RBNZ OCR Preview

17 June 2020

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In the 0.25 master's store

- Next Wednesday the RBNZ will acknowledge the positive surprise that NZ exited Level 2 lockdown much faster than they had assumed, but will be at pains to point out that beyond that, the outlook remains extremely challenging.
- We expect the RBNZ will emphasise that they stand ready to act further if required, mirroring the Fed's tone. We expect the RBNZ LSAP program to be further expanded to a cap of $90bn by August, but there is no need to act now.
- The RBNZ would likely prefer the currency to be lower. But with New Zealand a relative 'good news story' and risk appetite still elevated, any jaw-boning is unlikely to have a lasting impact.

Key points

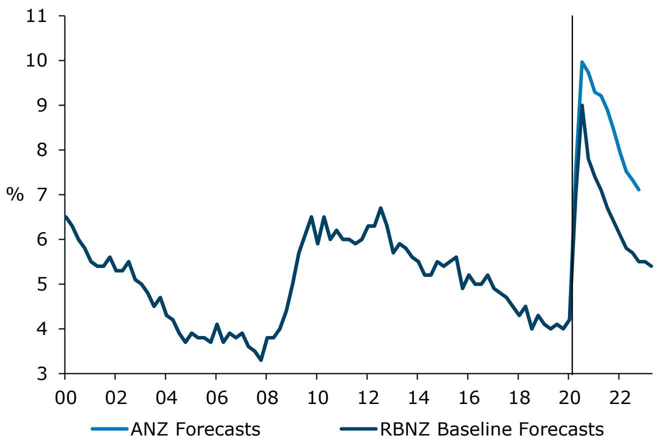
We expect the RBNZ to leave the OCR unchanged at 0.25% next Wednesday. Much of what the RBNZ has to say next week will be familiar. We expect a reiteration of several points from the May Policy Assessment:

- the global economic disruption will be enormous and long-lasting;
- fiscal policy is the main game in town;
- the OCR will remain low for the foreseeable future;
- retail interest rates are expected to decline further.

The 'new' news since the MPS is that New Zealand has emerged from Level 2 lockdown considerably more quickly than the RBNZ's conservative assumptions. The May baseline scenario assumed Alert Level 2 would be in place for 10 months, but it turned out to be just one. Around 5% more economic activity is permissible under Level 1, so it is material. Activity is bouncing back vigorously, and the RBNZ is likely to acknowledge and welcome this.

At the same time, however, they will be at pains to point out that a quicker bounce out of disruption is not the same thing as dodging a recession. There is no getting around the fact that New Zealand with a closed border is a smaller economy. Once spill-overs into other sectors are taken into account, international tourism is as much as 5% of the economy – and an even larger proportion of employment. The Reserve Bank now has a mandate to take labour market conditions explicitly into account as well, and it's going to be ugly.

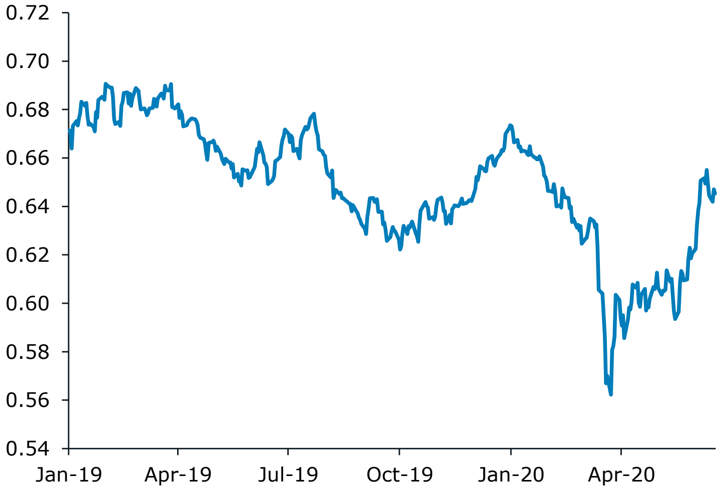
Figure 1. Unemployment forecast: RBNZ May MPS baseline, ANZ



Source: Statistics NZ, RBNZ, ANZ Research

The RBNZ will therefore attempt to strike a balance between an encouraging tone while still sounding suitably dovish in order to avoid giving the NZD any more encouragement. The renewed strength in the NZD represents a meaningful tightening in monetary conditions that will be decidedly unwelcome (figure 2).

Figure 2. NZD/USD



Source: Bloomberg

Unwelcome it may be, but it's hardly inexplicable. While the NZD typically – and helpfully – tanks when global growth hits the skids, this time is different:

- Global risk appetite has received an adrenaline shot from unprecedented monetary and fiscal stimulus.
- New Zealand is a relative good news story, having eliminated COVID-19.
- Prices for our export commodities are sliding, but more gently than might have been expected, given the size of the global demand shock.

As long as these drivers remain in place, it's going to be challenging to jawbone the currency lower. But we expect to see reminders that monetary policy still has plenty up its sleeve if required, potentially including negative rates. We are not forecasting that the RBNZ will take the OCR negative as it would be a very risky strategy. However, it is certainly in the Reserve Bank's interests to have the option firmly on the table, and remind everyone that it is there (or at least soon will be). Even just the threat of it is helping keep a lid on short-term wholesale and retail interest rates.

And it is not an idle threat. All kinds of taboos are being broken in global monetary policy circles, with the previously unconventional becoming conventional, and the line between monetary and fiscal policy, and indeed between the public and private sectors, becoming ever blurrier. Nothing can be ruled out.

For now, though, 'conventional' quantitative easing is where it's at. By the end of this week, the RBNZ will have bought $17.3bn (face value) of bonds, most of which has been NZ government bonds, helping drive the NZGB curve lower and flatter. We expect the RBNZ LSAP program to be further expanded to a cap of $90bn by August, but there is no need to act immediately. Recent data has generally been better than expected and aside from the exchange rate, domestic financial conditions (stock prices, capital raisings and credit spreads) have eased, fuelled by improved risk appetite. But that may not last and we believe by August the extent of the downturn will be more evident, necessitating further action, especially if the TWI remains elevated.

We expect the RBNZ will acknowledge the recent fall in retail deposit and lending rates and reiterate that they think this move has further to run. While there is a flurry of pent-up housing activity in response to both the end of lockdown and the easing of the LVR restrictions, a painfully high unemployment rate and much lower net migration mean the risk of a runaway housing market is roughly zero.

Strategy

The challenge for the RBNZ will be in sounding encouraging, but not hawkish, for fear of driving the NZD higher and steepening yield curves. Reiterating earlier forward guidance and going with a "we got this" vibe is probably the best approach, outlining that New Zealand has done well to contain the virus, QE is working well, but there is more they can do if required.

Like the Fed, the RBNZ is miles away from its mandated targets of 2% inflation and full employment, and the market knows it. This means that policy will remain easy for a very long time, which will in turn keep the curve low and flat. Although there is plenty of headroom in the $60bn QE programme as it stands, part of the reason why we see the need for it to be increased to $90bn is to signal in a crystal clear way that the Bank is ready and willing to do more, and that its resolve is unquestionable.

The market is not pricing in much easing in the OCR over the remainder of this year, but it is pricing roughly 75% odds of a cut by next May, which has been driven by the RBNZ openly talking about the prospect of negative rates. Reiterating that negative rates are an option still on the table will help cap the NZD, keep the OIS curve downward-sloping, and help stabilise yields out to 2-3 years.

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