insightpaper

NEW ZEALAND'S NEUTRAL CASH RATE

Think 'spread', not absolute level

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Determining the neutral cash rate is a challenge. This is because it is not directly observable and it is difficult to estimate precisely what the current level should be. This Insight takes a look at why for a small open economy such as New Zealand the neutral rate may be better interpreted as a spread to the global cash rate, rather than some absolute level or number. We also discuss how current economic and policy settings can be reconciled when viewed through this spread lens.

WHAT IS THE NEUTRAL CASH RATE?

To set the scene, it is worth reflecting on exactly what the neutral cash rate is. The neutral cash rate is the rate that neither adds nor detracts from inflation when the economy is growing at potential (ie there is a zero output gap) and inflation is at target.

GLOBAL INFLUENCE

A small open economy (SOE) like New Zealand should be heavily influenced by offshore developments. This is primarily through the trade channel, but is also through financial sector linkages, shared technological advances as well as business and consumer confidence spillover effects.

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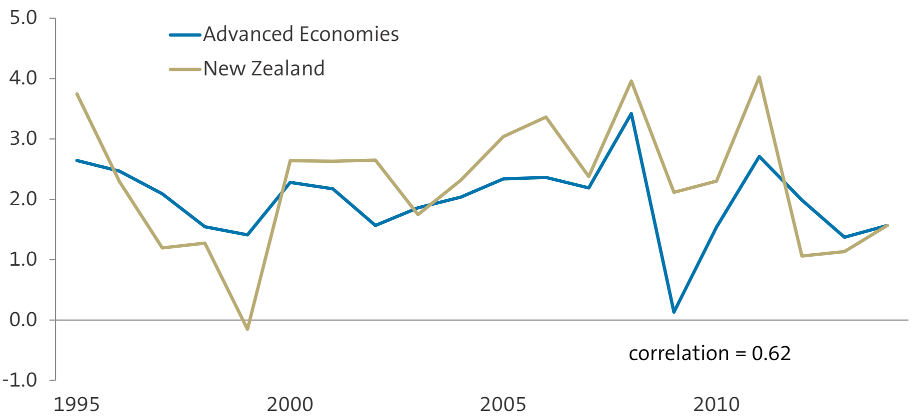
Head of Investment Strategy

Annual GDP

Source: IMF, AMP Capital

Given the trade and other linkages, it is fair to assume that global and SOE inflation will generally move together and share periods of higher and lower inflation.

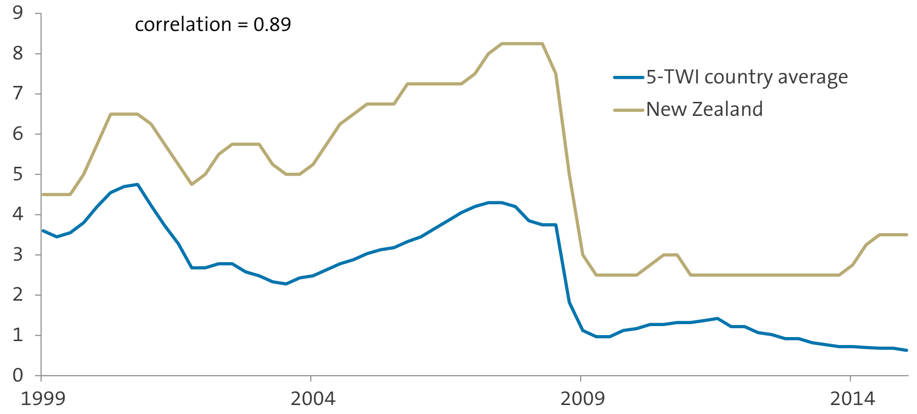
Annual inflation



Source: IMF, AMP Capital

If major global central banks are responding to the main drivers of inflation, it is also fair to assume a SOE central bank will want to respond to those same drivers given inflation's international co-movement.

Global monetary policy rates



Source: Bloomberg, AMP Capital

THINK 'SPREAD', NOT LEVEL

Given the strong evidence of international synchronicity, a neutral policy rate for a SOE may be better interpreted as a spread to the global neutral cash rate, not an absolute rate in and of itself.

For example, if global policy rates are at historic lows for an extended period because of global spare capacity it may not be useful to think of a SOE cash rate as stimulatory or not relative to some absolute neutral level that presupposes the global cash rate is at its long run neutral rate.

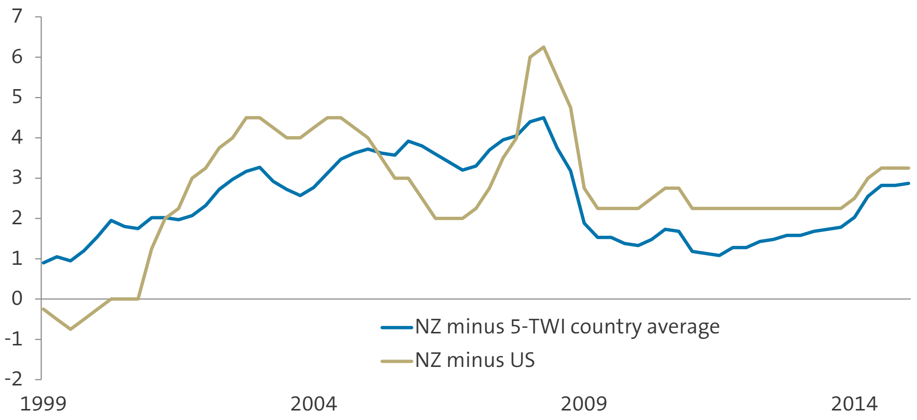
This is because, in a world of free capital movements, money will soon find a home in a SOE that offers a higher interest rate spread than usual, which will drive up the currency and subsequently lower inflation.

Therefore, even if the SOE cash rate is below some absolute neutral level, a higher than average spread could prove to be far from stimulatory (or at least not as stimulatory as expected). This is the situation New Zealand finds itself today.

THE CURRENT SITUATION

Since the introduction of New Zealand's Official Cash Rate (OCR) in 1999, the average spread to the five main developed market policy rates has been 2.4%[1]. The current spread is 2.9%.

New Zealand policy rate spread



Source: Bloomberg, AMP Capital

[1] Using a simple average or approximate five TWI weights of 30% US, 20% Australia, 25% Euro, 15%, Japan and 10% UK.

Viewed through an absolute neutral lens, the current domestic situation of a positive and rising output gap and rates on hold a full 1% below the Reserve Bank of New Zealand's estimate of the neutral rate looks a little puzzling.

Viewed through a spread lens, however, a positive and rising output gap and cash rates on hold is reconciled, given the higher spread than average. Of course, if and when the US Fed lifts interest rates, a higher domestic rate may be needed to maintain the higher spread if New Zealand's output gap is still positive and inflation is rising as the Reserve Bank expects.

A PERSISTENT SPREAD

One reason New Zealand has a persistent cash spread is we need relatively higher rates to attract short term foreign capital to fund persistent current account deficits. Another interpretation is the current account deficit simply reflects New Zealand's low level of saving relative to investment, and a higher interest rate is needed to contain inflation in the face of high domestic spending.

Either way, there should be some risk premium for investing in a small, concentrated, less liquid market versus a globally diversified, more liquid one.

BACK TO THE FUTURE

New Zealand's monetary conditions index (MCI) regime that was in place in the late 1990s placed a greater emphasis on international linkages. In this regime the 'neutral' cash rate depended on the level of the currency, which of course is heavily influenced by the global interest rate spread. The MCI failed because it introduced unwanted volatility into markets. Also, a strict rule based system can miss many economic and market nuances.

No-one is advocating a return to the MCI regime, but defining the neutral rate as a spread not a level could be a step back in the right direction.

CONCLUSION

In this note we have put the case that the neutral policy rate in New Zealand is best viewed as a spread to the global neutral cash rate rather than an absolute rate. We believe the current domestic situation of a positive and rising output gap and cash rates on hold is better able to be reconciled when viewed in relation to this global spread.

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