ANZ Research

RBNZ MPS Preview

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RBNZ to focus on the FLP in the November MPS

Summary

The focus of next week's Monetary Policy Statement will be the upcoming Funding for Lending (FLP) programme, including design details and deployment date. We expect the programme to have relatively few strings attached in order to facilitate take-up, and to be priced at or near the OCR. Our best guess is that the programme might be $30-50bn in size. We do not expect any changes to the OCR or the LSAP (QE) programme.

The market will also be looking for further comments on the likelihood of a negative OCR and to see if the OCR forecast track is extended beyond the end of existing forward guidance (ie Q1 2021). We expect the RBNZ to continue to dodge extending the forecasts until the February MPS, as it is very likely to be misconstrued as either a firm commitment to, or a ruling out of, a negative OCR. We expect the RBNZ to reaffirm its forward guidance that the OCR will not be lowered before mid-March.

As regards to the economic forecasts and the tone of the document, there were strong hints in the Governor's recent public comments that they will not be putting a great deal of weight on the more positive recent data flow, but rather remain firmly focused on the medium-term and the sub-par outlook for both inflation and employment.

However, one forecast they will definitely have to revise up is house prices. The subject of macroprudential mortgage restrictions is likely to come up in the press conference. We expect the Governor will reiterate comments made at the INFINZ conference, of watching and waiting.

In our view, the odds of a negative OCR have reduced, and the implementation of the FLP could see a negative OCR implemented later or more gradually. Nonetheless, on balance we still think that a negative OCR is more likely than not, given the balance of risks.

Key points for the market

We expect a verbatim reiteration of earlier forward guidance that the OCR will be "held at 0.25 percent in accordance with the guidance issued on 16 March". This could see a lurch in February OIS pricing. But we expect the overall tone of the MPS to remain very dovish, despite the stronger data flow in recent months, with a continued "least regrets" approach, meaning the market is unlikely to back away from the cuts that are already priced in.

The market will be keenly interested in the size of the LSAP program. We do not expect a change, with the focus rather on the FLP. Our central scenario is that the LSAP remains at $100m through until 30 June 2022. If there is a tweak, the risks are tilted towards a larger programme with an extended end date.

Finally, the market will be interested in any comments about the possibility of foreign asset purchases. We do not expect such purchases to ever actually happen, but there's no advantage to the RBNZ in ruling it out.

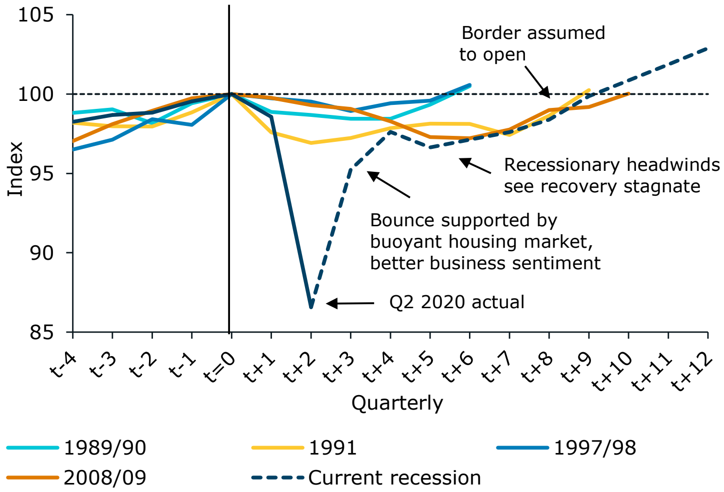
Dovish "least regrets" policy approach to remain

The rebound in the data since lockdown has been impressive. We've had a sharp rebound– not a complete recovery in level terms by any means, but it has been impressive enough that it presents a communications problem for the RBNZ, with its dovish medium-term focus somewhat out of kilter with the vibe on the street, or at least the vibe at the open home down the street.

At the INFINZ conference, Governor Orr indicated that he will be looking through the near-term positive data because it is distorted by both measurement difficulties and the policy response (in particular the wage subsidy, but also the beefed-up Income Relief Payment, the mortgage payment deferment scheme, and even the suspension of LVR restrictions). He indicated that the RBNZ will remain focused firmly on the medium term, where the recovery is expected to be sluggish and fail to deliver inflation and employment consistent with the RBNZ's mandates.

Our medium-term outlook is also weak, with output below pre-COVID levels for a couple of years, and the cumulative output loss one for the history books (figure 1).

Figure 1. GDP forecasts



Source: Statistics NZ, ANZ Research

But uncertainty remains huge. A successful trans-Tasman bubble could make a meaningful difference to job losses in the tourism sector. At the other end of the risk scale, global financial markets are still in denial about the impacts of the pandemic, which are escalating rather than petering out, and a range of other risks out there. That could change abruptly and affect the mood here too. There also remains enormous uncertainty about the timing, effectiveness and availability of a COVID-19 vaccine.

But the RBNZ still has to put a stake in the ground in terms of its forecasts, even though, like us, they'd probably prefer to be in possession of a few months' worth of post-wage subsidy data to have a better idea of the true lay of the land. Looking at their August forecasts, there are some obvious implications for the starting point at least.

- **The housing market.** In August, the RBNZ forecast house price falls to max out at an 8.9% fall in Q1 next year. We're not pointing fingers here – we all got this one wrong. But the RBNZ's forecasts matter more than ours do, and they'll be revising that number up significantly. The RBNZ models will build in a positive impact from that on household consumption.

- **Employment.** Data released today for Q3 showed the unemployment rate at 5.3%, versus an RBNZ August forecast of 7%. The labour market is being cushioned by wage subsidy supports, but has been more resilient than expected over recent months. That said, the fact remains that the sectors most affected by the closed border – tourism, hospitality and retail – punch above their weight in terms of jobs.
- **Business sentiment indicators.** The RBNZ doesn't forecast these, of course, but they are likely to have been as surprised as anyone else at the robustness of firms' plans for the immediate future.
- On the other hand, **inflation** was weaker than expected**.** The RBNZ was expecting 1.1% quarterly inflation in Q3; it came out at just 0.7%. There's some noise in the data, but it's not helpful.

Although the RBNZ's forecasts are likely to feature a more positive starting point on balance, they will still conclude that the balance of risks means an aggressive approach to monetary policy still makes sense in terms of achieving its mandates. Even in a best-case scenario, inflation and unemployment look set to be away from the RBNZ's targets for an extended period.

That said, a time for a more nuanced approach to policy is approaching. One can certainly argue about the costs and benefits of more monetary stimulus, given the cumulative effects of prolonged super-low interest rates, risks associated with unconventional policies, and the damage a boom-bust housing cycle would engender. But for now, the Reserve Bank has concluded that the path of least regret is to err towards doing more. The chances of a growth and CPI inflation overshoot certainly look remote in the near term.

At the same time, the chances of a house price overshoot are looking bigger by the day. That's leading to financial stability concerns, which may necessitate a response with macro-prudential policy. While we don't expect the RBNZ to pull the trigger just yet, LVR restrictions will soon be making a comeback if nothing comes along to spoil the housing party fairly promptly.

Weighing it all up, we expect that very dovish sentiment will continue to colour the forecasts, policy assessment and communication at the November MPS. But the RBNZ will need to take the time to clearly explain to the pubic why the stronger domestic data, and in particular the booming housing market, haven't changed their minds about needing to have the foot flat to the floor. But the communications challenge is that it will sound an awful lot like talking the economy down, while at the same time, of course, the RBNZ is attempting to boost confidence, real activity and investment through its policy actions.

Focus firmly on the Funding for Lending Programme

The Reserve Bank will want the attention in and about the November MPS to be firmly on the Funding for Lending Programme. We expect details to be announced on:

- **Timing** – we expect the programme to be introduced as soon as practicable. Banks will not need to take it up immediately. Indeed, as we have spoken about before, we may see a slow start.
- **Scale** – the RBNZ may not want to be specific and it may be defined in relative terms, but the implied size could be as large as $50bn.
- **Criteria** – the RBNZ will want to maximise effectiveness in terms of reducing retail lending rates. We therefore expect relatively few strings to be attached in terms of where the associated lending should be directed in order to encourage take up.

- **Pricing** – the OCR is a logical benchmark here. At 0.25% it compares favourably with a 2-year term deposit rate of 0.90% or 3-4 year domestic bond funding at perhaps 0.35% to 0.45%.

Given that the FLP and the LSAP are to some extent substitutes, we do not expect the RBNZ to further increase the cap for the LSAP scheme. It will continue to tick over in the background but will gradually concede the spotlight to the FLP. We expect the FLP will be successful in driving retail interest rates lower, but this will primarily fuel the housing market more than it will business investment, at least initially, given the stage of the business cycle we are at.

The FLP is the focus of the MPS, and we think the RBNZ will be keen to avoid the prospect of a negative OCR stealing all the headlines, though they will certainly choose words that keep their options open. The RBNZ has a long, proud history of publishing an endogenous OCR track to show what their current thinking is about the degree of monetary stimulus required. It's not a promise or a commitment, and this has always been understood by both the market and media commentators. Indeed it was often "wrong" – like everybody's macroeconomic forecasts – but this was never seen as reneging on a promise.

At the moment, though, there is a heightened risk that a standard OCR forecast track could be mistaken for true "forward guidance" in terms of representing a commitment. We don't believe the RBNZ is ready to commit to a negative OCR, nor ready to rule it out. So a continuation of the awkward fudge of simply stopping the OCR forecast in Q1 2021 (when the 12-month forward guidance runs out) seems likely. It's the safest approach. Better to be slightly less "transparent" than to shut down your optionality when the world is so uncertain.

Where to next?

If our broad macroeconomic view is correct, then the period of data surprising expectations on the upside has probably nearly run its course. Momentum has been artificially sustained by a massive fiscal injection and other temporary measures. The winding up of those schemes, plus the extreme seasonality of tourism, means it is far too soon to conclude we've dodged a bullet.

COVID-19 is exploding in many parts of the world. New Zealand's two biggest trading partners, China and Australia, are doing much better than most, fortunately. But this thing has a long way to play out yet, and the RBNZ will be at pains to point that out.

In our view, the odds of a negative OCR have dropped to around 60%, as a result of the better economic starting point, the momentum in the housing market, and what we expect will be a successful FLP programme (with success measured in terms of the fall in retail lending rates). And with the FLP giving the RBNZ the scope to wait and see, a negative OCR could be implemented later or more gradually that otherwise.

Nonetheless, given downside risks from here outweigh upside ones, going further down the unconventional rabbit hole remains odds on. We continue to expect the OCR will be dropped 50bps to -0.25% in April.

What’s in it for the market?

The focus for markets will be four-fold.

The first will be **forward guidance**. As noted, we expect the RBNZ to maintain long-standing forward guidance, likely reiterating verbatim wording used since May affirming its intention to keep the OCR “held at 0.25 percent in accordance with the guidance issued on 16 March”. If they do, that has very negative implications for short-dated OIS contracts, including February. However, provided the remainder of the document is dovish, reflecting the Bank’s long-standing **“least regrets” approach** – which is the second thing markets will be focussing on – then we are unlikely to see the market back away from the cuts that are already priced in, especially if the Committee maintain their preference for lower or negative rates, and confirms that domestic banks are operationally ready for negative rates. As noted, we don’t expect the RBNZ to publish an OCR projection, but any commentary reinforcing prospects for negative rates will keep rates out to around 3 years in check, and at the margin, weigh on the NZD.

The third thing the market will focus on is **the size of the LSAP programme**. As noted, we don’t expect an increase and instead we expect any incremental easing this month to come via the FLP. But this should be seen in the context of the FLP coming into the monetary toolkit to complement, rather than supplant the LSAP. Our central scenario is that the LSAP remains at $100m through till 30 June 2022, implying a sustained run-rate (assuming coupons and principal are repaid) of around $830m per week. At that rate, even if we see the pace of purchases slow (to say, $750m per week) to preserve some firepower for tactical deployment later, it will still be well above the pace of issuance, which is likely to remain at around $625m/week, as the November NZGB tender schedule calls for.

Alongside the prospect of tactical purchases, that should keep the yield curve low and flat. QE still has plenty of firepower and for now the market is probably safe assuming that QE will continue to exceed issuance for the foreseeable future. In terms of the risks around this, again they remain skewed towards the dovish end of the spectrum, and if there is a tweak, we’d expect a larger programme with an extended end-date.

The final thing the market will be focussed on is **the prospect of foreign asset purchases**. We don’t ever expect this to actually happen, but it has been under consideration since May and we doubt the RBNZ will want to rule out going down this road just yet. The small size of the NZGB market has always been a limiting factor for QE, and the exchange rate matters for New Zealand more than it does elsewhere. Keeping this option on the table will not only underscore the Bank’s erstwhile commitment to do what it takes, but it will get noticed by FX markets.

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