ANZ Research

RBNZ Monetary Policy Statement Preview

17 February 2021

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Stay the course

Summary

- With the economic picture considerably brighter than in November, the RBNZ will revise up its forecasts for GDP, employment and inflation. The medium-term outlook is now more assured and this will be clearly acknowledged.
- That said, we expect the RBNZ will signal that removal of policy stimulus remains a long way off. We may see the addition of further forward guidance, stressing that the policy outlook is highly conditional on developments and that OCR hikes remain a long way off, potentially even putting a (highly conditional) date on it (2023 at the earliest).
- We expect the time-frame of the LSAP programme to be extended to the end of 2022, in line with lower bond issuance and policy remaining stimulatory for some time yet. Formalised MPC-directed tapering of bond purchases is expected to be the first step on the path to policy normalisation and may occur late next year.
- Expressing the LSAP programme in terms of the pace of purchases (rather than its $100bn limit) would provide needed clarity to markets, and would assist in communicating eventual tapering. A change in communication could occur as early as next week.
- Markets have moved a long way since November, with a small chance of OCR hikes priced in over the next two years. We could see pricing for future OCR hikes pushed out if the RBNZ chooses to provide more explicit guidance that policy will remain easy for quite some time yet.

Long time between drinks

November feels a long time ago. Since then, the general flow of economic data has been more positive than expected. GDP bounced back more sharply; inflation exceeded expectations with core measures lifting; momentum in the housing market has remained strong; the unemployment rate unexpectedly fell to under 5% in Q4; export prices have remained buoyant; and inflation expectations have improved.

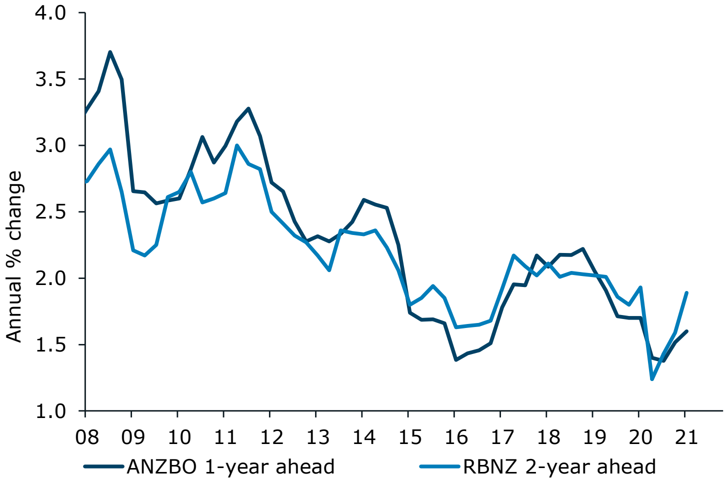
But it’s not all roses and sunshine out there. Services data is bleak and anecdotes from the tourism industry are increasingly, inevitably dreadful. The New Zealand economy is facing a large, negative income shock, and that will become increasingly evident over coming months. The RBNZ will be cautious about these headwinds, along with still-significant downside risks.

However, overall, the fact is that the medium-term inflation outlook, which is where the rubber hits the road for monetary policy settings, is looking much more assured.

For starters, the starting point for inflation is higher, and firms are reporting their highest pricing intentions since the ANZ Business Outlook survey started in 1992, on the back of cost pressures. Some of this is driven by higher costs (which can hurt growth and tends to be temporary), and isn’t the type of inflation central banks typically respond to.

However, inflation expectations, which do concern central banks because they have the potential to become self-fulfilling, have also risen in the ANZ Business Outlook survey and by even more in the RBNZ's preferred 2-year-ahead measure from its own survey (figure 1). This will support the outlook for medium-term inflation.

Figure 1. Inflation expectations

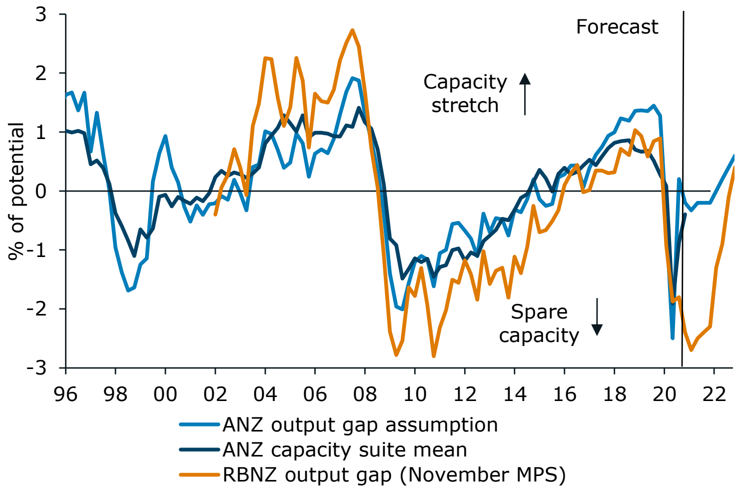


Source: RBNZ, ANZ Research

There is also much less slack in the economy than the RBNZ expected back in November. The picture is of course wildly disparate across sectors, but in aggregate, things are much more stretched than previously anticipated, with demand taking much less of a hit. And part of the issue is also that the economy is grappling with significant supply constraints: labour is less readily available because of the closed border, skills mismatches are a problem, and disruptions to imported goods are widespread. This means any given rate of GDP growth is likely to generate more inflation pressure.

Our suite of indicators for spare capacity in aggregate (the "output gap"), suggests there is only a small amount of slack in the economy. This estimate is highly uncertain, but clearly a lot less negative than the RBNZ thought back in November. This starting point for resource pressures and a better outlook for GDP (reflecting both the starting point and stronger export and house prices), is consistent with a much better outlook for both employment and inflation.

Figure 2. ANZ capacity suite, and ANZ and RBNZ output gap estimates



Source: RBNZ, ANZ Research

One-way traffic

Based on these developments, we expect the RBNZ's updated forecasts will close the gap significantly between their November numbers and our latest (figures 3-4 below). However, the RBNZ is likely to retain a weaker forecast for capacity and inflation than our own view, consistent with some continued conservatism. But we're still looking at a material upwards revision to the RBNZ's unconstrained OCR track.

Figure 3. RBNZ (Nov) and ANZ unemployment forecast

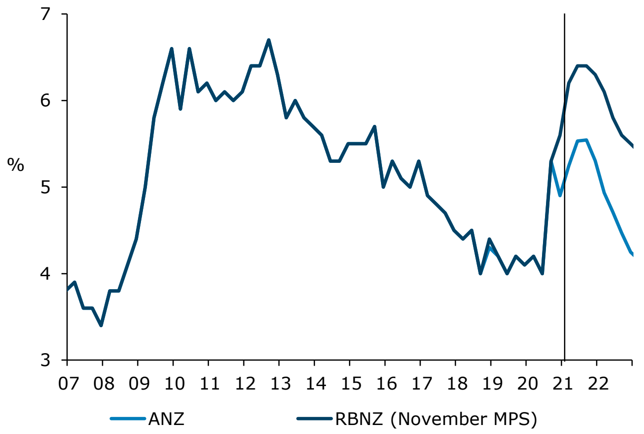
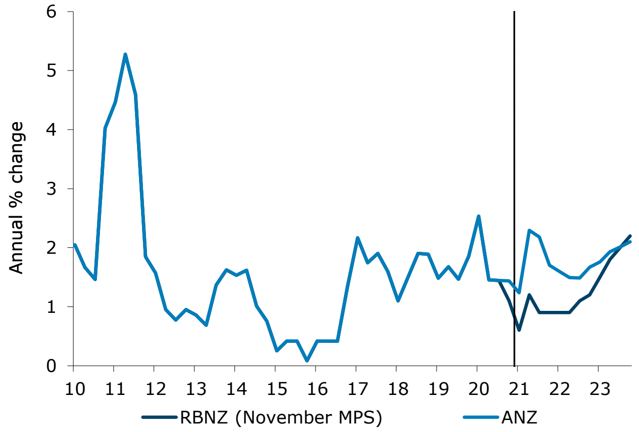


Figure 4. RBNZ (Nov) and ANZ CPI forecast



Source: Statistics NZ, RBNZ, ANZ Research

But caution is warranted

Based on this much-improved outlook, further stimulus is not required, provided that downside risks do not materialise. However, as we outlined in our Insight last week, policy normalisation is expected to be a gradual, multi-year process. The outlook is highly uncertain, but based on our central forecasts, we think that LSAP tapering may be able to commence in late 2022, with OCR hikes in perhaps mid-2023.

Next week the RBNZ will likely stress that:

- Inflation and employment are still away from target and need to be on track, sustainably. Indeed, conditions in the labour market are likely to get worse before they get better.
- Cost push pressures are temporary.
- Economic performance is patchy.
- The tourism income hit is enormous and yet to play out in the broader macroeconomic data.
- The strength seen in retail sales is supported by the housing market but has a significant temporary element – lockdown catch-up, and a one-off repurposing of overseas holiday savings.
- Risks remain tilted to the downside, as this week's community outbreak reminds us, and from this starting point, downside risks remain more problematic than upside ones.

Overall, the RBNZ will acknowledge – and be encouraged by – the better outlook, but will temper that with some caution. Striking the right balance will be a communication challenge. Stoking expectations of policy normalisation could cause an unwelcome further tightening in financial conditions, with global markets in steepening mode and long-end yields under upward pressure. But equally, erring too much on the dovish side may not be seen as credible.

On its own, the RBNZ's updated unconstrained OCR track may create more questions than it answers in this regard. We expect it to be consistent with an on-hold OCR for a long while yet, alongside the continued use of current unconventional tools. However, conveying this outlook via an unconstrained OCR projection (as in recent Monetary Policy Statements) will be challenging without additional forward guidance and clarity regarding the LSAP.

Policy levers

The Large Scale Asset Programme (LSAP)

We expect the overall size of the LSAP programme to remain at $100bn. Reducing the limit on the size of the programme would be confusing, even if less stimulus is ultimately needed. We also expect the time-frame of the LSAP programme to be extended by six months to the end of 2022.

This is mainly technical and is in response to reduced government bond issuance (which in turn limits how many bonds the RBNZ can buy while remaining within its percentage caps – 60% for nominal NZGBs and 30% for linkers). Nonetheless, a longer time-frame does also imply a slower pace of purchases than otherwise, which could technically be interpreted as 'tapering', even though an extension could also be seen as 'dovish'.

Even if the LSAP is extended by six months, the $100bn limit would still allow the RBNZ to purchase bonds at a pace that slightly exceeds the pace of issuance seen this month ($590m/week). Because of the issue of mixed messages, and uncertainty as regards to how the RBNZ came up with the current $590m/week pace, this potentially gives rise to changes in the way the RBNZ frames its LSAP programme.

As possible (deliberate/strategic) tapering draws nearer, we expect the Monetary Policy Committee (MPC) will at some point start expressing the LSAP in terms of the pace of weekly purchases, rather than leaving the market to triangulate that from size and time-frame parameters. This would provide much needed clarity to markets and would help with the eventual policymaker-driven tapering process.

Such a move could happen as early as next week, but we are open-minded about the prospect of that occurring later. Given uncertainties, the RBNZ may prefer to keep the pace of purchases vague. But tapering to date has confused markets, and left them to guess whether it has been driven by an improvement in the outlook, improving market conditions, or simply a reduction in bond issuance (or all three!), and whether it's a technical staff decision or something to draw policy implications from.

As we note in our policy normalisation Insight, we think it would be useful for the LSAP to be framed in pace terms before any more significant tapering occurs, so as to remove any ambiguity from the signal. And if such a move were accompanied by an extension of the time-frame for the LSAP until the end of 2022, that would render the size and time-frame of the programme into the background as factors that would really only be useful from a signalling perspective, and to frame the Crown's indemnity.

Forward guidance

With current RBNZ forward guidance ending soon (recall the RBNZ committed to leave the OCR at 0.25% for at least 12 months when it cut in mid-March 2020), we think the time has come for fresh forward guidance. We expect this to be conditional on progress towards the RBNZ's mandated targets, with an early indication regarding the period over which the RBNZ expects monetary settings will remain where they are.

Given the likely sequencing of normalisation and our expectation that the timeframe for the LSAP will be extended by six months to the end of 2022, we expect the RBNZ will signal that they expect conditions will remain easy with the OCR unchanged until 2023 at the earliest. This is likely to be framed as a typical conditional projection, rather than a commitment. At this point there's little to be gained for the RBNZ by tying its hands in this uncertain environment. If the market were to start aggressively pricing hikes, that could change, but for now, OIS pricing is close to flat.

Although the outlook is looking more assured, the RBNZ will not want to explicitly signal an OCR move for quite some time. And indeed there's no need to, given the time frames. We expect LSAP purchases to be tapered and then cease before the OCR goes higher, and international experience suggests that there will be a gap between LSAP purchases ceasing and the OCR going higher as the RBNZ gauges the impact of that stimulus being reduced. We currently expect that OCR hikes might begin in 2023, but it might be some time before the RBNZ is comfortable with signalling that intention.

Wording along the lines of the following make sense, inspired by the Reserve Bank of Australia's recent communications: "*the Committee expects that monetary policy will need to remain stimulatory for a long time, and will not lift the OCR until inflation and employment are sustainably at or above levels consistent with our remit, and downside risks have abated. The Bank's current projections do not see inflation returning sustainably to the mid-point of the target band and full employment being reached until 2023 at the earliest*".

A willingness to potentially overshoot the target for a time is broadly consistent with the US Federal Reserve's average-inflation targeting strategy and speaks to tightening only once inflation is back above its target (to make up for an extended period of time below target, which has undermined inflation expectations). This is in line with the RBNZ's hitherto "least regrets" approach, and the RBA's recent forward guidance extending to 2024. While the RBNZ will set policy for the New Zealand economy, it is hard to see the RBNZ embarking on OCR hikes well before the Fed or RBA.

Return of the OCR track

While the 12-month forward guidance has been in place, the RBNZ has not published an actual OCR projection. The OCR track is a key part of the RBNZ's projections, and the market does understand that it is a signal subject to change just like the rest of the projections, not a promise.

Recently, the unconstrained OCR track has been produced in its place. This is an analytical measure, capturing the OCR-equivalent amount of stimulus provided (and forecast) based on the range of unconventional tools at the RBNZ's disposal. However, this measure is difficult to understand and does not provide a clear mapping to the expected path of the actual OCR. More clarity will increasingly be needed as forward guidance ends, and reinstatement would help to address some of the communications challenges the RBNZ faces in the time ahead.

We expect the RBNZ to resume publishing an OCR track by May. Although the RBNZ could easily opt not to produce a track before its forward guidance ends, we think including one next week would be helpful. And it'd be flat as a pancake for the entire projection (to Q1 2024) and surprise no one, so why not? We expect any OCR track (be it published in February or later) will remain flat while the economy remains away from the RBNZ's targets and downside risks are still material – probably for the remainder of this year's MPSs at least. But the RBNZ will likely signal at the same time that LSAP tapering will be the first cab off the rank towards policy normalisation, with OCR hikes not contemplated until after that.

Market implications

There will be something for everyone in the MPS, with upwardly revised forecasts but cautious wording.

However, with forward guidance possibly extended and financial conditions already significantly tighter thanks to the higher TWI and steeper yield curve, and widespread expectations of a solid upward revision to the RBNZ's forecasts, it is difficult to envisage a significantly hawkish market reaction.

While there isn't much of a spread between the bellwether 2-year swap (at around 0.37%) and 3-month BKBM (around 0.28%), the market is now pricing in a small risk of hikes over the next two years, and that's technically inconsistent with the tone we expect the RBNZ to adopt, but not significantly so.

It's difficult to envisage markets pricing out hikes (given the psychological tendency to assume that if further cuts aren't necessary, then the next move will be a hike). But we do see scope for pricing of hikes to be pushed out a little, and a mild pull-back at the short end of the yield curve. But overall, we don't think the RBNZ will be aiming for a big market reaction, and all going well, it won't get one.

The long end continues to dance to the global beat and will only be mildly influenced by RBNZ rhetoric. Global bonds are in a bear market at the moment, and we expect New Zealand long-end rates to continue edging higher as US and global yields rise, further steepening the yield curve. With the OCR on hold for now at 0.25%, which is above both the in-market traded rate for cash in Australia (around 0.03%) and the interest rate on excess reserves in the US (0.10%), we expect NZGBs to continue to trade at a positive spread to their Australian and US counterparts. These spreads have already adjusted and we don't see much scope for movement. However, with system cash levels elevated here and abroad, physical assets remain in good demand, and that speaks to swap spreads widening as asset managers hedge against rising yields via swaps (rather than selling bonds) and credit spreads continuing to narrow.

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[1 February 2021]

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