ANZ Research

RBNZ Monetary Policy Statement

11 November 2020

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for more details.

Easy does it – OCR cuts slower, less certain

- The RBNZ today retained a dovish tone about the medium-term outlook, while acknowledging and welcoming robust recent data. It "must remain prepared" to provide additional support if necessary.
- There was no change to the OCR, forward guidance, or OCR forecasts. However, the unconstrained OCR track suggested the RBNZ now considers around 100bp less stimulus necessary.
- The Funding for Lending Programme (FLP) will launch in December, with relatively few strings attached, with loans for a three-year duration.
- Despite the RBNZ's ongoing dovish rhetoric, the evolving balance of risks suggests less justification for rushing into a negative OCR. We are now forecasting an RBA-style 15bp cut to 0.10% at the May MPS, with a highly conditional further 35bp cut in August taking the OCR to -0.25%.

The OCR outlook

As universally expected, the OCR was left unchanged today. The forward guidance was repeated verbatim. The OCR forecast remained cut off in Q1 2021, with the RBNZ understandably unwilling to run the risk of appearing to rule further OCR cuts either in or out once its forward guidance runs out in mid-March.

We've tweaked our OCR call, with the RBNZ now expected to take longer to get the OCR to -0.25%. The odds we'll see a negative OCR have fallen – on balance we still see it as more likely than not, but it's no longer a high-conviction call. See page 4 for details.

But first, how is the RBNZ now seeing the world?

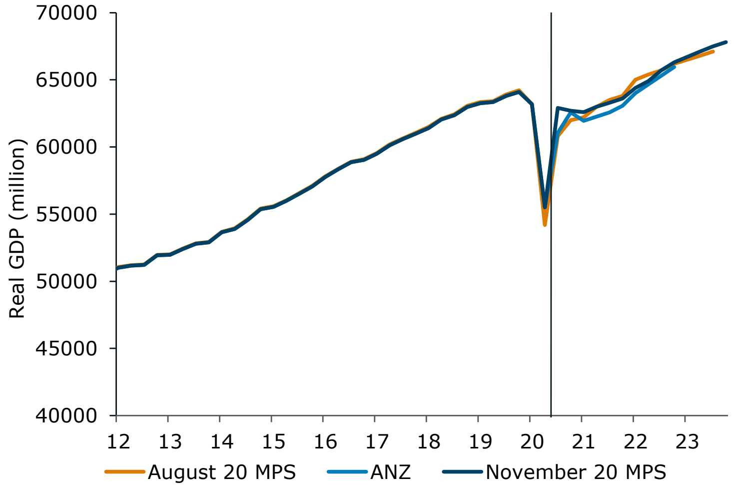
RBNZ forecasts

In the recent data, there has been nothing to suggest a fundamental change to the challenging medium-term outlook for the economy, but there has been a significant run of upward surprises in data compared to the RBNZ's August expectations, including in GDP, unemployment and house prices. There was therefore keen interest in how the RBNZ would build this stronger starting point ("more resilient than earlier assumed") into their forecasts.

The RBNZ's economic outlook incorporates a stronger starting point for housing, GDP and the labour market compared to the August MPS. But that's not true for inflation or growth among New Zealand's key trading partners. Nonetheless, the overall vibe of recent domestic data flow has been undeniably better than expected, but with considerable question marks around the sustainability of this.

Understandably, in the lead-up to today there had been much interest in how the Bank might dovetail the stronger starting point into the medium-term outlook, given that is what really matters for policy settings. And on that front, the Bank continues to see tough times ahead, with very little change to their GDP forecast over the medium term (figure 1). However, less stimulus is now needed to achieve this.

Figure 1. RBNZ GDP forecast August and November MPS



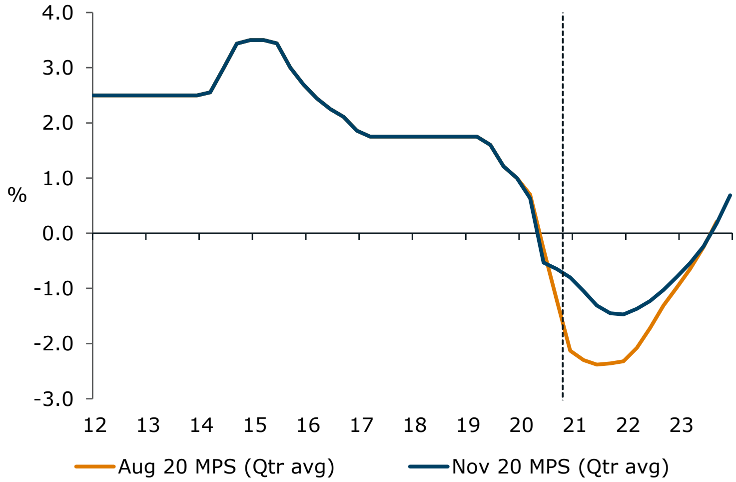
Source: RBNZ, Statistics NZ

In fact, the Bank is forecasting a technical recession from Q4 2020. But frankly the 'recession' label isn't something we are putting much weight on given the fact that it is a growth concept and at the current juncture the level of GDP is arguably more important. That is, it's possible that New Zealand avoids a double-dip recession, but the Q3 rebound is weaker and the overall level of GDP remains lower than what the RBNZ are forecasting without ever entering a technical recession.

The Bank's forecast peak in the unemployment rate is now 6.4% in mid-2021 compared to 8.1% in Q4 2020 at the August MPS. Headline inflation is expected to remain below 2% until Q3 2023 – unchanged from August.

The unconstrained OCR track (imagining there are no practical constraints on ever-lower rates) was significantly higher than in the August MPS, indicating that the RBNZ does now consider that less stimulus is necessary (figure 2). It now troughs at -1.5% rather than -2.4%. Roughly, based on their unconstrained OCR track they "need" 70-80bps more easing, which could be achieved via a combination of FLP impacts and OCR cuts.

Figure 2. RBNZ unconstrained OCR



Source: RBNZ

However, the RBNZ very much downplayed this upward revision in the document, consistent with downplaying their baseline forecasts more generally in light of the considerable uncertainty. But it is consistent with our view that the odds of a negative OCR have fallen considerably.

In the discussion of risks in the Summary Record of Meeting, "Most Committee members agreed that risks to the baseline scenario were less skewed to the downside than they had appeared earlier in the year. Economic outcomes could be stronger than assumed if household or business spending accelerated, for instance due to an earlier partial border reopening, or a higher propensity to consume out of household wealth. The latter could be supported by higher housing and financial asset prices, or improving sentiment about the global health outlook and its management. Members agreed that recent news around vaccine development was promising, but that there were still challenges to overcome before widespread availability could be achieved."

The Funding for Lending Programme

The RBNZ continued to express a strong willingness to provide more stimulus if necessary. All tools are still on the table, but the focus today was on the bank Funding for Lending Programme (FLP).

The key details of the programme are as follows:

- The RBNZ will offer loans to the banks for three-year terms against high-quality collateral from early December.
- The loans will be lent at a floating rate linked to the prevailing OCR.
- The size of the programme was set at up to 4% of each bank's eligible loans and advances.
- A conditional additional allocation will be available providing 50 cents of funding for every $1 increase in the stock of loans up to another 2% of eligible loans.
- We estimate the maximum size of the programme could be $20-30bn.
- Loans will be available for the next 18 months, with the additional allocation available for an extra 6 months after that.

In our view, the programme will be successful in lowering retail interest rates, but this will likely have a larger impact on the housing market than business investment in the near term, given firms are wary of investing until the economic outlook becomes clearer. There were no constraints imposed as regards the type of lending. Over time, as the economy recovers, the lower interest rates will help spur productive investment.

Other unconventional policy options

There's nothing to be gained for the RBNZ by ruling out any policy options at present. Quantitative easing will increasingly take a back seat as the FLP grows in scale and impact, but we expect it to be an enduring element of the market landscape, keeping a lid on bond yields.

Other unconventional policy options, including foreign asset purchases and other broadening of the QE program remain on the table, but with no urgency to consider them as imminent policy choices.

A tweak to our OCR call timing

The odds that the RBNZ will feel the need to take the OCR negative next year have fallen, and that is unambiguously good news. It reflects three things, primarily:

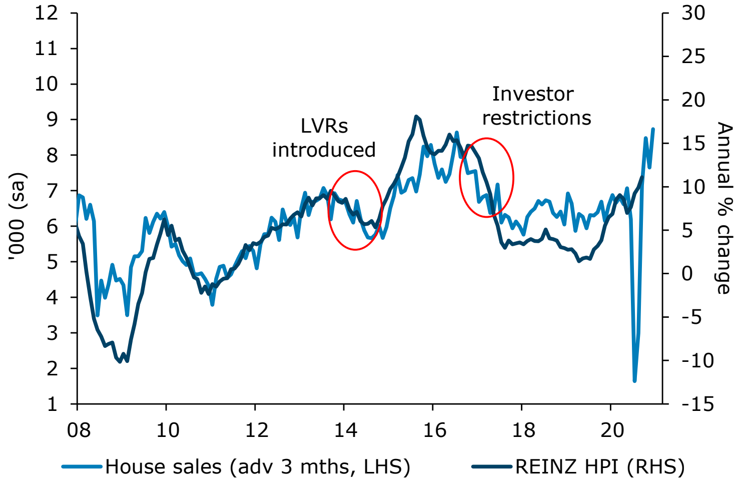
- a much better starting point for the economy than feared;
- a less downwardly skewed balance of risks, including recent positive vaccine developments; and
- the decision to introduce the FLP prior to OCR cuts, and our belief that this will be successful in lowering retail interest rates further.

At this stage, we still think a negative OCR is more likely than not. As the RBNZ stated today, "the COVID-19 shock to the economy is very large and persistent, and inflation and employment will remain below the remit targets for a prolonged period". But in our view it's become a bit of a toss-up. However, one thing that is clear is that the urgency for a negative OCR has reduced. We now expect the OCR to be cut 15bp at the May MPS to 0.10%, followed by a pause for a stock-take that may well turn into a ceasefire. But at this stage we've pencilled in a further 35bp cut to -0.25% in August.

We must stress that the economic outlook is extremely uncertain and this OCR forecast profile could very reasonably be interpreted as the probability-weighted midpoint of plausible upside and downside scenarios:

- The income impacts of the closed border have been deferred by fiscal support and seasonality, but are now rapidly looming.
- The housing market is booming, but the very likely reinstatement of LVR restrictions in March will change the mood abruptly, if history is anything to go by (figure 3).
- Our success against COVID-19 makes us a very desirable place to live and invest, but commodity prices, while resilient so far, remain highly vulnerable to a global slowdown.
- Global fiscal and monetary stimulus is enormous, but global financial markets could abruptly reassess risk with very little to no warning.
- There's been great news on the vaccine front this week, but as the RBNZ said today, "there remains a long and uncertain lag before any widespread vaccine deployment may be achieved".
- A travel bubble with Australia could save tourism jobs, but could also go horribly wrong.

Figure 3. Housing market response to LVR restrictions



Source: REINZ, ANZ Research

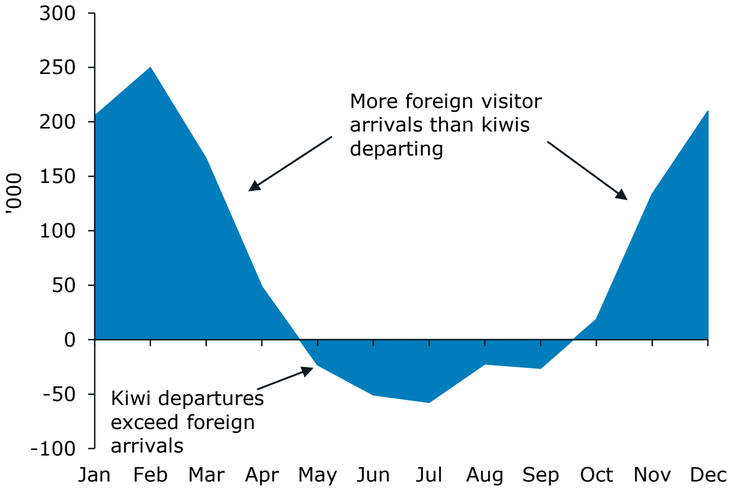
If the upside drivers and risks win out on balance, the OCR is stopping at 0.10%. If things lurch in the other direction, we're very likely going lower than -0.25%.

But as things stand now, the picture is nuanced enough that we believe the RBNZ can afford to wait and see to some extent, and accept taking a little longer to return inflation and employment to target as long as things continue to move in the right direction. If the RBNZ concludes the OCR doesn't need to go negative, that would be a great outcome on all fronts.

Key data we'll be watching to assess the ever-evolving likelihood of negative rates include the fall in retail rates brought about by the FLP, the housing market, sentiment measures, employment, commodity prices, travel bubbles, and vaccine developments. The exchange rate matters too, along with the decisions of other central banks.

Frankly, we'd prefer to join the RBNZ in dodging forecasting the OCR at all for a while. There's an awful lot that can and will happen in the four months until the RBNZ's no-change forward guidance runs out, let alone before August. But a key point is that we suspect we're nearing the peak of the "we dodged a bullet" mentality and data flow. We still expect the economy to stagnate in the first half of next year as firms exposed to tourism start to burn through the cash they accumulated through a good 2019/20 season, the generous wage subsidy, and a winter of stuck-in-the-country Kiwis (figure 4).

Figure 4: The seasonality of tourism (average 2016-19)



Source: Statistics NZ, ANZ Research

Broader momentum is likely to slip as that happens, and the medium-term inflation and employment outlook is still short of target. That's why we're still over the line for predicting that the RBNZ will eventually deliver negative rates (while we're certainly not advocating them). But the August cut into negative territory is best seen as a stake in the ground regarding where we see the balance of risks, as opposed to a very strong view on the most likely exact outcome.

If a negative surprise hits, it’s entirely possible that the RBNZ will be back in foot-to-the-floor mode. But for now, a more nuanced approach is justified. One only has to look at the housing market to see that monetary policy is working – but not without risking trouble down the track. Might be time to ease up on the gas a little.

Prudential policy

The RBNZ is aware of the tension between inflation targeting and financial stability, given the supportive impact of stimulatory monetary policy on the housing market and borrower risk appetite. Prudential policy, rather than monetary policy, is the right tool to respond to financial stability risks that are clearly increasing, as we discussed in our recent ANZ Property Focus.

Consistent with this, the RBNZ announced this morning that they will begin consulting on the reinstatement of LVR restrictions on high-risk lending, with an eye to these coming into effect on 1 March, a couple of months earlier than initially indicated. This should temper some of the heat in the housing market and banks will be encouraged to start to take these new rules into account in advance, but a flurry of activity before implementation is nonetheless possible. Overall, the reinstatement of LVR restrictions should send a strong signal to the market, helping curb recent frothiness, which is also expected to be somewhat dampened by rising income strains as the economic recovery stagnates in the first half of next year.

For the RBNZ, moving to reinstate LVRs has the benefit of mitigating some of the financial stability risks of further monetary stimulus, removing one hurdle to taking the OCR lower. But it does tighten credit conditions. It is not a game changer for our view on the OCR outlook, but at the margin contributes to risks being slightly tilted in favour of a negative OCR in time. To the extent that some wind is taken out of the housing market’s sails, economic activity would be expected to be a bit weaker.

The RBNZ had previously planned to re-evaluate LVR restrictions after a year (in May 2021), but recent developments have necessitated a reconsideration. While this represents a change in stance, it would be a mistake in our view to infer that the RBNZ’s forward guidance on the OCR is therefore less binding. The RBNZ have repeated verbatim on many occasions, including today, that the OCR will remain on hold until at least mid-March. And the urgency for OCR cuts has waned.

The RBNZ has also announced that increases in bank capital requirements have been delayed a further 12 months until 2022, in order to ensure that credit can flow freely to support the recovery. Implemented too soon, these changes could risk stymying agricultural and business lending in particular, restraining the recovery. The RBNZ will have more to say about these prudential announcements in the Financial Stability Review on 25 November.

Market reaction

The NZD was almost unperturbed by the news, dipping briefly on the maintenance of the LSAP programme and overall dovish tone, only to come back on the higher unconstrained OCR. But the reality is that the RBNZ has not changed its persona, and while the threat of a negative OCR and foreign asset purchases will be a perennial niggle for the NZD, global factors will dominate going forward.

In the interest rate space, the reiteration of forward guidance (a commitment to “retain the Official Cash Rate at 0.25 percent in accordance with the guidance issued on 16 March”) will see February OIS converge on 0.25% into maturity. But the remainder of the yield curve has snapped a touch lower, and against the backdrop of the nervous rise in rates seen in recent days, we expect the whole curve to correct lower over coming days. Of particular note, the RBNZ left the LSAP unchanged as we expected, and have scheduled $850m of LSAP purchases next week. That is broadly in line with the long-term implied run rate, and significantly larger in notional and delta terms compared to issuance, which should keep a lid on long-end yields. With global rates rising, this will be reflected in resumption in NZ/US spread compression.

With the FLP offering funds out to 3 years at the OCR, we expect all assets out to 3 years to converge on the OCR – which we now expect to fall to 0.1% in May. And with the LSAP in place and the settlement cash level (SCL) on track to move steadily higher, we expect Bills/OIS spreads to converge on zero.

Policy Assessment

Tēnā koutou katoa, welcome all.

The Monetary Policy Committee agreed to provide additional monetary stimulus to the economy in order to meet its consumer price inflation and employment remit. The Committee agreed that the additional stimulus would be provided through a Funding for Lending Programme (FLP), commencing in December. The FLP will reduce banks' funding costs and lower interest rates.

The Committee will also continue with the Large Scale Asset Purchase (LSAP) Programme up to $100 billion, and retain the Official Cash Rate (OCR) at 0.25 percent in accordance with the guidance issued on 16 March.

Progress has been made on the Bank's operational ability to deploy an FLP and a negative OCR. The Committee agreed that these instruments can be mutually supportive in bolstering economic activity if necessary.

Economic activity since the August Monetary Policy Statement, both international and domestic, has proved more resilient than earlier assumed. In New Zealand this trend was evident across a range of indicators, including employment, household spending, GDP, and asset prices. These outcomes reflect the effectiveness of the health and economic policy responses to the initial shock.

However, the COVID-19 shock to the economy is very large and persistent, and inflation and employment will remain below the remit targets for a prolonged period. These outcomes are despite the current significant fiscal and monetary stimulus.

The outlook for global economic activity remains dependent on the containment of the virus. While recent news on vaccine developments is positive, there remains a long and uncertain lag before any widespread vaccine deployment may be achieved. Meanwhile international border restrictions will continue to curtail international trade and migration, with variable impacts across industries and regions. International prices for New Zealand's exports have remained resilient, although export returns continue to be partly offset by the New Zealand dollar exchange rate.

Domestically, fiscal stimulus remains significant even with the Wage Subsidy scheme having now run its course. Government spending on business assistance and household income support continues, and government investment will rise.

However, we expect an ongoing increase in unemployment as the economy adjusts. Consumer price inflation is also projected to remain at the lower-end of the remit target range for a period, and inflation expectations remain subdued.

The Committee agreed that monetary policy will need to remain stimulatory for a long time to meet the consumer price inflation and employment remit, and that it must remain prepared to provide additional support if necessary.

Meitaki, thanks.

Adrian Orr
Governor

Summary record of meeting

The Monetary Policy Committee discussed international economic and financial market developments. The Committee noted that following a severe contraction, economic activity has subsequently improved. However, these outcomes diverged across countries, depending largely on the degree of social restrictions imposed as a COVID-19 containment measure.

Members noted that economic activity had been surprisingly resilient in some economies, including China. They also noted that the impact on New Zealand of the global economic weakness had been more muted than expected, with commodity and asset prices remaining firm. However, members remained concerned about the downside risks from the persistent spread of the virus in Europe and the United States in particular, which would constrain demand for global exports.

Members discussed domestic economic developments since the August *Statement*. Overall, economic outcomes had been more resilient than earlier assumed. This trend was evident across a range of information, including the labour market, household spending, GDP, asset prices, and goods trade. These outcomes partly reflected the effectiveness of policy responses to the shock.

However, members noted that the severe economic effects of the pandemic were persisting and have significant implications for the Committee in meeting its remit. Both headline and underlying inflation were below 2 percent, inflation expectations were subdued, and employment was assessed to be below its maximum sustainable level.

The Committee discussed the implications of the pandemic and associated steps to contain it for the New Zealand economy. The implications of closed international borders meant service export industries, such as tourism, would operate well below capacity for a prolonged period. Meanwhile, economic activity in other sectors appeared resilient, with labour shortages re-emerging in some cases.

The Committee agreed that the assessed maximum sustainable level of employment may continue to be lower than otherwise while the economy adjusted to the virus shock. Some members noted that resources could take a considerable period to be redeployed, which could result in isolated cost pressures. Others emphasised that underutilised labour from some sectors would put downward pressure on wages and inflation.

Members agreed that there was substantial uncertainty around how the economy would adjust. The Committee agreed that it remained appropriate for fiscal policy to play the primary role in bolstering economic outcomes, given the nature of the economic shock, with monetary policy in an important support role.

Members discussed the outlook for inflation and employment. Staff presented a baseline scenario, conditioned on a number of assumptions, including that there were no further substantial community outbreaks of COVID-19 in New Zealand, and that the international border would be fully open by 2022.

In this scenario, the labour market was projected to weaken further in the near term. It was projected to recover over subsequent years, in particular after the border was assumed to be fully reopened. Inflation was projected to fluctuate around the bottom of the Committee's 1 to 3 percent target range until late in the projection period.

Most Committee members agreed that risks to the baseline scenario were less skewed to the downside than they had appeared earlier in the year. Economic outcomes could be stronger than assumed if household or business spending accelerated, for instance due to an earlier partial border reopening, or a higher propensity to consume out of household wealth. The latter could be supported by higher housing and financial asset prices, or improving sentiment about the global health outlook and its management. Members agreed that recent news around vaccine development was promising, but that there were still challenges to overcome before widespread availability could be achieved.

Members agreed, however, that it was still the case that unpredictable events could push inflation and employment significantly lower than in the baseline scenario. They discussed events such as ongoing virus outbreaks, delays in borders reopening, and continued reluctance to invest by businesses due to general uncertainty.

The Committee discussed the effects of its recent monetary policy actions. Members noted that wholesale interest rates had eased following the August *Statement*. This reflected the expansion and front-loading of the Large Scale Asset Purchase (LSAP) programme, and expectations from market participants that the OCR could be reduced below zero next year. Bank term deposit rates had also fallen substantially in recent months. In particular, these falls had followed the Committee's guidance to Bank staff issued in September to prepare a Funding for Lending Programme (FLP) to be ready to deploy before the end of the year.

However, members noted that bank lending rates were largely unchanged since August despite the reduction in funding costs. They discussed the importance of banks passing on funding cost reductions to their lending rates in order for monetary policy to transmit effectively. Members noted that the Reserve Bank had announced a further 12-month delay to the start date of increased capital requirements for banks following the capital review, to July 2022, which would assist them in maintaining lending growth.

The Committee agreed that a prolonged economic downturn would make it difficult to achieve its inflation and employment objectives. Some members noted that while the decline in inflation expectations this year was not surprising given the scale of the shock, it would be concerning if expectations fell further or remained low for a prolonged period. The Committee agreed that it was important to anchor inflation expectations around the mid-point of the target range over the medium term.

Members agreed that, under current circumstances, the appropriate stance to achieve its remit objectives would be to provide further monetary stimulus. They also agreed that providing sufficient monetary stimulus would also promote financial stability, through improved employment and household income prospects. The Committee agreed that, given the current inflation and employment conditions, and the ongoing significant uncertainty with regard to the outlook, there was less regret associated with the risk of temporarily overshooting their policy remit.

The Committee noted that other prudential policy settings could be adjusted to reduce risks to the financial system if required. Members noted that the Reserve Bank will consult on the possible reintroduction of limits on high loan-to-value ratio lending, in order to slow the build-up of riskier lending on bank balance sheets.

The Committee reaffirmed that an FLP, a lower or negative OCR, purchases of foreign assets, and interest rate swaps remain under consideration.

The Committee noted that staff were prepared to implement an FLP from early December. The FLP was expected to work primarily by lowering system-wide funding costs, benefiting all financial institutions, not just those that drew on FLP funds. Lower funding costs would enable financial institutions to lower borrowing costs for firms and households.

Members noted that the effectiveness of an FLP would depend on financial institutions passing on declines in their funding costs to borrowers, and agreed to monitor pass-through to lending rates closely. Members agreed with the staff assessment that an FLP would be an effective way to provide additional monetary stimulus, and that it was the best tool to deploy at this time given the Committee's principles for alternative monetary policy instruments. They also noted that evaluations of similar programmes deployed overseas had shown that they were effective.

Members discussed the design of the FLP. They endorsed staff advice that the programme should be of sufficient size to allow financial institutions to reduce interest rates with confidence that a low cost, stable funding source was available.

Members noted that the FLP was likely to be drawn down gradually given banks' current funding needs, and that the success of the programme would be measured by the fall in household and business borrowing rates, rather than the level of drawdown.

The Committee agreed that including an incentive to expand lending would help to ensure adequate supply of credit to support the economic recovery, but that targeting the incentives to specific sectors would reduce the programme's effectiveness. The Committee noted that overseas initiatives to target sectors of the economy had been designed to overcome specific issues in those countries. The Committee agreed targeting credit to specific sectors was the role of the banking sector or government initiatives.

Members noted that the banking system is on track to be operationally ready for negative interest rates by year end. The Committee agreed that it was prepared to lower the OCR to provide additional stimulus if required. The Committee noted staff advice that bond purchases under the LSAP programme had been effective at keeping yields low, and endorsed their recommendation to continue adjusting purchases as market conditions dictate. On Wednesday 11 November, 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 implement an FLP in early December 2020.

Attendees

Reserve Bank members of MPC: Adrian Orr, Geoff Bascand, Christian Hawkesby, Yuong Ha

External MPC members: Bob Buckle, Peter Harris, Caroline Saunders

Treasury Observer: Tim Ng

MPC Secretary: Ross Kendall

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