ANZ Research

RBNZ Monetary Policy Review

23 September 2020

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Contact

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No FLP-flopping

- The RBNZ left the OCR and QE cap unchanged today, as expected, and repeated their forward guidance that the OCR will not change before March.
- The RBNZ reminded markets that a lower OCR and bank funding for lending programme (FLP) are the preferred options for further stimulus, noting that the FLP would be ready "before the end of this year." It will almost certainly be introduced before OCR cuts.
- We continue to expect a 50bp OCR cut in April, with this likely to enter the RBNZ's published forecasts in the November Monetary Policy Statement.

The view

As expected, the RBNZ left the OCR unchanged at 0.25% and the QE program unchanged at a cap of $100bn today.

The RBNZ reiterated again that "The Official Cash Rate (OCR) is being held at 0.25% in accordance with the guidance issued on 16 March." Strictly speaking this isn't a promise to not change its mind, of course, but it's a reminder of their commitment that strongly suggests they do indeed intend to stick to it, as we expected. Further reinforcing the point, the Summary of Meeting also said that "Members noted staff advice that deploying an FLP *before the forward guidance period for holding the OCR ends* could provide additional stimulus to the economy sooner."

In our FAQ on a negative OCR and FLP yesterday we noted that introducing a bank Funding for Lending Programme (FLP) before a negative OCR might well be a strategy the RBNZ could choose to pursue. The RBNZ declared that an FLP "would be ready before the end of this calendar year", and that while complementary, an FLP and a negative OCR "can be deployed independently". Indeed, the Summary of Meeting noted that an FLP before the end of the year was "preferred". This sequencing makes sense, if the two policies are not to be introduced simultaneously. A negative OCR without a FLP could be highly detrimental to credit supply, but introducing a FLP even before the OCR is moved should provide banks with certainty that deposit rates can safely be cut further, paving the way for lower lending rates as well.

The RBNZ has seen little in the data since the August MPS to convince it that it doesn't need to have its foot flat to the floor. "In line with the weak underlying international and domestic economic conditions, the Committee expects a rise in unemployment and an increase in firm closures." The renewed COVID-19 restrictions also warranted a mention, as did the fact that fiscal support has started to roll off. The NZD was mentioned in the context of being a partial offset to New Zealand's "robust" commodity prices.

The RBNZ stopped short of promising a negative OCR, saying rather that they "are prepared to provide additional stimulus". But it's pretty clear which way the wind is blowing. We continue to expect that the RBNZ will cut the OCR 50bp in April to -0.25%, with risks skewed to another cut after a pause to check that things are panning out as hoped.

The RBNZ reiterated that "the outlook for inflation and employment remained subdued." With the impact of the current QE programme set to start to wane next year, and yet a commitment to leave the OCR on hold until March (with mid-April being the first scheduled meeting after that date), the RBNZ will therefore be looking for ways to deliver stimulus quickly.

The RBNZ has been fudging its OCR forecasts since May, cutting off the forecast in March next year at the point that its forward guidance runs out. That sits uncomfortably with a central bank that has historically prided itself on the transparency of its forward guidance via explicit projections of where it expects the cash rate to head, conditional on economic developments. The fudge was necessary because the financial system was not ready for a negative OCR, and the RBNZ itself was still investigating whether it was a good idea to cut the OCR further or not. But we expect the RBNZ will explicitly forecast OCR cuts in its Monetary Policy Statement (MPS) OCR projections in November, or by February at the latest if they still have residual concerns about banks' readiness (or are not yet convinced that the stimulus is necessary). Such a forecast will immediately put short-term interest rates under further pressure, effectively delivering stimulus ahead of time. This would appear to be a priority, based on the comments today about introducing the FLP as soon as possible.

The resilient exchange rate is probably causing some consternation inside the RBNZ but the RBNZ is likely realistic about how much "jaw-boning" (ie public comment complaining about it) can achieve, given New Zealand remains a relative good news story in terms of both how it is dealing with COVID-19 and our commodity prices. The RBNZ did take the opportunity to remind markets that "progress is being made" on the option of purchases of foreign assets, as well as a negative OCR and a FLP.

For now, though, it remains all about quantitative easing (QE). The RBNZ has not been hiding from the fact that it'll be running short of QE ammo by the middle of next year. In the meantime, "the Committee endorsed staff advice to continue front-loading purchases under the LSAP programme, while maintaining flexibility to adjust purchases as market conditions dictate." This suggests that the tactical approach to the LSAP will continue to be aggressive.

Market reaction

There was no question that the RBNZ would leave the OCR unchanged today while sounding 'dovish' about the outlook. The main interest for markets was rather firstly, any change to the forward guidance, and second, any tweaks to the likely implementation of weekly bond purchases associated with the QE program.

As we anticipated, the forward guidance was left unchanged, and indeed, was underscored by comments about the timing of the FLP, meaning the most likely scenario remains an OCR cut in April. Given the market had started to take quite a punt on an OCR cut in February, this is likely to see the very short end under pressure to correct higher in current days.

With regard to the LSAP, we saw a $200m reduction in the pace of purchases scheduled for next week. While that was a reduction, it was a lesser reduction than the $400m reduction in issuance next week. The pace of next week's LSAP purchases of NZGBs is almost twice the rate of issuance, and the delta of next week's QE is almost 2.5x that of issuance ($1114k vs $448k). The fact that the tactical approach to purchases will continue to be aggressive gives scope for more purchases at the longer end of the curve. That in turn speaks to continued vigilance and pressure on the curve to flatten.

The NZD bounced initially on the reiteration of forward guidance. However, the flatter curve implied by the pace of the LSAP being reduced by less than the pace of issuance is likely to weigh on the NZD in coming days, as will the Bank's reiteration that foreign asset purchase remain under consideration.

Text of Statement

Prolonged Monetary Support Necessary

Tēnā koutou katoa, welcome all.

The Monetary Policy Committee agreed to continue with the Large Scale Asset Purchase (LSAP) Programme up to $100 billion. This action is necessary to further lower household and business borrowing rates in order to achieve the Committee's inflation and employment remit. The Official Cash Rate (OCR) is being held at 0.25 percent in accordance with the guidance issued on 16 March.

Reflecting the possible need for further monetary stimulus, the Committee noted the progress being made on the Bank's ability to deploy additional monetary instruments. The instruments include a Funding for Lending Programme (FLP), a negative OCR, and purchases of foreign assets. The Committee agreed that these instruments can be mutually supportive in bolstering economic activity. Members also agreed that the alternative instruments can be deployed independently, and noted that the FLP would be ready before the end of this calendar year.

Economic information available since the August Monetary Policy Statement, both international and domestic, has confirmed the level of economic activity remains significantly below that experienced prior to the COVID-19 economic disruption. The ongoing virus-led activity restrictions – most notably in Auckland – had also continued to dampen economic activity, and business and consumer confidence.

Any significant change in the global and domestic economic outlook remain dependent on the containment of the virus, which is highly uncertain. International border restrictions will continue to significantly curtail migration and tourism, and lead to the activity outlook being uneven across industries and regions. Commodity prices for New Zealand's exports remain robust, but this has been partly offset by the New Zealand dollar exchange rate moderating the return to local export producers.

Ongoing support for domestic economic activity is being provided through significant government spending on business assistance and household income support. This will be accompanied by a rising level of government investment. However, the removal of temporary support policies has commenced. For example, the Wage Subsidy scheme is now closed to new entrants.

In line with the weak underlying international and domestic economic conditions, the Committee expects a rise in unemployment and an increase in firm closures, as resource reallocation continues. Members agreed that monetary policy will need to provide significant economic support for a long time to come to meet the inflation and employment remit, and promote financial stability. They also agreed they are prepared to provide additional stimulus.

Summary record of meeting

The Monetary Policy Committee discussed international and domestic economic and financial market developments. The Committee noted that global economic activity had increased in recent months as social restrictions in some regions had eased, and that the consensus outlook was for a partial recovery in the level of economic activity. Members agreed that the balance of risks to the global economic outlook remained to the downside. The Committee noted that cases of COVID-19 were growing and social restrictions were being reintroduced in some regions of the world, including some areas where the virus had previously appeared to have been reasonably well contained. Members noted that while global monetary and fiscal easing has supported financial and economic conditions, there was a risk that the recent recovery in international activity could stall or reverse if policy stimulus was withdrawn prematurely.

The Committee noted that the August outbreak of COVID-19 in New Zealand appeared to now be contained. Restrictions imposed to contain the virus had constrained economic activity, but were being relaxed. Some members observed that the outbreak had dented confidence, as firms and households are wary of a future outbreak with a subsequent reduction in activity and spending.

The Committee noted the historically unprecedented contraction in economic activity in the June quarter, as measured by the national accounts. The size of the contraction had been smaller than earlier expectations. The Committee noted that some more timely measures of activity had recovered quickly following the easing of restrictions after the initial lockdown, but had dipped again as restrictions were re-introduced, particularly in Auckland. The Committee agreed that the pandemic and associated travel restrictions could have a significant long-term negative impact on the economy, with lower potential growth as resources were gradually redeployed within and between industries. Some members noted that it is also harder to estimate what the maximum sustainable level of employment is under these conditions.

The Committee discussed the recent strength in the housing market. House prices had risen over recent months, in contrast to the Reserve Bank's baseline scenario which had assumed a decline. Some members noted that economic activity in New Zealand has historically been closely correlated with changes in household wealth, and that a stronger housing market may indicate a stronger recovery in consumer spending and residential construction if sustained. However, other members noted that low population growth and rising unemployment are expected to constrain further house price increases.

Members agreed that the outlook for inflation and employment remained subdued. Members discussed the balance of risks, and agreed that they remained to the downside. There is substantial uncertainty about the future spread of COVID-19 both domestically and globally, and how economic, health, and social activity will adapt.

The Committee discussed the effects of monetary policy easing measures taken so far. Members agreed that the reductions in the OCR, forward guidance, and Large Scale Asset Purchase (LSAP) programme had contributed to lower wholesale, household, and business interest rates, and had kept the exchange rate lower than otherwise. Members noted that the expansion and front-loading of the LSAP programme after the August Statement had contributed to lower government bond yields. They also noted that market participants now believed that it was likely the OCR would be reduced below zero next year, and that this had also contributed to lower wholesale interest rates. The Committee expected lenders to continue to pass through these reductions in wholesale rates to household and business borrowing rates over time.

The Committee reaffirmed that a Funding for Lending Programme (FLP), a lower or negative OCR, purchases of foreign assets, and interest rate swaps remain under consideration. The Committee maintained its view as expressed in the August Statement that a package of an FLP and a lower or negative OCR could provide an effective way to deliver additional monetary stimulus.

The Committee discussed the sequencing of deployment of the components of the package. Members noted staff advice that deploying an FLP before the forward guidance period for holding the OCR ends could provide additional stimulus to the economy sooner. Having an FLP in place earlier would provide certainty to financial institutions planning their funding needs, and speed up the transmission of the programme by allowing banks to replace funding as it matures over time.

The Committee agreed that providing term funding at rates near the OCR via an FLP would lower the financial system's funding costs, and therefore borrowing costs for firms and households, and support the availability of credit to the economy. The effectiveness of the programme would be influenced by the degree to which financial institutions passed on their funding cost declines to their customers. Members agreed that they preferred to launch an FLP before the end of 2020.

The Committee noted that the banking system is on track to be operationally prepared for negative interest rates by year end. Members agreed with the previous assessment that a lower OCR would be complementary to its other monetary policy tools, and that it was prepared to lower the OCR to provide additional stimulus if required.

The Committee endorsed staff advice to continue front-loading purchases under the LSAP programme, while maintaining flexibility to adjust purchases as market conditions dictate.

The Committee discussed the appropriate settings for monetary policy. It agreed that further monetary stimulus may be needed in order to achieve its remit objectives. The Committee agreed that a severe and prolonged economic downturn would make it difficult to achieve its inflation and employment objectives, and at the same time would pose a material risk to financial stability. Providing sufficient monetary stimulus would therefore both help achieve the Committee's remit objectives, and promote financial stability.

On Wednesday 23 September, the Committee reached a consensus to:

- hold the OCR at 0.25 percent, in accordance with the guidance issued on 16 March;
- maintain the existing LSAP programme of a maximum of $100b by June 2022; and
- direct the Bank to prepare to have an FLP ready to deploy before the end of this calendar year. Details on the design of the programme would be agreed and published ahead of deployment.

Attendees:

Reserve Bank staff: Adrian Orr, Geoff Bascand, Christian Hawkesby, Yuong Ha

External: Bob Buckle, Peter Harris, Caroline Saunders

Observer: Tim Ng

Secretary: Ross Kendall.

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