ANZ Research

NZ Insight: Weighing it up – possible OCR paths

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Contact

Liz Kendall or Sharon Zollner for more details.

Weighing it up – possible OCR paths

Bottom line

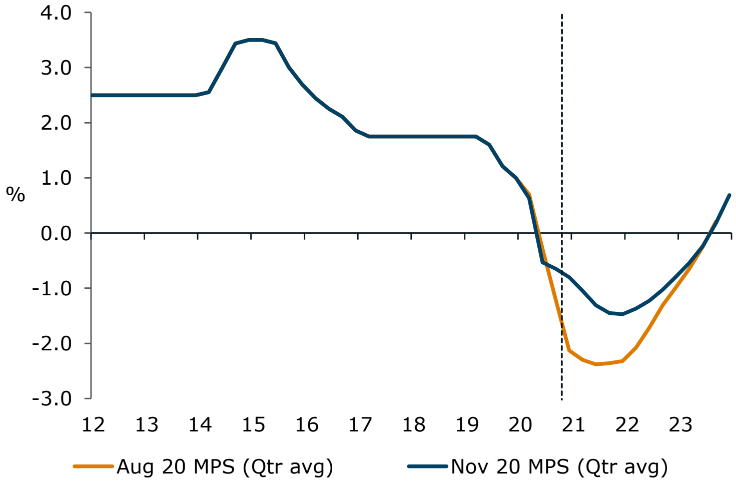
- We now expect a more gradual easing in the OCR to -0.25%, and it is looking less clear-cut that a negative OCR will occur at all.
- The OCR outlook is highly conditional and much more uncertain than it was before. A lot will depend on developments over the next three to six months, and we can see this playing out in a number of possible ways, which we outline in policy scenarios.
- Weighing up all the possibilities, we still think a negative OCR is more likely than not, but there are a number of risks that could change the landscape.

Urgency to cut the OCR has reduced

We have updated our OCR call on the back of recent developments that suggest the case for a negative OCR is no longer so clear-cut. This reflects a better starting point for the economy than feared, risks looking less skewed to the downside, and a strong expectation by the RBNZ that the bank Funding for Lending Programme (FLP) will lower retail rates further.

Overall, we maintain the view that the outlook still looks quite challenging, and that a negative OCR is more likely than not. The RBNZ's view remains consistent with further policy action. They may change their minds of course, but the November MPS contained an unconstrained OCR track that, while higher than previously, suggested the RBNZ believes another 70-80bp of easing is required, and we don't think the current policy mix is going to deliver that (figure 1).

Figure 1. Unconstrained OCR



Source: RBNZ

Note: The unconstrained OCR is the level of stimulus needed to achieve the RBNZ's objectives, achieved through the Bank's suite of alternative policy tools and potentially lowering the OCR further.

Our new forecast is that the OCR will be cut to 0.1% in May, then be lowered to -0.25% in August – the same endpoint as we previously expected, but getting there in a more gradual, wait-and-see fashion. But it's fair to say that the certainty around any specific OCR forecast has reduced, with a much more nuanced picture now than simply pedal-to-the-metal. That's a really good thing, as it reflects the economy doing much better than initially anticipated, but it does make forecasting harder.

Outlook highly conditional

Ultimately, we can see developments playing out in a number of ways. There's an awful lot that can happen between now and when the RBNZ's forward guidance that the OCR will remain unchanged at 0.25% runs out in mid-March (with the RBNZ's first scheduled opportunity to change rates being April).

The unprecedented nature of the current economic shock means that the outlook has been uncertain for a while now! But the economy faces a real test in the months ahead. We will learn how resilient the economy is to the closed border now that direct fiscal support has worn off (including impacts on the labour market); we will get a better sense of how COVID-19 developments, including vaccine news, are tracking; and we will learn more about effectiveness of the Funding for Lending Programme (FLP) and the ever-evolving risk profile (see our ANZ Quarterly Economic Outlook for more).

Our OCR forecast is best seen as a stake in the ground regarding where we see the balance of risks, conditional on a number of assumptions, as opposed to a very strong view regarding exactly what will happen. Essentially, our chosen profile weighs up a number of alternative policy responses, depending on developments.

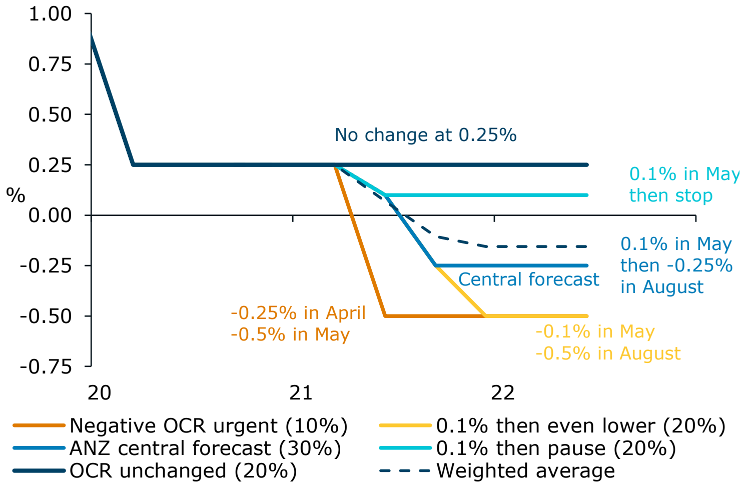
Broadly, as a benchmark, our central OCR forecast assumes the following:

- That the hurdle to cut the OCR negative is greater than for a regular OCR cut, given potential risks;
- That the RBNZ has a general preference for landing the OCR on multiples of 0.25, except for avoiding the software risks associated with 0%;
- COVID-19 remains contained in New Zealand without further lockdowns;
- Progress continues to be made on a vaccine, with borders to reopen by early-2022;
- The FLP is fairly effective, lowering retail lending rates 20-40bps;
- The recovery will become a bit shaky over the summer, reflecting the highly seasonal impacts of the closed border. Economic activity stagnates into 2021;
- Economic data are broadly similar to the somewhat challenging picture conveyed in the November MPS – or perhaps a bit worse;
- This view is cemented by a gradual but not alarming deterioration in the data flow through the first half of next year;
- Downside risks remain a concern for businesses, dampening investment;
- By May, the RBNZ considers that the outlook is fragile and that a little more stimulus would be helpful. We have pencilled in a 15bp drop in the OCR to 0.1% (or somewhere very close to 0% but slightly above);
- By August, the outlook still isn't satisfactory given the RBNZ's targets, and the hurdle to deploy a negative OCR is met, with a 35bp cut to -0.25%; and
- Sufficient improvement in the data sees the RBNZ pause from there.

A number of possibilities

Given everything that's going on in New Zealand and abroad, it's easy to imagine conditions evolving differently to what we have outlined above. Below, we consider what conditions might lead to different outlooks for the OCR, as shown in figure 2.

Figure 2. Possible outlooks for the OCR



Source: RBNZ, ANZ Research

It should also be noted that there are a number of other trajectories for the OCR that are possible beyond those considered here, but we have focused on what we think are the most relevant alternatives to our forecast and some illustrative circumstances that could lead to them (table 1).

Of course, there are a lot of moving parts and factors to weigh up. Should a given set of conditions materialise, that does not guarantee the RBNZ will respond in the way we have outlined, nor that we will necessarily change our forecast to precisely what is shown here. This merely provides a broad outline of our current thinking.

Below we have assigned rough probabilities to each scenario. These are highly subjective, not "right" or "wrong", and they will evolve continuously and may ebb and flow as the news flow unfolds. The current relatively even spread of probabilities is consistent with particularly high uncertainty at the moment, and accordingly, that our current forecast is lower conviction than usual. In our view, it's more useful at times like these to be humble about the art of forecasting than to overstate our confidence in our central view and dismiss all other possibilities. But we freely admit we're not so much sitting on the fence as sitting on a woodpile.

Table 1. Possible OCR profiles and associated illustrative developments

OCR path	Rough probability	Possible set of conditions that could lead to it
Unchanged at 0.25%	20%	COVID-19 remains eliminated, vaccine advancing, risks clearly diminishing Economy remarkably resilient through summer, momentum continues, commodity prices stay robust Housing market remains buoyant Unemployment and inflation better than November MPS forecasts and medium-term outlook looking assured Unconstrained OCR another 50+bp higher than Nov MPS, perhaps reinforced by FLP being very effective at providing stimulus (say 50bps)
0.1% then pause	20%	COVID-19 remains eliminated, vaccine developments look promising, risks appear to be diminishing Economy quite resilient through summer, momentum wavers only a little Unemployment and inflation profile a bit better than Nov MPS, but given some deterioration, a little more stimulus considered helpful insurance in May Unconstrained OCR a bit higher than November and FLP seen as fairly effective (20-40bps)
ANZ central	**30%**	**COVID-19 remains eliminated and vaccine developments look promising, but downside risks remain** **Economy a bit shaky through summer, recovery stagnates into first half 2020** **Unemployment and inflation profile broadly similar to November MPS or perhaps a bit worse, with gradual but not alarming deterioration in the data flow relative to expectations through first half of 2021** **Unconstrained OCR similar to or a bit lower than November MPS and FLP seen as fairly effective (20-40bps)**
0.1% then even lower, eg to -0.5%	20%	COVID-19 remains eliminated and vaccine developments look promising, but downside risks clearly remain Economy shaky through summer, momentum falters, perhaps with further isolated lockdowns contributing Unemployment and inflation profile worse than November MPS and keeps pointing in the wrong direction through H1 2020, with concerns this could continue into H2 Unconstrained OCR quite a bit lower than November MPS, perhaps seen alongside FLP underwhelming (<20bps)
Negative OCR urgent	10%	Downside risks appear to be coming to fruition, such as widespread lockdowns, a significant COVID-19 wave, significant financial market ructions, or a marked housing downturn Economy turns quite sour through summer, or suffers considerably as downside risks materialise By April, unemployment and inflation profile quite clearly much worse than November MPS Unconstrained OCR much lower than November, perhaps seen alongside FLP underwhelming (<20bps)

If the news flow is considerably more positive than we expect – particularly if the economy proves very resilient to closed border impacts through summer and the FLP is very effective – then we could see the OCR go no lower from here. Or, we could see the RBNZ drop the OCR to (say) 0.1% in May then a pause, which turns into a ceasefire. This would be consistent with economic data deteriorating but being better than expected by August, such that the medium-term outlook is looking more assured. In this case, a little more stimulus in May might be considered helpful but the hurdle for a (riskier) negative OCR would not be met. If, on the other hand, the economy falls short of the RBNZ's (and our) expectations and is heading in the wrong direction into the second half of next year, then the OCR could be taken even lower than we currently assume (and/or a little sooner, in May).

Finally, if significant downside risks were to come to fruition, we would see that as signalling a green light for a negative OCR, with a drop of 50bps in April and perhaps even more in time. These are exactly the risks that the RBNZ has been worried about. Its "least regrets" approach would suggest that a substantial downside risk could quite easily tip the balance to a negative OCR being deployed once the RBNZ's forward guidance effectively ends in April. We remain of the view that even if downside risk were to materialise, the RBNZ would stick to its OCR forward guidance and not cut sooner than mid-March (perhaps in an emergency move). But of course, if conditions were bad enough, never say never – the Governor did very deliberately stop short of a promise not to break the forward guidance at the MPS press conference, even when pressed.

What does it mean for markets?

Following the November MPS, market pricing has significantly repriced to now be consistent with much lower odds of a negative OCR being deployed – particularly in February and April, but right across the whole OIS curve. Based on our central view, and the different possibilities above, this move looks overdone to us.

We're possibly around 'peak bulletproof' in terms of the national mood. In time, we think that the data will affirm the challenging outlook ahead, and that the short end will adjust. And at current pricing, the short end is possibly vulnerable to moving sharply lower should bad news come to light. Until then, a reduced threat of a negative OCR gives the NZD the green light to go higher, with the possibility that this then sees a more abrupt move should the RBNZ signal more clearly it is actively considering a lower OCR.

As we enter a period of data-watching over the summer, we expect a shift in the tempo as markets move from trending to debating whether we are at a turning point. That portends of more volatility in outright interest rates and the slope of the curve, which we expect to ebb and flow, steepening on good news and flattening on bad news.

It's true that there is a long time until we will hear from the RBNZ formally in February, and it possibly would have been more convenient for the RBNZ if the market had interpreted the Statement with a more dovish lens. But at the end of the day, developments will dictate where the outlook lands, and the market knows that. And if the RBNZ wants to provide further guidance on how its thinking is evolving, it only takes a few headlines intra-meeting to give the markets that sort of nudge.

Contact us

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Sharon Zollner
Chief Economist

Follow Sharon on Twitter
@sharon_zollner

Telephone: +64 27 664 3554
Email: sharon.zollner@anz.com

General enquiries:
research@anz.com

Follow ANZ Research
@ANZ_Research (global)

David Croy
Senior Strategist

Market developments, interest rates, FX, unconventional monetary policy, liaison with market participants.

Telephone: +64 4 576 1022
Email: david.croy@anz.com

Susan Kilsby
Agricultural Economist

Primary industry developments and outlook, structural change and regulation, liaison with industry.

Telephone: +64 21 633 469
Email: susan.kilsby@anz.com

Liz Kendall
Senior Economist

Research co-ordinator, publication strategy, property market analysis, monetary and prudential policy.

Telephone: +64 27 240 9969
Email: elizabeth.kendall@anz.com

Miles Workman
Senior Economist

Macroeconomic forecast co-ordinator, fiscal policy, economic risk assessment and credit developments.

Telephone: +64 21 661 792
Email: miles.workman@anz.com

Kyle Uerata
Economic Statistician

Economic statistics, ANZ proprietary data (including ANZ Business Outlook), data capability and infrastructure.

Telephone: +64 21 633 894
Email: kyle.uerata@anz.com

Natalie Denne
PA / Desktop Publisher

Business management, general enquiries, mailing lists, publications, chief economist's diary.

Telephone: +64 21 253 6808
Email: natalie.denne@anz.com

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