ANZ Research

NZ Insight: The path to normal

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The path to normal

Summary

Markets don't tread water for long. If the RBNZ is done cutting – and it appears to be – the market has naturally started to ask the question: when will monetary policy tightening begin?

- We expect the hitherto impressive economic recovery to stagnate somewhat this year as the real income hit bites; it's nowhere near as simple as onward and upward.
- The outlook is highly uncertain, depending on how a myriad of macroeconomic demand and supply factors evolve, and it is too soon to come to a firm view on exactly what policy normalisation will look like – and when.
- History tells us that it is equally likely that the RBNZ will be too late to the hiking party as it is that they move too soon. But we expect that the RBNZ will maintain a cautious and gradual approach to removing stimulus in line with their recent "least regrets" approach.
- Before embarking on normalisation, we expect the RBNZ will want to see employment, inflation and inflation expectations all at or close to target, and perceive that risks to the outlook are balanced.
- We see LSAP tapering as the first cab off the rank for policy normalisation, with a conscious reduction in the pace of purchases then eventual cessation. The timetable for tapering is partly dependent on how issuance evolves, and not just dependent on how the economy evolves (although the two are linked). With the pace of bond issuance slowing, tapering has already begun, and with the risks to issuance going forward lower still, we are likely to see more tapering over coming quarters.
- We think the pace of asset purchases needs to be a clear decision from the Monetary Policy Committee (MPC), rather than a tactical adjustment based on bond issuance at staff discretion (which is what is occurring right now).
- To make communication clearer, we think it makes sense to shift emphasis from the size of the overall LSAP programme ($100bn, which is a cap rather than a goal), to focusing on the pace of purchases. This can be used to signal tapering intentions.
- Eventually, the RBNZ will look to reduce the amount of overall asset holdings by letting bond mature and not fully (or partially) re-investing the proceeds. This is likely to be a very gradual process.
- Based on our current economic forecasts, criteria to start tapering the pace of purchases might be met such that reduction and eventual cessation of purchases can occur over the second half of 2022, as the first part of the normalisation process. However, the timing of this will depend on how developments unfold. This is consistent with our expectation that the timeframe of the programme will be extended to the end of 2022 at the February MPS.

- The RBNZ could theoretically embark on OCR hikes during any phase of the LSAP tapering process, but this will most likely will occur after purchases have ended. Based on our current economic forecasts, the OCR might start to be gradually lifted in mid-2023, with risks currently skewed to earlier.
- We expect the RBNZ will let the FLP reach its planned end from the middle of 2022. This will provide a liquidity backstop but is expected to largely operate in the background and then naturally come to an end, rather than being a key moving part in the tapering process.
- Overall, policy normalisation is expected to be a gradual, multi-year process in which the RBNZ will feel their way as they go. A faster-than-expected return to inflation and employment targets would of course be welcome but would bring its own headaches, particularly for the bond market. It's a lot easier to get into unconventional monetary policy than out of it.

The following sections can be accessed via clickable links:

1. Policy normalisation – lessons from history

Monetary policy is a tricky business. When planning the way forward the RBNZ will look to history – while acknowledging that this has been a recession like no other, and that history may therefore lead us astray!

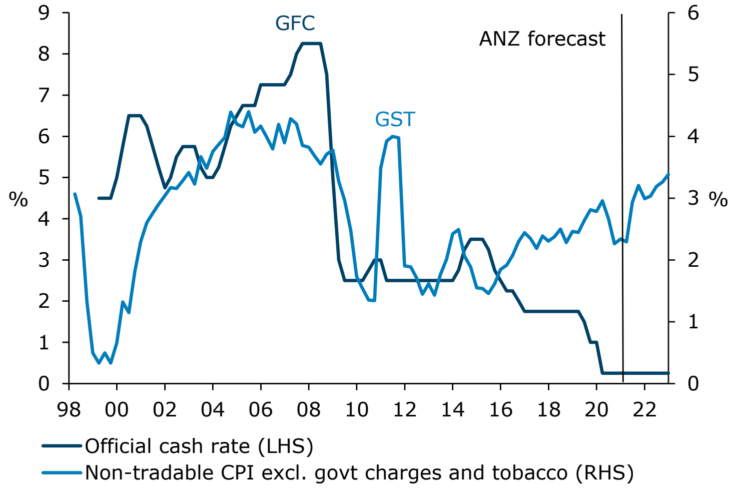
Figure 1 shows the short history of the Official Cash Rate (OCR) since it was introduced in March 1999. As a general rule, the OCR tends to go up slowly and down fast.

The OCR was steadily hiked over the frothy, credit-fuelled years of 2004-2007 before the Global Financial Crisis changed the picture abruptly, leading to almost 600bp of cuts in short order. The OCR hung around its low point for only a relatively short while, before the RBNZ concluded it was time to start normalising. It quickly became clear that it was too soon – the economy stagnated in 2010 and the OCR was rapidly restored to 2.5%.

It was three years before the RBNZ tried again, but it managed only 100bp of tightening before, again, having to unwind it – and more – with inflation expectations having slipped such that the OCR had to be cut by considerably more than it had been hiked.

There it stayed, as CPI inflation remained stubbornly low, before weakening growth in 2019 saw two cuts taking it to 1.00%. Then COVID-19 struck, and one day shy of its twenty-first birthday, the OCR was cut to a fresh record low of 0.25%, where it still sits (figure 1).

Figure 1: OCR and non-tradable CPI excluding government charges and tobacco



Source: Statistics NZ, RBNZ, ANZ Research

The lesson from recent history seems to be this: don't hike too soon or your half-baked cake will collapse in on itself and you'll have to start again. While formulated for slightly different reasons (ie primarily the balance of risks around impacts of the pandemic), that thinking is at the nub of the RBNZ's "least regrets" policy. Better to run the oven hot and burn the edges of the cake slightly, the thinking goes; it'll still be edible.

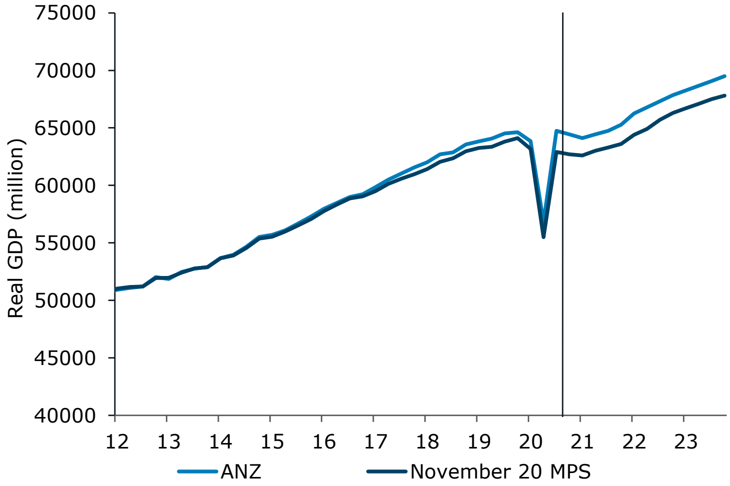
In short, the primary concern for monetary policy in recent years has been that inflation expectations will become entrenched too low, and that with limited monetary policy ammunition remaining, it's therefore better to err on the upside. Central banks globally are falling over themselves to make promises of how long policy will remain highly stimulatory, in order to keep long-term interest rates down and support confidence.

But some of us are old enough to remember the 1990s and 2000s cycles. In the 1990s, the RBNZ hiked too late and too slowly; inflation got too high, and monetary policy become a "one-way bet" and the NZD went sky high. The housing market proved very challenging to rein in, and by the time the Asian Financial Crisis brought the party to an end, there was quite a lot of silliness to rue. A similar dynamic played out in the 2000s prior to the Global Financial Crisis, with excessive credit growth that deepened and lengthened the subsequent recession. It is just as possible that the RBNZ will be too late to the hiking party this time around as it is that they will tighten too soon.

2. Where we are now

At the onset of the COVID-19 crisis, the RBNZ responded aggressively with monetary policy to shore up the outlook in the face of what could well have been a much bigger and more disruptive economic hit than turned out to be the case. That stimulus, alongside fiscal support and our effective health response, has seen the economy weather the crisis remarkably well. GDP fell dramatically in Q2, but bounced back far more vigorously than anyone expected, including the RBNZ, to be back at pre-COVID levels in Q3 (figure 2).

Figure 2: GDP forecast (levels) – ANZ and RBNZ



Source: Statistics NZ, RBNZ, ANZ Research

It is now clear that more monetary stimulus isn't needed, provided the still-significant downside risks do not materialise. But while the Reserve Bank can announce that they'll keep policy settings constant indefinitely until the picture is clearer, markets are always looking for the next trade. Increasingly, that trade is likely to be a punt that the RBNZ is going to tighten monetary policy, and potentially be the first central bank to do so.

That means the RBNZ faces a communication challenge in the year ahead. Markets will take what they are looking for out of its Monetary Policy Statements. And as things stand, the RBNZ's forecasts are likely to show less and less need for extreme policy stimulus over time. In that context, words about downwardly skewed risks will have a limited ability to offset market pricing for future moves. The RBNZ will understandably be cautious not to normalise policy too soon, given recent historical experience. But with two-sided risks around the medium-term outlook, the RBNZ would be unwise to back itself into a corner RBA-style and make a firm promise not to lift rates for years. They simply can't be that certain that they won't need to, as the New Zealand economy is in quite a different position to that of Australia, with the labour market far tighter, for starters.

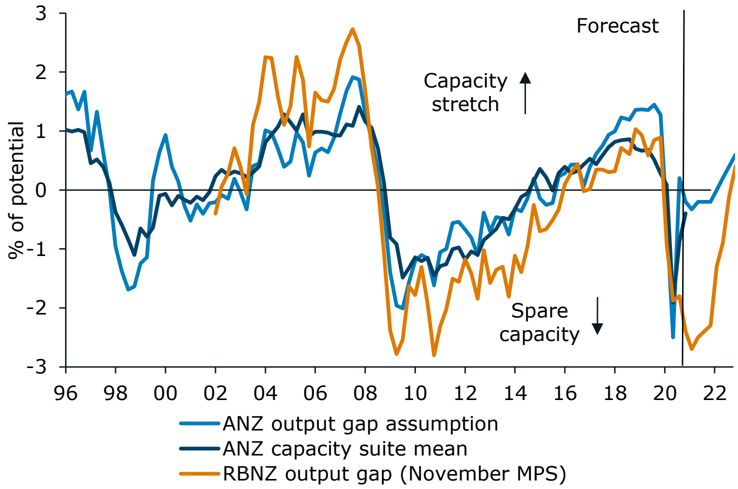
The COVID-19 crisis has been a shock unlike any in recent history, and it presents unique challenges that make the outlook complex and more uncertain than usual. Unlike regular recessions, it is not primarily a hole in demand, such as the Global Financial Crisis engendered. It started out as a sudden, dramatic interruption to production, but one in which incomes were ably supported by a generous wage subsidy. Beyond that, it has morphed into a complex web of demand and supply disruptions from lockdowns, here and globally, transport disruptions, and a closed border. Relative to initial expectations, overall demand has been far less impacted than previously assumed, due to both fiscal and monetary policy support, and a redirection of overseas holiday spending. Meanwhile, a raft of supply challenges (freight and labour supply being at the top of the list) has so far been quite persistent.

A key determinant of the stance and outlook for monetary policy is the degree of capacity stretch in the economy. The extent to which resources (including workers) are fully employed largely determines underlying inflation pressures. Capacity stretch is summarised by a concept called the "output gap", which is unobservable but expresses the extent to which demand is pushing against the economy's supply constraints. If the output gap is negative, demand is not sufficient to use the economy's supply potential and the economy has spare resources that are not being fully utilised. If it's positive, we're running hotter than is sustainable, and prices and wages will be under upward pressure.

The net effect of the supply and demand impacts on overall spare capacity in the economy has been quite uncertain. Up until now, the RBNZ (and everyone else) has made the assumption that COVID-19 would hit demand much more than supply, with weaker spending both domestically and by tourists, resulting in a large negative output gap (figure 3). But recent data, such as a much lower-than-expected unemployment rate, suggest that the demand hit has not been anywhere near as large as previously feared and that perhaps supply factors have been more of a constraint on activity.

Based on our ANZ capacity suite, it appears that the output gap is currently slightly negative, though this is hard to gauge due to volatility in the data. On the whole, we suspect we are indeed seeing a net demand shock – but the size of the shock appears to be much smaller – ie less disinflationary – than the RBNZ has been factoring in.

Figure 3. Output gap



Source: RBNZ, ANZ Research

This picture, of course, masks extremely wide variation in the degree of capacity stretch across the economy. Some industries, like construction, are booming, and are operating with resources very stretched, and cost inflation looks set to soar. Meanwhile, industries like tourism are seeing a massive hole in demand, with prices falling.

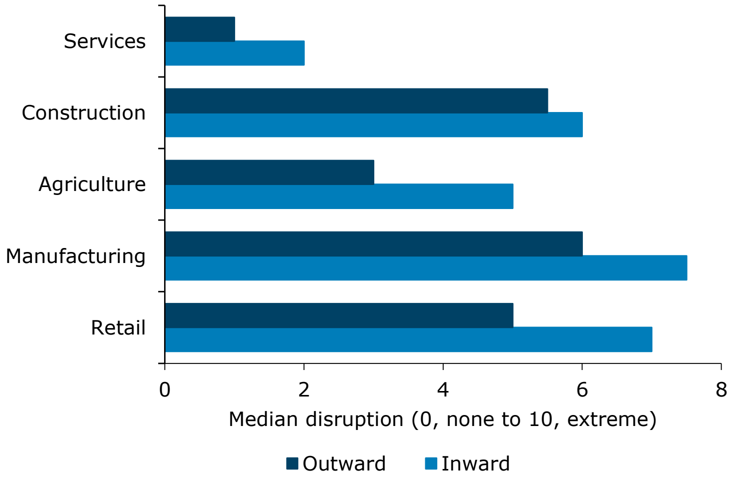
The income hole from lost tourism and education exports is very real, but it hasn't become fully evident in the aggregate data just yet. This is due to pent-up domestic demand for travel, which has buoyed the industry coming out of lockdown, and also because of the extreme seasonality of tourism. Tourism firms were sitting on a pile of summer cash from the 2019/20 season when the border closed. Then the wage subsidy arrived, no questions asked. Once lockdown ended, kiwis were stuck in New Zealand at a time they'd rather be on a warm beach somewhere, meaning we saw pretty decent winter demand – the best winter season ever, for some. But now, with hundreds of thousands of tourists MIA, many tourism firms will be bleeding cash. This is starting to be borne out with anecdotes of extremely quiet demand in international tourism hotspots following the end of the school holidays.

Even though tourism used to earn as much foreign exchange as the dairy industry, other industries have so far managed to plug the GDP gap at an economy-wide level. Monetary policy and income support have been more effective than anyone could have dreamed by supporting household spending, the housing market and construction. On a sobering note, unlike tourism revenue, housing and construction, and the wage subsidy income support, are debt fuelled. Debt has to be paid back – we are bringing forward spending from the future. But it is fiscal and monetary policy doing what is says on the tin, and has undoubtedly prevented a much sharper drop in economic activity than looked likely when COVID-19 first hit, in turn supporting incomes, business sentiment, employment and investment.

Meanwhile, the economy's scope to meet demand – its supply potential – has taken a big hit too.

- **Labour supply.** Population growth has provided around half of our economic growth in the past five years. It's put a strain on housing, health and education, but it certainly has kept things humming. Migration is now a shadow of its former self and will remain so until the borders open. And we're now finding out just how reliant on short-term visa holders we have become, to pick our fruit, look after our children, build our houses and make our coffees.
- **Labour skills mismatches.** The New Zealand economy may now be a similar size to pre-COVID days, but it certainly isn't the same shape. There's a mismatch between both the skills and the locations of workers needing opportunities and the current needs of employers. Firms report that finding skilled labour is their #1 problem. That means that for a given unemployment rate, we'll probably see more wage pressure than otherwise.
- **Shortages of goods.** So far shortages have been primarily in durables and a pain in the neck for anyone wanting a new kitchen. However, anecdotally, shortages are worsening for intermediate goods too, from building supplies to farm inputs to machine parts. There's a paucity of hard data on this front, but a question on the topic in our ANZ Business Outlook survey suggests that there are significant issues in the manufacturing, retail and construction sectors with the supply of imported goods (figure 4).

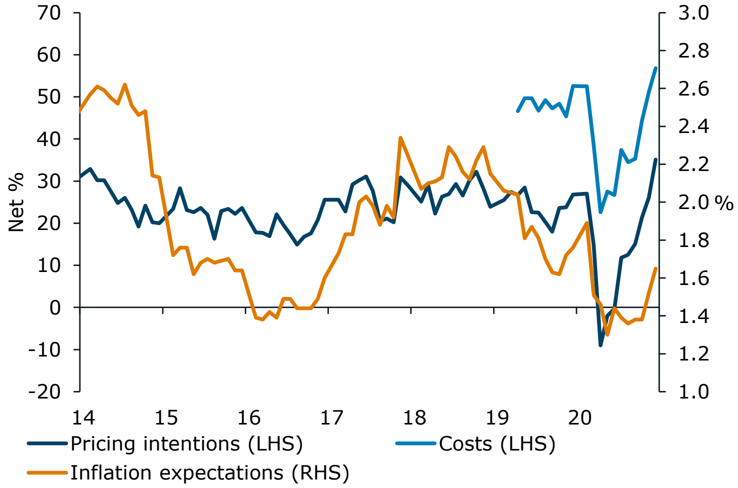
Figure 4. Median reported freight disruption (0, none, to 10, extreme)



Source: ANZ Research

These supply constraints limit the overall productive potential of the economy, but also put direct upward pressure on prices. Our ANZ Business Outlook survey shows how sharply the cost and pricing picture has turned around (figure 5). Firms' pricing intentions in the preliminary February results were the highest since the data began in 1992! And that period included a hike in the rate of GST. And it's not just intentions – we have already seen stronger inflation on the back of supply disruption manifest in the Q4 CPI data.

Figure 5: Inflation indicators from the ANZ Business Outlook survey



Source: ANZ Research

3. The highly uncertain outlook

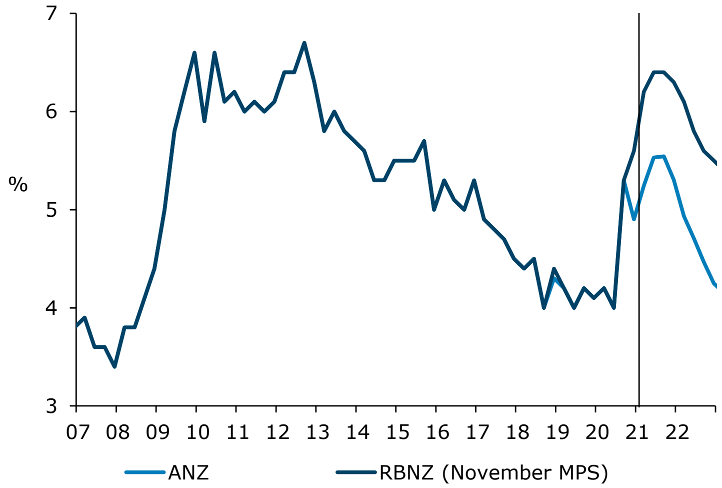
The outlook for the economy – and RBNZ policy – depends crucially on how demand and supply factors evolve and net out from here. This is highly uncertain, given that there are many moving parts and a wide spectrum of risks. As such, we could see things playing out in a number of ways. See Scenarios for normalisation for how this might impact the outlook for policy.

Our central forecast assumes that headwinds emerge that mean the economy moves broadly sideways this year, notwithstanding data volatility. This is due to the impact of lost international tourism income becoming apparent and flowing on to other industries, and because it is expected to be difficult to generate further income gains in the current uncertain environment. Export intentions in our ANZ Business Outlook survey are starting to look a bit wobbly, which makes sense.

With this demand impact expected to become more apparent, we are forecasting that the economy overall will operate with a little spare capacity this year, even as strong demand in construction and other areas continues to provide an offset. Consistent with this, unemployment is expected to gradually lift through to the middle of this year to peak at 5½% (figure 6). This will weigh on domestic incomes and spending, though the extent of these second round effects is uncertain, given the powerful offset coming from strong demand in the likes of the construction sector.

Underpinning this outlook, we are assuming that the housing market gradually cools, but there are risks in both directions here too, which could easily see the tug of war between booming and suffering parts of the economy netting out differently. A stronger housing market over the remainder of the year would challenge our view that economic momentum will struggle, and could see the economy come up against enduring capacity constraints. On the other hand, we are assuming that the global environment remains challenging, but that demand for our exports continues to be favourable. If our export prices were to soften markedly, then this could result in a weaker demand outlook and more slack in the economy than we anticipate.

Figure 6. Unemployment rate



Source: Statistics NZ, ANZ Research

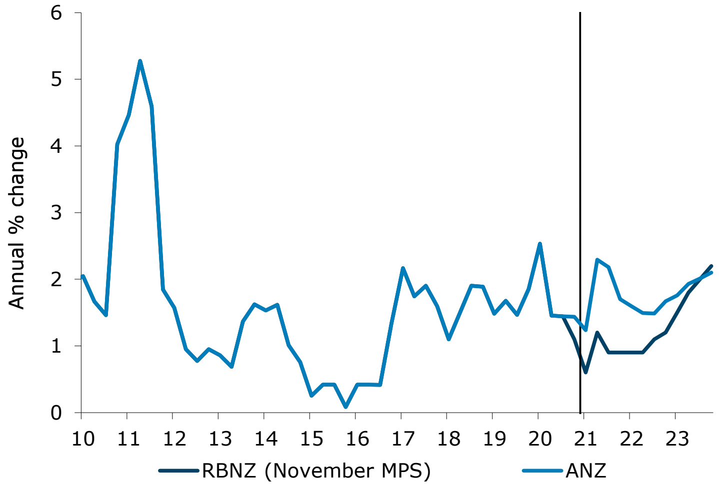
Lingering spare capacity this year is expected to see some persistent underlying softness in inflation remain. In the short term, tradable inflation is expected to be boosted by cost pressures. At the same time, overall CPI is expected to be boosted by base effects, with weakness dropping out of the annual calculation. This will see a temporary lift to around 2.3% y/y. However, later this year global shipping timings and costs are expected to normalise – there is a widespread expectation that things should be much improved within six months. At this point, cost pressures could subside considerably, particularly given the dampening impact of the elevated NZD. We expect to see a moderation in tradable inflation at this time, with the softer overall inflation pulse becoming evident.

Supply-driven tradable inflation is the type of inflation that central banks "look through", because it's temporary. However, we expect that stronger inflation will pass through into inflation expectations to some degree, supporting the medium-term outlook for inflation. However, it is possible that inflation expectations lift even more than we expect, and bleed into core, non-tradable inflation even more over time, especially if supply issues take a long while to resolve.

More broadly, the supply capacity of the economy is expected to be constrained as long as the border is closed, and we expect that gradual reopening will not begin until early 2022. At that point, we expect to see a strong bounce back in demand as international visitors return to our shores and confidence domestically increases, but likewise this will see an offsetting relaxation in supply constraints, with labour easier to come by.

Overall, GDP is expected to see a strong bounce when the border reopens, but the bounce in demand won't necessarily push up against supply constraints strongly as the supply side of things normalises too. Unemployment is expected to decline more rapidly after this point as skills mismatches ease. Full employment is expected to be reached in the second half of 2022 and capacity pressures are expected to become evident. These capacity pressures are expected to support a gradual but persistent improvement in underlying inflation, with CPI inflation comfortably back at target by mid-2023 (figure 7).

Figure 7. CPI inflation



Source: Statistics NZ, ANZ Research

4. The path back to normal: what would see the RBNZ turn?

Given all the moving parts, it is no mean feat to figure out the magic numbers that will see the RBNZ conclude that they can safely start to roll back stimulus without worrying about causing an undershoot in inflation and employment down the track. The RBNZ will be feeling its way just like everyone else, and will be wary of the uncertainty surrounding the outlook and all the offsetting forces at play. Given this, the RBNZ is expected to take a patient approach, seeing how these developments play out.

Broadly speaking, the RBNZ will want to be reassured that its targets are firmly in view before normalising policy, consistent with its "least regrets" approach. When it comes down to it, inflation over target implies chucking another hike or two into the forecasts. Inflation under target means that, should downside risk materialise, a negative OCR and more forays into unconventional policy become more likely – a worse outcome. Consistent with this, we think there are four criteria that the RBNZ will consider necessary to meet before they are ready to normalise:

1. The labour market will need to be at or close to full employment.
2. Inflation needs to be at or close to the target mid-point and expected to stay there.
3. Inflation expectations need to be at or above the target mid-point.
4. Risks to the economic outlook need to be balanced. This is clearly subjective, but so long as downside risks loom large, there will be a reluctance to remove support, lest it need to be hastily reinstated. It is possible that the RBNZ remain cautious on this front until COVID-19 herd immunity is reached.

See Scenarios for normalisation for more on when these criteria might be reached.

5. Sequencing in the world of unconventional policy tools

Tightening monetary policy no longer just means lifting the OCR. We now have a complex web of policy tools in play – the main ones being:

- The OCR – currently at 0.25%.
- A $100bn large-scale asset purchase programme (the 'LSAP'), which has lowered bond (and wider financial market) interest rates, and flattened yield curves, though one can't be precise about the impact. The RBNZ is currently buying around $600m of bonds per week under this programme. See our FAQs here and here for how this works.
- Associated with the LSAP, much higher system settlement cash levels (SCL). SCL is sensitive to both bond issuance and the pace of LSAP purchases, and impacts liquidity in the financial system and market pricing. Historically, it was tightly managed at a level deemed appropriate to facilitate the smooth running of inter-bank payment systems (it averaged $7.6bn over 2018 and 2019). Thanks to the LSAP, SCL is currently around $26bn, but it has been above $30bn and it will continue to grow over time as asset purchases continue.
- A bank Funding for Lending programme ('FLP') that the RBNZ has explicitly ruled out exiting early (wind-up begins in mid-2022).

Exactly what sequencing is followed when it comes time to dial back on stimulus matters crucially for financial markets. We expect the RBNZ to be guided by international experience, and to consider the peculiar aspects of each policy tool as it sequences the eventual withdrawal of stimulus.

The above list is presented in the order that policy was rolled out over 2020, but it does not necessarily follow that policy will be unwound in reverse order. It might, but there are a number of factors to consider:

- Depending on how funding markets are faring, the RBNZ may wish to leave the FLP in place even after it starts to scale back asset purchases. Our central expectation is that the FLP will simply roll off at its planned end. However, it might be deemed a plus to keep it in the background should global bank funding conditions abruptly turn.
- Commitments have already made, eg the RBNZ has committed to the FLP programme until 6 June 2022.
- The RBNZ will be keen to avoid any sudden policy shifts that might unsettle markets. Ideally the process of withdrawal will be gradual rather than binary, in part to avoid the kind of "taper tantrum" seen in the US when then Fed chair Ben Bernanke suggested in 2013 that the Fed might taper the pace of its asset purchases.

Financial markets are less concerned about when the FLP ends and are more focused on how quickly the pace of LSAP purchases slow, and when the OCR goes higher. What happens to the pace of LSAP purchases will, in turn, influence how quickly SCL balances come down.

At this point it is worth clarifying some technical points around the LSAP – the most salient being to note that "tapering" means buying fewer bonds, not reducing the size of the balance sheet. That is, tapering means that size of the RBNZ's LSAP portfolio will grow less quickly, not fall. Trimming the size of the LSAP portfolio or allowing it to run down as bonds mature is a later part of the normalisation process. It is worth noting up front that when a central bank tapers asset purchases, it is still providing stimulus, but it is doing so at a lesser rate. Allowing the portfolio to run off comes much later.

We think the sequencing that the Fed followed post-GFC was logical, providing a road-map for what likely lies ahead in New Zealand. That sequence went as follows:

1. First, the pace of asset purchases was gradually slowed. In December 2013 the Fed signalled that, starting in January 2014, the pace of purchases was slowed by around $10bn per month (from $85bn per month over most of 2013). Purchases ceased in October 2014.
2. Just before purchases ceased, the Fed issued a paper detailing the principles it would follow as it looked to "normalise" its balance sheet.
3. A little over a year later, in December 2015, the Fed hiked the Fed funds rate by 25bps.
4. Around 18 months later, in July 2017 the Fed indicated that it would allow the size of its asset portfolio to run down slowly. This began in October 2017, three years after the cessation of asset purchases.

In our view, this was the logical sequence to follow as it allowed the Fed to re-engage in QE if it needed to, either before hiking, or after it started hiking. The gradual nature of tapering (which was well signalled) gave markets plenty of time to adjust, and gave the scope the Fed to alter course had the recovery faltered. And similarly, by publishing its normalisation principles towards the end of the tapering of purchases, the Fed was able to give the market plenty of warning of what was coming in the next stage of the process, when the balance sheet would be run down.

If we put this in the New Zealand context from early 2020, the full sequence goes:

1. Cut OCR
2. Introduce and conduct LSAP
3. Taper LSAP purchases
4. Outline normalisation principles
5. Cease LSAP purchases
6. Hike OCR
7. Allow LSAP portfolio to be run down.

At the moment New Zealand is still in the LSAP implementation phase, or arguably in the early stages of the taper phase. We say "arguably" because strictly speaking, some tapering of asset purchases has begun, but this has been based on operational decisions made by RBNZ staff in response to changes in market conditions and bond issuance, rather than policy decisions made by the MPC.

This distinction is important because the RBNZ's LSAP has always been framed in terms of its upper limit and duration ($100bn to mid-2022), which in turn implies, rather than specifies, a pace. But staff have discretion to alter purchases as conditions dictate, which means the weekly pace is not intended to be a policy signal. As tapering begins, some signalling from the weekly pace of purchases would be useful, potentially justifying a change in how monetary policy decisions regarding the LSAP are communicated by the MPC to clearly delineate conscious changes for the purpose of tapering and other variation in purchases at the discretion of staff.

While we think that it is likely that the RBNZ follows the same sequencing followed by the Fed in 2014-2017, there are some key differences that could cause divergences:

- The Fed faced years of low inflation, giving them the luxury of a very gradual normalisation. As outlined in our discussion of Scenarios for normalisation, the RBNZ may not have that luxury if inflation starts to move higher on a sustained basis.
- RBNZ purchases are currently broadly matching bond issuance and with the RBNZ such a big player, any withdrawal will be clearly felt by the market.
- Unlike the US, New Zealand long-end bond yields are heavily influenced by global factors.

These points are worth expanding upon.

The Fed tapered to the point where it was no longer purchasing bonds (but was still reinvesting coupons and maturing bonds so as to keep the size of its portfolio constant). It then waited a little over a year before hiking. Given two-sided risks around medium-term inflation, it is possible that this process needs to be undertaken more rapidly by the RBNZ in coming years, though we still expect it will most likely be a phased process.

Whichever way things unfold, the RBNZ needs to tread carefully. Since QE began in New Zealand, the weekly pace of LSAP purchases has generally matched or exceeded the pace of NZGB issuance (excluding syndications). The RBNZ’s presence in the market is thus clearly felt, and any withdrawal from the market will have to be carefully managed with a very open mind to changing tack should markets react unduly.

In the US, all that really matters for the Treasury bond market is how the US economy is performing and what the Fed is doing. Global factors have an influence, but the US bond market is so big that it tends to driven primarily by US domestic factors. But in small economies like New Zealand, while the short end reacts almost purely to expectations of what the RBNZ will do, long-end interest rates are heavily influenced by global factors, which might in turn make it appropriate to tweak or alter the pace of sequencing. If, for example, local long-end interest rates here were moving up quickly for global rather than domestic reasons, and the steeper curve was threatening investment intentions or having an unduly large impact on the exchange rate, the RBNZ might want to continue buying bonds even while it is hiking. We think such a scenario is unlikely, but it could happen, especially if monetary policy continues to play a supporting role in helping facilitate fiscal policy. The LSAP has been aligned to bond issuance all along, and if that is to remain the case and it comes to pass that fiscal policy has more work to do but retail interest rates don’t need to remain low, the RBNZ might consider hiking while still buying bonds. Ideally, the RBNZ would not want to be going in opposite directions on policy levers like that, and lifting the OCR while still buying bonds could be confusing and costly. Indeed, if the market thought many more hikes were to come, odds are bond yields would just shoot higher as soon as the RBNZ stopped buying, exposing the Crown to greater losses under the indemnity.

In the bigger picture, what observation of the Fed’s transition tells us is that the whole process of withdrawing stimulus and ultimately tightening is likely to take several years to play out. Whether it takes three years like it did in the US in 2014-2017, or less, depends on inflation and employment, and how the general macroeconomic backdrop evolves. But the RBNZ will be eager to avoid a taper tantrum, and to avoid the market getting fixated on normalisation and getting ahead of itself.

For that reason, we think the RBNZ will follow the Fed's example of not outlining principles for balance sheet normalisation (which is code for run-off) until it is well through the process of tapering. Communicating these principles is crucial, just as it was when unconventional policy was rolled out last year. But outlining these principles early (say, in the next few months) risks confusion and folks assuming that the RBNZ is champing at the bit to unwind stimulus. We don't think the RBNZ are there yet – without doubt they will welcome, and acknowledge, the speed of the recovery, but they will likely to so cautiously, rather than declare that their job is done.

We have already said that we expect the RBNZ to extend the time-frame of its LSAP programme at the February MPS. While that might seem like "more" stimulus, it is actually less, as the way the RBNZ's programme has been expressed is in size and time terms. By extending the time-frame by six months, that implies a slower pace of purchases. It would also give the RBNZ plenty of "runway" to slow the pace of purchases. This runway is crucial if the RBNZ is to preserve optionality.

We believe it would be useful for the MPC to start expressing the LSAP in terms of the pace of weekly purchases, rather than leaving the market to triangulate that from size and time-frame parameters.

First, size: we see no merit in reducing the overall size of the programme (doing so risks an unwelcome market reaction), and indeed, if the programme is to remain at $100bn and be extended to the end of 2022, those parameters really only exist to define the Crown's indemnity and to offer some forward guidance. Reducing the size of the programme now (to reflect the smaller size of the market implied by reduced bond issuance) risks a premature tightening in conditions.

Second, time-frame: announcing an extension of the programme (as we expect) sends mixed messages – is it dovish, because it extends further into the future, or hawkish, because it implies a lower weekly run rate? Some might argue that murkiness like that creates optionality and thus could be beneficial at the moment. But going forward, clear communication would be assisted by shifting the focus of the programme to the pace of purchases, giving the market, businesses and households more information.

At the moment, our calculations show that the RBNZ could purchase around $850m of bonds per week if it wanted to get the size of its LSAP portfolio to $100bn by the end of June 2022, assuming it reinvests both coupons received and the principal payments from maturing bonds like the NZGB 2021s and LGFA 2022s. But buying at that rate would (on the Treasury's new, lower bond issuance projections) take LSAP holdings of nominal NZGBs above the 60% cap specified in the RBNZ's indemnity.

This dependence on the size of bond market is one obvious factor that suggests that the size of the LSAP programme should be viewed as a limit rather than a target. At the moment, purchases are proceeding at a $590m per week pace, which is above the pace of tender issuance (which excludes syndications). We calculate that proceeding at this pace would take the LSAP portfolio to around $82bn by mid-2022. What is not clear is why the RBNZ has arrived at purchasing bonds at this pace.

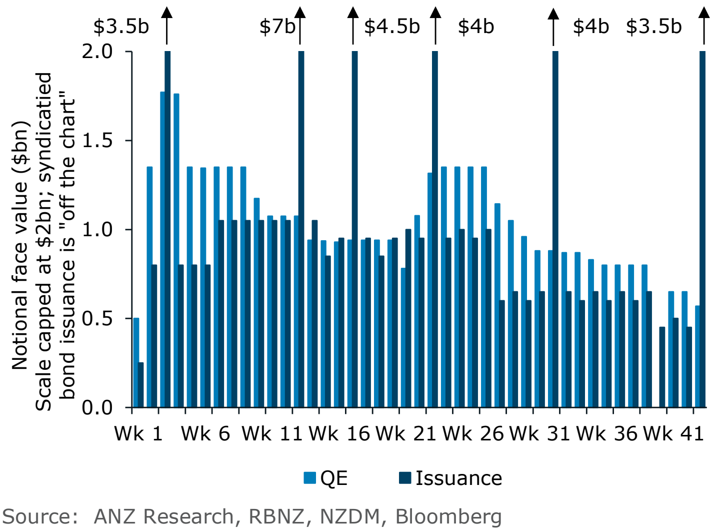
What we have observed is that RBNZ staff have tended to (but don't always) scale the pace of weekly purchases up or down to match changes in the pace of issuance. This is a logical thing to do given that one of the aims of the LSAP is to keep long-end yields lower than they otherwise would be, and given the role supply (ie bond issuance) plays in setting bond yields. But what has been confusing to the market has been whether any signal can be taken from these changes. We have always been of the view that there is no signal to be taken, because the decision to taper has thus far been a decision made by RBNZ staff, rather than by MPC, and because changes have tended to often match changes in the pace of issuance. However, the RBNZ could move to the MPC making explicit decisions on the pace of LSAP purchases at each six-weekly meeting, and give RBNZ staff the discretion to purchase additional bonds via the Bond Market Liquidity Support (BMLS) facility should market conditions warrant. That would both make the MPC's policy view clearer and give the RBNZ more scope to intervene in markets without clouding its policy objectives should markets become disorderly. If the BMLS was "resourced" via the LSAP, it would have plenty of firepower, especially with the current pace of purchases well below theoretical limits.

If the RBNZ did adopt this approach, given the LSAP's dependence on the pace of issuance, it's worth asking: at what pace might the LSAP proceed from here?

What follows is guided by two main observations. First, NZGB LSAP purchases have varied with issuance. Second, outside of syndication weeks, LSAP purchases have always matched or exceeded the pace of regular NZGB tender issuance. That overhang has diminished over time, especially over the past six months. The overhang this month (excluding last week – when the syndication occurred) will be $95m per week and the market is functioning well, even if the yield curve has steepened considerably. That being the case, the argument for increasing the pace of LSAP purchases beyond $570m (plus $20m of LGFA bonds) is limited.

With no changes to the size of the bond programme likely until the May Budget, MPC could be confident in announcing that LSAPs would continue at a pace of "around $600m per week" at the February MPS. We think a change in the RBNZ's communication style to emphasise the pace of purchase rather than the size of the programme (which is a cap not a goal) would be helpful and clarify the RBNZ's policy stance and intentions. We think it would be useful if the RBNZ was communicating in this way before embarking on tapering, and we could see a change in the communication approach (framing the LSAP in terms of the pace of purchases) as early as the February MPS. This is the communication approach used by the Fed, and it was helpful to them when it ultimately became prudent to taper. That being the case, we are open-minded, and such a change in communication might not occur until much closer to actual tapering beginning.

Figure 8. Face value of weekly LSAP purchases versus NZGB issuance since QE's inception



Source: ANZ Research, RBNZ, NZDM, Bloomberg

If the economic and fiscal outlook continues to improve, that would be enough to comfortably shave $5bn off the 2021/22 and 2022/23 bond programmes (from $30bn to $25bn in each year), possibly more. That's not a hard forecast – there simply isn't enough data on the table at the moment to go making a definitive call. But that's the direction of travel, and if we loosely assume that NZDM might syndicate perhaps $6bn of issuance each year across two transactions, that leaves $19bn of bonds to be issued over 48 weeks (assuming no issuance on syndication weeks and over Christmas/New Year). That would see the pace of regular tender issuance fall to around $400m per week, which would in turn allow the RBNZ to taper to purchasing "just" $500m of bonds per week from the middle of this year.

If by mid-2022 the RBNZ MPC were comfortable that it would be in a position to gradually reduce the pace of purchases even further, such that it was no longer purchasing bonds by the end of 2022 (but was still reinvesting coupons and principal so as to stop the portfolio from shrinking), it could start to reduce the pace of purchases by say $125m per week at the last four RBNZ meetings in 2022.

Given the uncertainties around the pace of bond issuance, which is a crucial determinant of how quickly tapering can proceed, we are reluctant to etch these numbers into our forecasts, but we are prepared to pencil them in as a baseline assumption. That's what the market is likely to do, and loosely speaking, it's the way we think things will evolve. They point to the LSAP portfolio growing to around $83bn by the end of 2022.

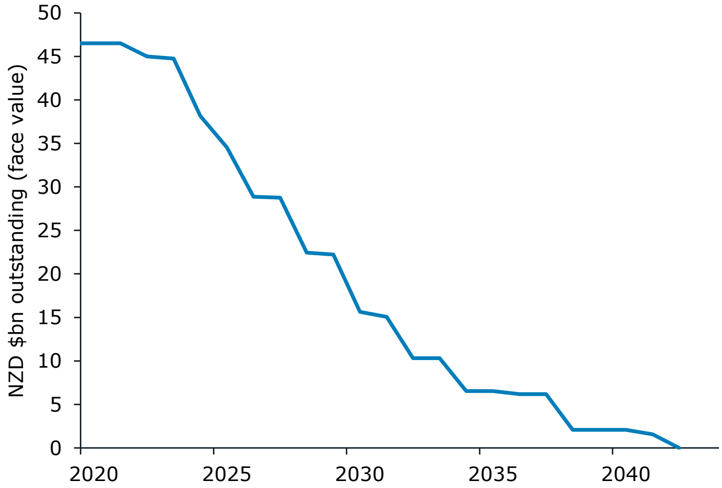
Overall, what this sequencing does tell you is that:

1. The long end of the curve will get hit well before the short end does (because tapering will likely precede hikes).
2. The level of SCL will likely continue to grow and remain high even after the OCR goes higher.

And that speaks to ongoing pressure for the yield curve to steepen, and for basis swap spreads to remain under downward pressure. And if the market takes the view that the RBNZ is likely to be an early hiker, that all speaks to further NZD strength too. That said, too much curve steepening and too much NZD TWI strength could see the RBNZ temper how quickly it tapers the LSAP, and drive a market correction. But for now the focus seems to firmly be on when, not if, the RBNZ will unwind stimulus.

At some point the RBNZ will likely reach the point where it will allow its portfolio of bonds to slowly run off, but that's an issue for much later and is expected to be a very gradual process. Given that the exact make-up of the portfolio is unlikely to match the desired run-off rate of the portfolio, the process will need to be managed carefully to minimise the impact of the resultant fall in SCL on short-term interest rates, and to ensure that market movements are orderly. In the Fed's case, when it started allowing its portfolio to run off, the process was driven by the timing of coupon and maturity flows, with reinvestment occurring during periods where lumpy maturity flows exceeded the desired rate of run-off. In New Zealand's case, if the RBNZ's LSAP portfolio were to be left to run off naturally, it would cease to exist in May 2041, when the longest bond matures. Figure 9 shows the current run-off profile. However, this is unlikely to be what transpires, not least because the portfolio (currently $46bn) will grow bigger before it starts rolling off (because LSAP purchases are ongoing).

Figure 9. How quickly will the RBNZ's current QE portfolio naturally run off?



Source: RBNZ, ANZ Research

6. Scenarios for normalisation

Given the uncertain outlook, it is too soon to come to a firm view on what normalisation will look like exactly, and when. As the RBNZ embarks on the tapering process, they will feel their way and alter the pace and degree of tightening if required, as economic conditions change. But based on our assumptions for how developments may play out, we can see some key scenarios for how this may unfold.

Our current forecasts see inflation and the labour market back to or close to their targets from the latter part of 2022. At this point, we would expect that the RBNZ would allow the FLP to naturally finish and be ready to embark on tapering of the LSAP, with the reduction and then eventual cessation of purchases over the second half of 2022. The RBNZ would then want to see that removal of asset purchases has not had undue effects and that the outlook is proceeding as expected. Assuming that it is, with inflation and the labour market firmly back at target in mid-2023, a gradual lift in the OCR would then be on the cards.

But there are risks in both directions. We could envisage a scenario in which the demand impacts of the COVID-19 hit prove to be larger and more persistent, weighing on inflation and seeing unemployment remain above full employment for longer. This could occur if headwinds from the closed border and broader economic slowdown are more potent than expected, a high TWI and lingering headwinds see persistent weakness in inflation, and/or the housing market turns abruptly. In this case, the RBNZ would be more reluctant to normalise policy and may wait much longer to do so.

Assuming that the RBNZ continues with its patient approach, in this scenario a weaker demand pulse would likely become evident before the latter part of 2022, when we would otherwise expect an LSAP taper to commence. This means that it is more likely that we see a later or more gradual normalisation rather than a normalisation then reversal (although this could occur for other reasons if unforeseen risks were to arise). In this scenario, a softer demand pulse could result in an extension of the LSAP programme to delay tapering until the outlook is more assured and/or a more gradual or later increase in the OCR, with eventual hikes potentially occurring in 2024 or later.

Alternatively, it is possible that the normalisation process begins sooner. This could occur if the housing market remains strong through 2021, headwinds simply do not materialise or have the effect we think they will, and/or inflation and inflation expectations are persistently higher. In this case, the RBNZ may choose to begin tapering of the LSAP programme in early 2022. It is hard to imagine the RBNZ being comfortable tapering before the border opens, and downside risks are still very problematic. We can’t rule it out, but it just doesn’t seem likely. More likely to us is the possibly that the RBNZ waits until 2022, but has to embark on more aggressive tightening if upside risks materialise. That could mean tapering beginning earlier in 2022, followed by more imminent OCR hikes.

It is possible that tandem tapering of the LSAP could occur alongside OCR hikes in 2022 if conditions were running very hot. But tightening with the OCR while still conducting purchases under the LSAP could send a confusing message to the market, with uncertain and counter-productive effects, including making purchases more expensive. More likely, should upside risks eventuate, is that tapering occurs more quickly, followed by more imminent OCR hikes.

Whether upside or downside risks materialise, we think normalisation will be a gradual process, with LSAP tapering beginning before the OCR is increased, so that markets and the economy can digest the prospect of normalisation, and the RBNZ can adjust its approach if required. But as things stand, risks are slightly skewed towards that process of policy normalisation perhaps starting a little sooner than we expect.

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