next year is probably more like 2.25% now, with global forces being the most likely source of any upside pressure.**
- **The proposed new policy framework stemming from revisions to the RBNZ Act has had no bearing on our monetary policy outlook. Some traders and market commentators see the changes from a dovish perspective, but we do not agree with that assessment.**

Short rates make fresh lows

This week the 90-day bank bill rate traded down to 1.905%, a record low, taking the spread to OCR down to 16bps, while the 30-day rate has traded at a spread of just 1bps. T-bill yields and RB bills have recently been bid below OCR. It all points to a domestic banking system flush with cash. Easy funding conditions offshore have seen banks well ahead of plan on their funding targets.

The missing link has been demand for loans, as a softer market for existing houses, loan-to-value restrictions and uncertainty around the election have seen softer credit growth. In the absence of credit growth picking up, banks will remain well-funded and will be looking for a home to park cash, keeping downward pressure on short term rates. This all feeds into lower short-end swap rates, with the 2-year rate down to 2.16%, at the lower end of the range this year despite last week's ever so slightly more hawkish tone from the RBNZ.

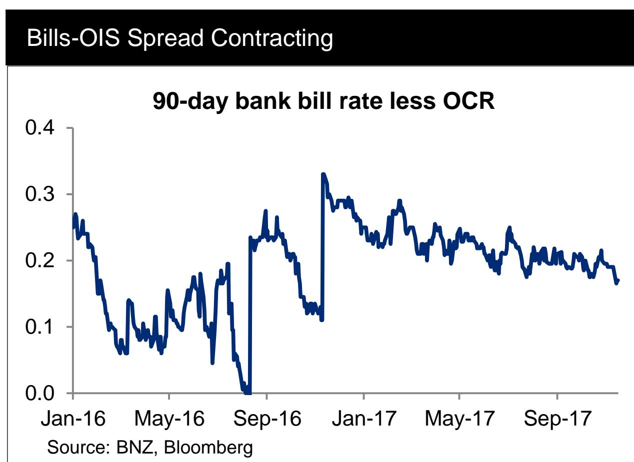
Independent of monetary policy, we see these flush funding conditions continuing over the next month or two, keeping a lid on short-term rates. Over the first half of the year, the bills-OIS spread averaged 23bps and we wouldn't be surprised to see the spread settle in a 10-20bps range over the next few months.

It's just another factor to consider when thinking about the outlook for short-term rates. Last week's Monetary Policy Statement saw the RBNZ guide the market towards policy remaining on hold "for a considerable period". We project a much earlier tightening than the Bank's mid-2019 projection, with the second half of next year firmly in our sights for the first tightening. But that's still far enough away to suggest that short-rates will remain underpinned for some time yet, particularly with the next MPS not due for another three months.

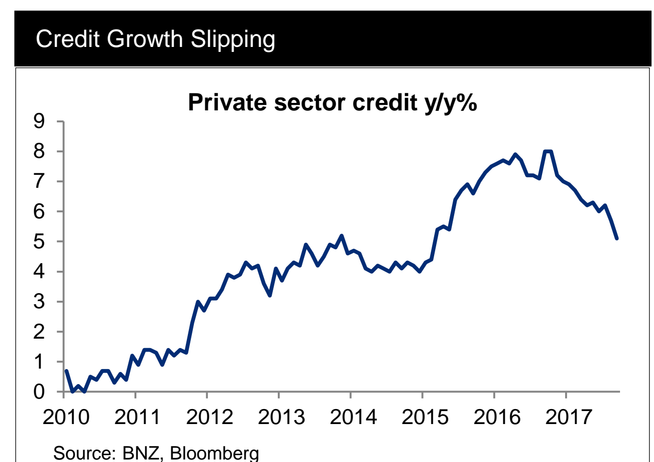
Domestic liquidity factors are a key near-term downward force at present and increase the probability of the 2-year swap rate making a fresh low for the year, below the early-September level of 2.13%. We previously thought that the 2.15% level might represent the bottom of the range, but flush funding conditions could easily see new lows re-tested.

At the other end of the scale, global forces are the more likely source of any possible upside pressure. We saw

Bills-OIS Spread Contracting



Credit Growth Slipping



temporary upward blips in rates in late-June and September, as other major global central banks adopted a more hawkish tone, with some spillover impact into the NZ market. More of these can't be ruled out as the global mood improves towards higher policy rates.

Over the next few months, expect a range of 2.10%-2.25% for 2-year swap. As the first tightening comes into focus, we'd expect to see the 2-year rate drift higher, but that's more a story for next year.

The New Policy Framework

Since the new government was formed there has been a lot of debate and potential confusion around reform of the RBNZ Act and what it might mean for monetary policy.

The first phase of the review, due early next year, will look at including employment alongside price stability as a key objective, look at formulating a committee approach, including external advisors, and consider whether changes are required for the role of the Reserve Bank Board, given the changes to the decision making model.

On the new employment objective, last week Acting Governor Spencer should have allayed those with fears that proposed changes to the RBNZ Act would significantly change the course of monetary policy. Speaking at the post-MPS press conference, Spencer noted that moving to a dual mandate was unlikely to impact monetary policy as the Bank already considers itself a "flexible" inflation targeter, already taking into account employment dynamics.

In our view, adding some sort of "maximising employment" language into the mix might matter for monetary policy, at the margin, if the unemployment rate was much higher than normal but that doesn't apply in the current cycle. And arguably, the RBNZ already considers, and has done for some time, such real economic effects of its monetary policy actions. The proposed change to the Act just formalises the approach into legislation.

Spencer's comments supported our view that the Bank's reaction function will be little changed after the legislation is passed, with a target date of before the end of March 2018.

As for the proposed change to legislating for a committee based approach, the Bank already has two external advisors sitting in on the monetary policy decisions and takes on board their advice. The addition of three external advisors which the Finance Minister proposes simply formalises the current approach and should do little to alter the Bank's policy reaction function. To argue that the presence of external advisors makes the RBNZ "more dovish" is a leap of faith not backed up by any evidence.

Last week, what also got the market's attention was Finance Minister Robertson's comments in a couple of interviews that he expects to discuss the central bank's current focus on the 2 percent midpoint of its inflation target band once a new governor is appointed.

Some see this as a "dovish" statement, allowing the Bank to go easier on its inflation target in the context of employment being added to the Bank's mandate. Governor Wheeler made a point of aiming directly for the 2% mid-point after inflation averaged 2.7% over Governor Bollard's prior reign.

With the benefit of hindsight, Wheeler's fixation on the 2% mid-point reduced the Bank's flexibility, as global disinflationary pressures meant that the Bank failed to meet that objective, with inflation persisting well below 2%. The Bank drove its policy rate down to a record low of 1.75% in a bid to generate some inflation and added macro-prudential measures to counteract the asset price inflation and financial stability concerns it managed to generate in the process. It was an odd policy mix that might have been avoided had the Bank simply accepted that using the full width of the 1-3% inflation band was perfectly acceptable.

So we would see a move by the Bank – and with the blessing of the Finance Minister – to remove its fixation on the 2% mid-point as a positive development.

In the current disinflationary world where global central banks have struggled to meet their 2% inflation targets, over-stimulating economies and stoking asset price inflation doesn't make a lot of sense to us. Relaxing the mid-point focus could pave the way for tightening policy earlier than otherwise, "accepting" the trade-off of inflation settling in the lower half of the target range, or taking longer to get to the mid-point.

So while some claim that relaxing the mid-point target allows lower than otherwise interest rates, the opposite could well apply and lead to higher rates from current levels.

In sum, the proposed new policy framework has had no bearing on our monetary policy outlook. Some traders and market commentators see the changes from a dovish perspective, but we do not agree with that assessment.

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