NZ Insight: Some cheer heading into Christmas – further OCR cuts becoming less likely

25 November 2020

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Some cheer heading into Christmas – further OCR cuts becoming less likely

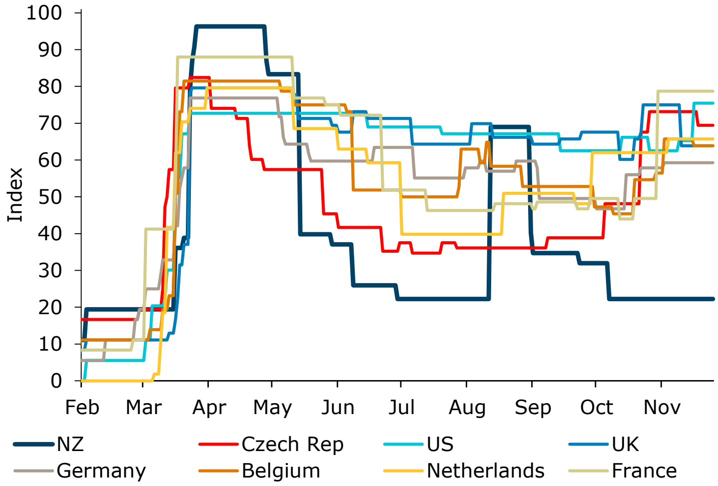
Bottom line

- There are good reasons to feel positive heading into the holiday season. Our OCR call remains the same for now and is highly conditional on how developments unfold. But given the news flow, odds are increasing that the RBNZ will not take the OCR negative, and that's a good thing.
- There is genuine good news on several fronts: New Zealand's successful health response, resilient business sentiment, commodity price strength, and vaccine news. In addition, monetary and fiscal stimulus have been very effective this year, providing a significant cushion to the economy.
- From here, though, the outlook is finely balanced. It's much less clear further monetary stimulus is justified and it wouldn't take much to tip the balance and see us forecasting no further (or at least fewer) OCR cuts. But the overarching question is whether the recent positivity we have seen will be sustained, or whether it might fade as we move past the holiday season. There are reasons to be cautiously optimistic, but enormous uncertainty remains. Key near-term data we'll be watching include momentum in both housing and business and consumer sentiment.
- We don't believe adding consideration to avoiding unnecessary instability in house prices to the RBNZ's remit would have changed how policy would have been conducted thus far, given the enormity of the economic shock. Nor does it in itself change our view on the OCR outlook. It might make a difference at the margin if an OCR change were a line-ball call on the day, perhaps, or could lead to tweaks in FLP design or macro-prudential policy settings and tools. But it doesn't change the fact that it's the economic outlook that will ultimately drive policy decisions. And it certainly won't solve the fundamental issue of high house prices.

It's been a difficult year, but things could have been much worse

To say that 2020 has been a challenging year would be an understatement. The world has faced an unprecedented health and economic crisis that has exacted an enormous human toll and is impacting billions of lives the world over. When the crisis started, few could have imagined the success of New Zealand's health response, the effectiveness of policy in cushioning the economic blow, or the resilience of the economy to the events that have unfolded. Some people have clearly felt the impact, but things could have been much worse. We're largely able to get on with our lives like few can (figure 1).

Figure 1. Oxford stringency index

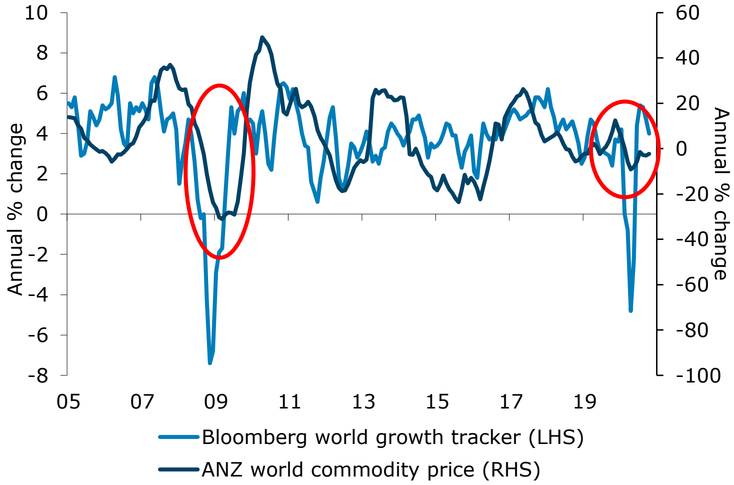


Source: Oxford University, Bloomberg, ANZ Research

New Zealand is in a much better position than anyone would have imagined at the beginning of this crisis and is better equipped to meet the economic challenges that we might face ahead. It is certainly true that some of the recent 'good news' is arguably better characterised as extreme volatility, or else is very much a double-edged sword (housing market, we're talking about you). But there is some genuine, heartening good news out there from which we should all take some Christmas cheer:

- **We have managed to eliminate COVID-19 from our shores repeatedly, at decreasing cost.** Our health response has been highly effective, we have learnt a lot, and systems around testing and tracing have improved throughout the process. Even if we have some bad luck from here (and luck does play a large role with this virus), a renewed widespread lockdown now looks unlikely. Economically, that means that a lot of activity has taken place – and very importantly, can reasonably be assumed by businesses to continue to take place – that would otherwise have been in jeopardy. Jobs have been saved as a result.
- **Conditions for our goods exporters have been better than expected.** Although COVID-19 remains an enormous challenge globally, through sheer good luck the countries that we trade with the most are in relatively good positions, including China, Australia and parts of Asia. Our commodity prices have also held up. Although these could yet come under some pressure, this has cushioned the blow relative to the negative export price impacts typically seen in a global recession (figure 2). It hasn't been smooth sailing by any means, especially with supply chain disruption, labour shortages and an elevated exchange rate, but our export sector has been pretty resilient, all things considered.

Figure 2: Bloomberg global growth tracker and ANZ NZ commodity price index



Source: Bloomberg, ANZ Research

- **Highly effective vaccines are on the way.** It won't be an instant fix, but with light at the end of the tunnel, New Zealand's elimination strategy looks sustainable and optimal, both for public health and the economy. We haven't felt the full tourism industry pain from the closed border yet, but the rebound in the remaining, protected 95% of the economy has been nothing short of remarkable.

Policy has been highly effective

Although New Zealand has not seen the same economic ramifications as elsewhere, we have experienced periods of significant disruption, and fiscal and monetary policy have certainly stepped up to the plate.

Fiscal policy, particularly through the wage subsidy, has supported incomes, saved jobs and helped businesses through uncertain times, albeit in a way that is too expensive to be sustained for long.

Sadly, some job losses will have only been delayed and there will be some headwinds ahead, with the subsidy now having ended. But the labour market has been less badly affected than previously feared, meaning there are more opportunities for displaced workers than would otherwise have been the case. There are more media stories about wage-subsidised firms subsequently making embarrassingly large profits than there are stories of firms complaining about a lack of support. In the heat of the moment the policy was never going to be perfectly calibrated; probably better on balance to err on the too-generous side of things. Ultimately, temporary fiscal support has been very effective at damage control, and more so than many expected. And with a low fiscal debt starting point, our credit-worthiness is not in question as a result, provided the fiscal strategy includes a path to consolidation.

Monetary policy has helped too. In large part, this has worked through stimulating the housing market, but not solely. Love it or hate it, the housing market strength has flowed through to the broader economy, via increased confidence and willingness to spend. It's not a fix-all. We do unfortunately still expect a wave of business failures amongst firms exposed to the closed border. But the momentum in the housing market is providing a powerful offset and will help head off negative feedback loops through the wider economy. Not without bringing its own costs and risks, absolutely. But you certainly can't argue monetary policy hasn't 'worked'.

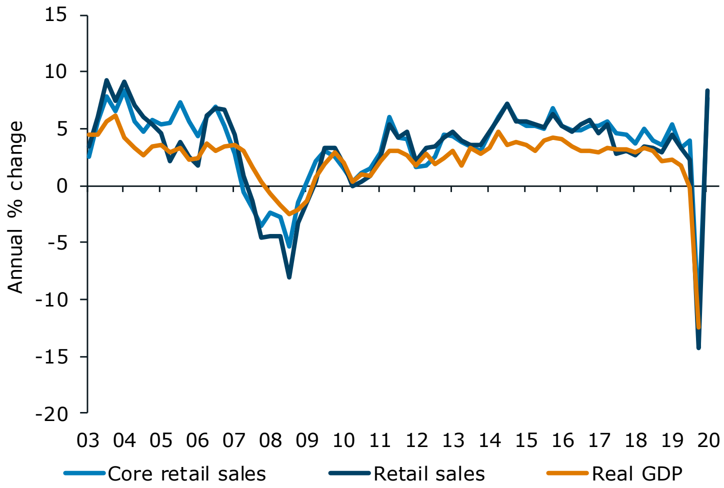
Housing is getting all the attention, but monetary policy has broader impacts too. Easy financial conditions have made cash-flow conditions easier and supported business confidence, spending and the labour market. This support will help keep the economy going as we face into the challenges ahead. We are not out of the woods yet and the domestic economy faces a serious test in coming months – fiscal support has waned just as highly seasonal tourism impacts will become apparent. But there are also genuine reasons to be more optimistic about the outlook from here, with the risks much less downwardly skewed, and the monetary policy outlook now appears much more nuanced as a result.

Monetary policy outlook finely balanced

The monetary policy outlook and policy trade-offs are now more finely balanced. Recently, better-than-expected data flow has provided policy makers with a little breathing room. Sugar-hit fiscal policy and foot-to-the-floor monetary easing are now making way for a more measured response. The damage-control element of the policy response is now behind us, and it's all eyes on the data to see what more is needed. There are a number of key milestones policymakers will be watching, as we discussed in last week's Data Wrap.

The challenge will be disentangling what aspects of the recent positive economic news flow will be enduring, as opposed to those that represent welcome but unsustainable overshoots. Although the data flow has certainly turned more positive, we still think the individual data prints will be very noisy and there will be much to look through. For example, the bounce that we have seen in domestic spending is unlikely to be sustained at current levels that are considerably higher than a year ago (figure 3). Some of it is nice stuff replacing margaritas on a Bali beach, and that substitution will continue. But the fact remains that in aggregate, we're dealing with a significant income hit. Tourism was as big a foreign exchange earner as the dairy sector before this happened.

Figure 3. Real retail sales and GDP



Source: Statistics NZ

Activity can't keep indefinitely surprising on the upside; things just don't work that way. But as the inevitable disappointments start to occur as the one-off boosts fade, we need business and consumer confidence to remain robust to see momentum sustained. That test lies ahead. Another wild card is that global markets may lurch. For now, it's all guns blazing for risk appetite with US equities hitting fresh record highs. But some very large Northern Hemisphere economies are taking a significant hit from COVID-19 currently and some very poor data inevitably must lie in store before vaccines drive the virus into retreat.

The overarching theme that will shape New Zealand's economic outlook is the sustainability of the recovery and whether it can see the economy safely through the period until borders re-open. That is still an open question, with uncertainty still far higher than normal as the economy continues to navigate uncharted territory. And so we continue to watch and wait. At the end of the day, the RBNZ still has inflation and employment mandates to think about and although the outlook on those fronts is looking much better, we are simply not out of the woods yet.

Positivity could see our assumptions challenged, implying less need for stimulus

Our OCR forecast is predicated on a view that the economic recovery will stagnate to some degree early next year, and the RBNZ will eventually deem that more stimulus is needed, taking the OCR to 0.1% in May and to -0.25% in August. But this second cut in particular is a line-ball call, and is highly conditional on exactly how things pan out. It's predicated on a number of assumptions that have always been subject to considerable uncertainty – and still are!

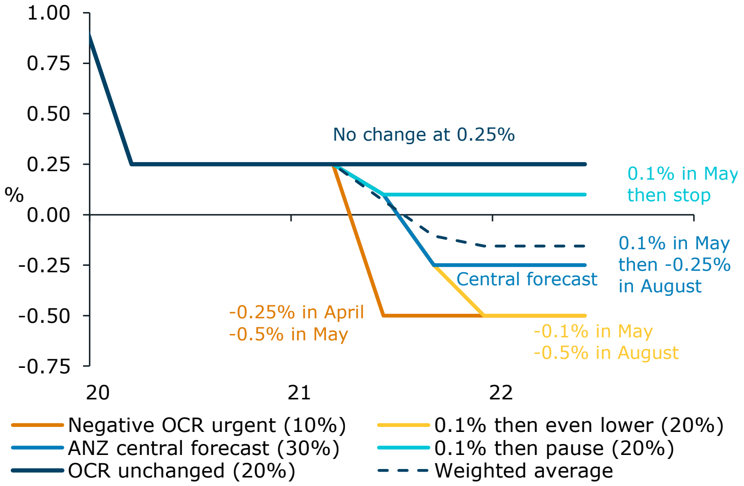
- **Recent vaccine headlines could see borders open earlier than our assumption of early 2022.** Virus and vaccine developments have the potential to change the outlook materially by moving the date our borders are expected to reopen, boosting business and household confidence, and supporting the global economy. Recent vaccine developments are very encouraging and suggest the pace of opening could be faster, but we will await concrete announcements from officials before altering our assumed timeline.
- **We expect the housing market to calm down as reality (and renewed LVR restrictions) bite, but this particular horse can be hard to rein in once it's got the bit between its teeth.** Housing is a powerful driver of economic activity. While we've seen economic fundamentals deteriorate (chiefly incomes), this deterioration has been smaller than expected and has been concentrated in specific (broadly lower-paid) industries. This has left a considerable cohort of people economically unscathed and keen to participate in the housing market. Our central expectation is for a small wobble in house price inflation in early 2021, but one could easily tell a different story. The key point is that when it comes to the aggregate economic outlook, housing market momentum is going head-to-head with the lost summer of international tourism. The vibe on the street is that housing-induced domestic momentum is certainly winning the battle so far, but the war is not over yet – the tourism story is just getting started. But continued momentum in the housing market into the New Year, if that were to occur, would flow through into stronger economic activity and would therefore likely tip the balance away from any further OCR cuts.
- **Resilience in confidence could see a more self-sustaining recovery.** Our OCR outlook is premised on a stagnation in economic momentum early next year as fiscal policy support rolls off and the impact of the closed border hits in full force. Should sentiment soften, this would manifest in reduced headcount and investment, and greater precautionary saving (at the expense of consumption). But with sentiment relatively resilient so far, the initial income hit (concentrated in particular industries) has not broadened yet. Our forecasts assume it will, but that's far from certain. Unfortunately, volatility brought about by lockdowns, alongside explosive (but temporary) fiscal stimulus have made it very difficult to gauge the underlying state of the economy. That's why, although the balance of risks is certainly shifting, we're holding off for now on taking

OCR cuts out of our forecasts. Key near-term data we'll be watching include momentum in both housing and business and consumer sentiment.

- **The worst of global supply chain disruption, which has affected a range of industries, may soon be behind us.** Logistical challenges are likely to ebb and flow until economic volatility ends and borders open, and have been pretty significant, and under-appreciated. But as bottlenecks ease, some relief should come, even if it isn't fully resolved for a while yet.

We have made it clear that we can see developments playing out differently to our central forecast – better or worse – and talked about possible scenarios (figure 4) in detail in a recent ANZ NZ insight. Happily, over time, odds appear to be rising that one of the more optimistic scenarios we outlined may be playing out, with less stimulus required than we are currently assuming. Although we continue to watch and despair at how to put trends through crazy data, the case is gradually building for no further (or at least fewer) OCR cuts.

Figure 4. OCR scenarios



Source: RBNZ, ANZ Research

Has policy done too much, then?

With conditions in the economy nowhere near as bad as previously feared, has the RBNZ done too much?

In short, probably not – the odds of an inflation or employment overshoot at this stage still look low, and that is how the Reserve Bank frames it in terms of their "least regrets" approach. Recently, the reasoning has been that the implications of doing too little are worse than doing too much, and the RBNZ can flip the paddle over to the other side pretty quickly should they end up oversteering.

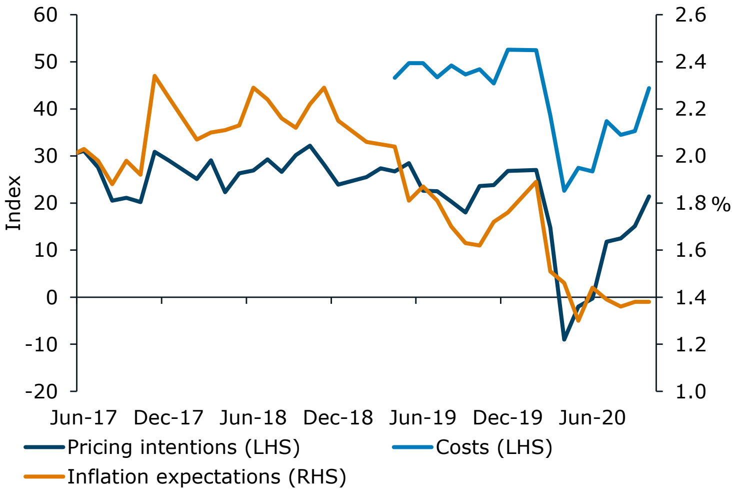
With regular OCR cuts, that's true enough, though the economy can be a slow ship to turn. International experience suggests that unconventional monetary policy can wrap the paddle in weeds over time, making changing course more difficult as economies become increasingly reliant on cheap money, ongoing central bank bond purchases, and the like. Fortunately it's still early days for New Zealand on the unconventional front and economy-wide debt levels are not yet worrisome, though record-high and rising household debt is quite rightly garnering more and more attention.

Just as with fiscal policy, nuanced calibration of monetary policy when COVID hit wasn't really an option – the economy was in cardiac arrest. It would be a bit unfair to argue that the RBNZ has got it wrong because the economy is doing so well, when an unmeasurable but probably significant part of the reason the economy has been so resilient is itself the monetary policy response! The RBNZ has done what it needed to in order to reduce the number of job losses in the face of this crisis and ensure that the price and availability of credit are not hurdles to the eventual recovery. While the case for further stimulus from here has diminished significantly, that doesn't mean one can draw the conclusion that a policy mistake has been made, given the challenging outlook that remains ahead for inflation and the labour market.

That's not to say the inflation outlook is a one-way bet. The RBNZ could still in time be surprised that inflation is stronger than their projections, and find they do in fact need to change course earlier than they thought:

- Businesses' pricing intentions and cost measures have bounced right back to pre-COVID levels, and inflation expectations have stopped falling (figure 5);

Figure 5: Business cost expectations, pricing intentions and inflation expectations

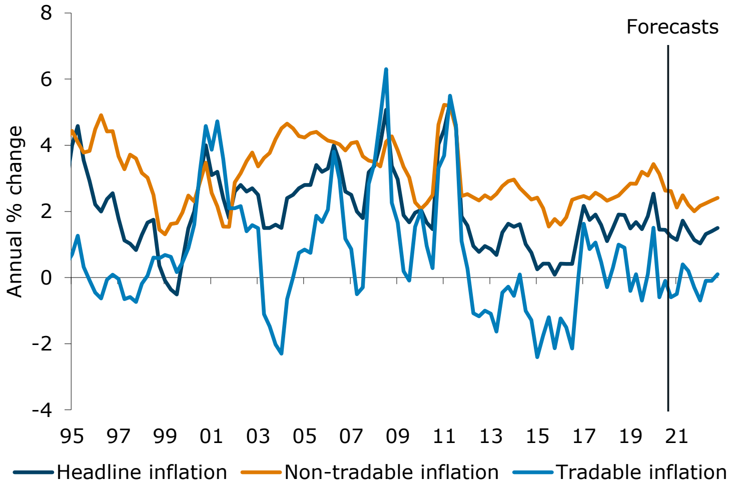


Source: ANZ Research

- Shipping disruptions are causing significant shortages of various goods;
- In September firms reported their largest problem was finding skilled labour – and anecdotally the labour market has tightened more since then;
- House prices are not in the CPI, but they directly impact various housing-related items that are.

To be clear, our forecasts suggest the RBNZ is quite right to be more worried about inflation being too low than too high, and that they haven't over-egged the salad (figure 6). But it's just worth pointing out that the risks aren't as one-sided as people might think.

Figure 6. Inflation forecasts



Source: Statistics NZ, ANZ Research

What about housing?

Higher house prices are certainly the political topic *du jour*, and lower mortgage rates have undoubtedly contributed. But the **only** long-term solution to New Zealand's housing affordability problem is to correct the balance between demand and supply – that is, build more houses. The simple fact is if New Zealand's housing supply were more responsive to demand, and more building had taken place in the past, the market would be less susceptible to these bouts of rapid house price inflation, and houses would be more affordable.

It's a multifaceted issue, but some of the aspects of improving housing supply responsiveness include reducing red tape, freeing up land for development, encouraging intensification, helping councils fund required infrastructure, and incentivising investment and training to lift the productive capacity of the construction industry. Other changes that might help knock a bit off house prices include changes to immigration settings, tax and other regulatory settings.

The RBNZ can't do anything about any of that.

What about a change in the remit?

The recent proposal in a letter from the Minister of Finance to the Governor to include avoiding unnecessary volatility in house prices as a consideration in the RBNZ's remit shouldn't be a game changer for policy outcomes. Importantly, the Minister of Finance is not suggesting that the RBNZ target house prices. In short, if the RBNZ deems house price volatility as "necessary" to achieve its overarching inflation and employment policy mandates, so be it. Policy deliberations always have regard for house prices through the policy-setting process, due to both their cyclical impacts on the economy, and their potential effects on financial stability. Indeed, macro-prudential and monetary policy have recently been used in conjunction for exactly that reason, with the RBNZ planning to re-impose LVR restrictions in light of increasing financial stability risks.

But there's the economics, and then there's the politics. There's no question that yesterday's public letter makes OCR cuts (even) more political at this juncture. The Minister was keen to emphasise that the RBNZ maintains its operational independence, but when it comes to it, this was a letter attached to a press statement, not a quiet chat. Public deliberations about the shape of the remit in real time are certainly a new development, and could impact the RBNZ's ability to respond to the evolving economic picture and effectively communicate its decisions. It's quite different from the studied, languorous review that eventually led to the previous change in the RBNZ's remit.

Of course, the point of central bank independence is to stop politicians from adding ever more stimulus to juice the economy and thereby their election chances with no thought for the long-term consequences. The implicit suggestion this time is rather that the RBNZ might want to ease up on the gas a bit. But still, it's an uncomfortable precedent. To do its job well the RBNZ needs as much as possible to be kept separate from the political cycle.

That's not to say that monetary policy doesn't have costs, trade-offs, side effects and constraints. It does. That's why each policy decision has to be weighed up carefully to achieve the best outcomes possible, even though they may not be perfect. It's also why good fiscal, regulatory, and prudential policy are so important – to help address the problems monetary policy cannot solve.

It's unclear exactly how things will transpire regarding the remit or indeed if any changes will be made in time. In response to Robertson's letter, RBNZ Governor Orr said, "We will consider your suggestion of how the Monetary Policy Committee (MPC) could further take into account house prices when formulating monetary policy, and will respond with considered feedback in due course."

The RBNZ has copped a lot of the blame of late for spurring the housing market. And there's no question that record-low mortgage rates have given the market a gee-up. But ultimately, we don't think the suggested change in the RBNZ's remit would have implied a different path for policy through the crisis to date. The inflation target is #1, the full-employment mandate is #2, and all other considerations are subordinate.

To the extent that the housing market remains buoyant and this is supportive of the broader economic outlook, the hurdle to further easing will be higher – but that would have been true anyway, with or without the suggested change to the remit. Indeed, in a response from RBNZ Governor Orr, it was acknowledged that "the MPC, in making its decisions, gives consideration to the potential impact of monetary policy on asset prices, including house prices", saying that house prices and asset prices are "important transmission channels that affect employment and inflation". Perhaps a change in the remit would increase the hurdle for further easing slightly, but only at the margin relative to current practice, for example if an OCR change were a line-ball call.

It's more likely in our view that the proposed remit change might lead to tweaks to macro-prudential policy tools or settings to curb riskier loans. The OCR is a very blunt instrument after all. Another approach would be to tweak the Funding for Lending Programme (FLP) to tilt future lending growth away from housing, but the Governor has expressed a reluctance to do so.

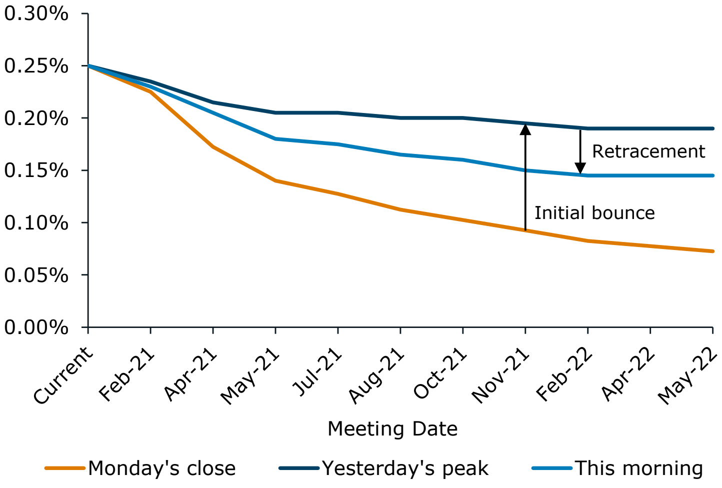
Weighing it all up for markets

The recent stronger data flow, the upward revision to the RBNZ's forecasts and the positive vaccine developments have all seen the market price ever-lower odds of OCR cuts. In that context, it was not surprising that the letter from the Minister gave interest rates and the NZD a further nudge, with the Kiwi "gapping" about half a cent on the news and short-end rates moving about 10bps higher (figure 1).

But it's the nuances that will ultimately determine where the dust settles.

At one level, the implications are simple: a stronger outlook and a higher-than-otherwise OCR outlook means the whole term structure of interest rates needs to adjust higher, and along with it, the NZD. Given the strength of views in the market going into the MPS, and the consolidation seen in recent days, the risk of the market having a real tantrum was high, and things looked like they were heading that way until Orr published his letter in response. But having slept on it overnight, the market has taken a more measured and considered view of the whole episode. We think that's appropriate because it's just not that simple.

Figure 7. OIS before MPS and now



Source: ANZ estimates

We say that because there are other factors to consider, including how the RBNZ decide to respond to the Minister's suggestion. To the extent that the RBNZ concludes it might be expedient to ease less aggressively and take a little longer to lift inflation and employment to target, policy will be easier for longer. All else equal, that is good news for nominal bondholders and bad news for inflation-linked bondholders. And the prospect of policy remaining easier for longer is likely to eventually temper some of the immediate enthusiasm we have seen to sell bonds and buy the NZD.

If the RBNZ rather decide to try to steer stimulus away from housing and towards the rest of the economy (even at the cost of less stimulus in aggregate), that might lead to tweaks in the FLP design and/or tighter macro-prudential policy. At the margin, it could also effectively put some of the burden back on the LSAP in time. That would speak to the NZGB curve flattening from here, especially with RBNZ buying generally targeting the longer end (unlike in the US and Australia).

Basis swap spreads have been on the rise in recent weeks too. That move appears to have been exacerbated yesterday by an assumption that needing to explicitly consider house prices in its remit might see the RBNZ scale back, delay, or alter the FLP, which might in turn put pressure back on banks to source funds offshore. We don't think it's that simple. First, if house prices are the problem and the RBNZ is directed to slow the provision of credit to the housing market (via less monetary easing or tighter macro-prudential policy), then that is likely, on balance, to reduce bank funding needs. And second, if the OCR has less scope to move and the and the LSAP takes up the strain, that will, in turn underscore the growth of deposits in the banking system, further reducing bank demand for funding.

In our view it is at least as likely that the RBNZ simply points out all the ways it already takes the housing market into account in its policy decisions (Governor Orr did exactly that in his initial reply) and the exchange of letters has no practical implications for markets at all. Nonetheless, this episode has all added to the vibe that further OCR cuts are looking less likely, drawing a line under short-term rates. We certainly agree that some upward re-pricing was needed at the short end, and given it primarily reflects the fact that things are going much better for the economy than anyone dared hope a few months ago, we'll raise a Christmas toast to that.

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