ANZ Research

NZ Forecast Update: Just one more OCR cut in May, to 0.1%

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Contact

Sharon Zollner for more details.

Staying positive

Key points

- We now expect the RBNZ to cut the OCR only one more time, with a -15bp tweak to 0.10% at the May *Monetary Policy Statement*. This further cut may not prove necessary, but as things stand it makes strategic sense.
- If the housing market and domestic economy maintains momentum well into autumn, the RBNZ will not cut again at all. If COVID-19 returns to our shores in a significant way, a negative OCR will once more be game on.
- We expect the RBNZ to maintain a dovish bias for a long time yet in order to head off any premature tightening in monetary conditions that would undermine improvement in inflation and the labour market.

Why is less stimulus now necessary?

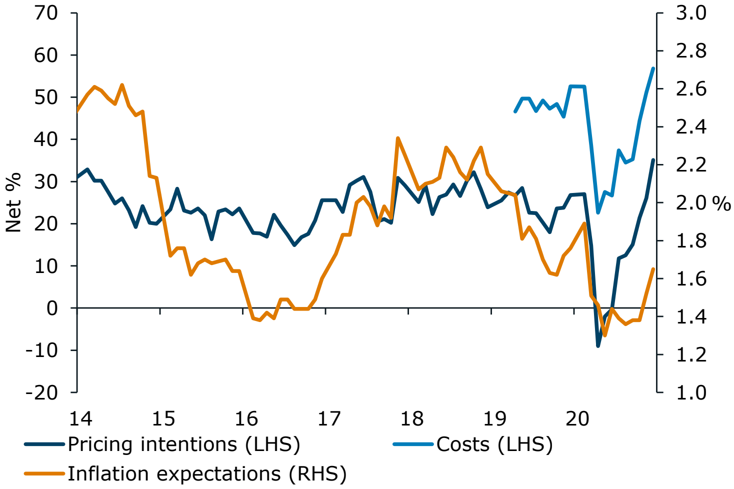
We described in a note late last year why the odds of a negative OCR have declined. We have now formalised this in our forecasts, removing the August cut into negative territory, forecasting rather that the RBNZ will deliver a final 15bp cut in May (the first *Monetary Policy Statement* after the no-change forward guidance expires), and stop there.

The reasons why a negative OCR is no longer necessary are manifold:

- Monetary policy has worked. The housing market has boomed, defying widespread predictions of a bust. While exacerbating wealth inequality and worsening housing affordability, this has supported household spending and construction, and thereby employment and inflation.
- Vaccine developments provide more certainty around the path to normality in most of our trading nations. It's still a very difficult path ahead, but a key source of medium-term downside risk has been ameliorated.
- New Zealand's commodity prices have held up very well in the face of the hit to global growth. This week we revised up our payout estimate for this season by 50c to $7.20/kg MS.
- Touch wood, we have only required one lockdown-lite since April in our ongoing national COVID-19 elimination strategy. The wage subsidy has been very successful in keeping workers attached to their employers through the two lockdowns – albeit at enormous cost.
- GDP bounced a spectacular 14% in the September quarter, to see the economy the same size as pre-COVID – though most assuredly not the same shape, with tourism withering but construction booming.
- The labour market is tighter than previously expected, albeit partly due to a hit to labour supply. There are certainly pockets of oversupply and underutilisation – growing queues at foodbanks attest to that. But there are real labour shortages in some areas too, most notably construction and agriculture. Firms continue to report that finding skilled labour is their largest problem, and the unemployment rate is not going to lift as much as previously expected (our updated forecasts will be in Friday's ANZ Data Wrap). More broadly, this does not feel like an economy with a lot of spare capacity. The hit to the economy's productive capacity must not be underestimated – and it impacts how much stimulus is appropriate.

- The medium-term inflation outlook is looking more assured largely due to the smaller-than-expected output gap. But also, while the near-term supply-driven cost and pricing pressures strongly evident in our ANZ Business Outlook survey (figure 1) aren't growth friendly, higher headline inflation reduces the risk of inflation expectations becoming entrenched too low, also reducing downside risks to medium-term inflation.

Figure 1: ANZBO inflation indicators



Source: ANZ Research

- Views around the riskiness of a negative OCR differ, but in our view, a 15bp tweak to 0.1% is just 'more of the same' to shore up a still-challenging outlook, while a cut to a negative OCR is a higher stakes move.
- It's been a slow start, but the RBNZ's Funding for Lending Programme is starting to get some traction on getting retail lending rates lower, reducing the need for all-out OCR action.
- The politics of OCR cuts have become a little more pointed due to concerns around housing affordability. That might matter at the margin perhaps.

Why bother at all?

A natural question to ask then, is why, if things are going so well, the RBNZ will bother to cut the OCR again at all. There is certainly a good chance that they won't. But on balance, the scales are still tipped towards one more cut:

- The local dataflow is likely to deteriorate in the near term – it's pretty hard to top 14% q/q GDP growth after all! More seriously, waning fiscal support and seasonal tourism impacts will collide in Q1 and are likely to dampen the mood. Tourism earned as much foreign exchange as dairy did pre-COVID. That's a real national income hit that we haven't fully felt yet. And in the sectors that are straining at the seams, like construction, shortages of labour and/or imported inputs will constrain their contribution to GDP.
- Business sentiment is very strong at present, but the RBNZ needs it to hold up through the near-term growth wobbles ahead so as to be well-positioned to see a lift in investment when the time is right. A bit more stimulus will help at the margin.
- The RBNZ is likely to view an expected near-term lift in inflation cautiously. Core inflation tends to evolve slowly, remains well under par, and is likely to be quite low for a while yet, increasing only gradually. Supply-driven inflation tends to dissipate quickly and shipping disruptions should ease as the year goes on.

- While it is becoming clear that the unemployment rate will peak far lower than original feared (barring a severe community outbreak or other unexpected development), it will still be sitting well above the RBNZ's estimate of sustainable employment until well into 2022.
- The global dataflow will likely still be pretty bad in May. The virus will outpace vaccination efforts for a few months yet at least, with the potential consequences of the new, more easily transmissible COVID strains of enormous concern. And the virus will leave enormous economic scarring behind it in terms of long-term unemployment and debt that will reduce growth for years.
- While vaccine developments are positive, the border looks likely to remain closed for a long time yet, and then only open in a phased, cautious fashion. A return to 'normality' for tourism is a distant prospect.
- The RBNZ has taken a "least regrets" approach so far. If they cut the OCR a little too far, it just means one more hike is required on the way back up. If they don't cut far enough, with the zero bound right next door and quantitative easing well on the way to being tapped out, the problem becomes much harder. And the balance of risks to the economic outlook remains tilted to the downside.

Risks on both sides

The OCR outlook remains highly uncertain. As we noted at the end of last year, key data we'll be watching include momentum in housing, and business and consumer sentiment.

What might see the RBNZ not cut again?

It's all about economic resilience and housing.

On resilience, we expect the economy to wobble as 2021 unfolds, reflecting both a technical pull-back from the post-lockdown bounce, the highly seasonal impact of the closed border, and policy supports wearing off. If instead the economy proves more resilient than we expect and GDP manages to continue to grow and stay above pre-COVID levels, then this would result in a smaller increase in unemployment and less downward pressure on inflation than we are currently forecasting.

On housing, the outlook is looking stronger, with the market supported by low interest rates, tight supply, and pure momentum, ie self-fulfilling expectations. We still expect a cooling in the pace of house price inflation over the first half of the year as affordability constraints bite and LVR restrictions rein in property investors to some extent. But the market has momentum on its side, and a history of defying gravity for longer than one would think reasonable. A longer boom is entirely feasible, though that would bring with it greater chances of a bust down the track, given affordability metrics are already highly strained and household debt at record highs. If the housing market is still going strong in May, the RBNZ won't be cutting the OCR.

Relatedly, if mortgage rates fall more than we are forecasting, the RBNZ is also less likely to feel the need to cut the OCR again. We expect that we will see some modest moves lower in the short term, but a more significant fall seems unlikely to us at this stage, given the modest impact of the Funding for Lending Programme to date.

What might see the RBNZ cut more, or more urgently?

Scary downside risks haven't completely gone away. A severe New Zealand community outbreak of the more transmissible UK or South African COVID strains could see a re-run of the March-April lockdown, or worse. We are not out of the woods on that front by any stretch.

But there are other downside risks too:

- Global yield curves are steepening. We expect that trend to continue, even if there is a limit to how far we can go in the short term. Wholesale swap rates troughed in September and are already well off their lows (figure 2), but long-end rates have experienced another kick-up recently as US markets ponder inflation pressures and the path for monetary policy, and that has started to bleed into the local market too. So far the shorter rates that dominate retail lending remain unmoved, so it isn't an immediate concern. But if we see a premature market-led tightening in financial conditions, that may force the RBNZ's hand.

Figure 2. NZ swap rates

Source: Bloomberg, ANZ Research

- Global data looks set to be nothing short of terrible in the near term as COVID restrictions tighten. So far, as regards risk appetite, the monetary morphine has more than countered downside risks around about earnings outlooks or other such prosaic concerns. But the drug could abruptly wear off for equity markets that have been firmly in 'any news is good news' mode for six months now. It's utterly impossible to forecast, but it's a risk. Credit availability may tighten should a risk aversion spike occur.
- New Zealand's commodity prices are performing strongly but global milk supply is set to rise sharply over coming months. It's possible that this could cause a sharper fall in our terms of trade than we are forecasting. It's very unusual for our commodity prices to rise while global incomes fall. With exports of services out for the count, it's more important than ever that our goods exports perform well.

Dovish bias to persist

We debated long and hard about taking the May 15bp cut out of our forecasts as well. We don't have a strong conviction that another OCR cut is necessary. But on balance, we think a last insurance cut makes strategic sense, given the economic outlook, the risks around it, and the RBNZ's 'least regrets' approach.

The outlook remains very uncertain, and even the current situation is obscured by enormous data volatility. But by May, core inflation and employment are likely to still be well short of target, and the RBNZ will not yet have conviction that these are consistently heading in the right direction, even if the outlook is looking brighter. The fact is, overshooting inflation would be far easier to deal with than a slump, with the zero bound looming large. So why not do what you can to tilt the risks in that direction?

Whether the RBNZ cuts the OCR again or not, we expect the RBNZ to maintain dovish rhetoric for a long period, starting at the February MPS. In our view, the chances of further cuts are greater than the market currently expects (the OIS market is currently pricing 7bp of cuts).

With headline inflation set to lift but a medium-term return to target not guaranteed, the RBNZ will be keen to ensure that current upward pressure on 10-year rates doesn't transmit to the shorter rates that are more important for retail borrowers. They also won't want the NZD to head to the moon. This all speaks to a continued easing bias for a while yet, given the balance of risks. At this stage, a gently negatively sloped OCR track is likely to be a feature of Monetary Policy Statements once the RBNZ returns to publishing forecasts for the OCR.

What about the LSAP?

Although the RBNZ will acknowledge a better starting point for the economy at the February MPS, they will emphasise a willingness to provide stimulus for a long period until the outlook is more assured. As part of this, we expect to see tweaks to the LSAP programme.

With the Government books in better shape, there will be fewer bonds to buy in the LSAP programme, and the RBNZ would be running up against their (60%) indemnity cap if they left the pace of purchases and the length of the programme unchanged.

Rather than reducing the overall programme, we think the reduced supply of bonds will motivate a slower pace of purchases but an extension of the programme (and indemnity), such that $100bn of bonds can be purchased over a longer time frame, out to December 2022 (or later). This adjustment would speak to stimulus remaining in place for a long time, reaffirming the RBNZ's forward guidance that monetary policy will remain expansionary, while allowing the RBNZ flexibility to affect the yield curve should risks arise.

Contact us

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Sharon Zollner
Chief Economist

Follow Sharon on Twitter
@sharon_zollner

Telephone: +64 27 664 3554
Email: sharon.zollner@anz.com

General enquiries:
research@anz.com

Follow ANZ Research
@ANZ_Research (global)

David Croy
Senior Strategist

Market developments, interest rates, FX, unconventional monetary policy, liaison with market participants.

Telephone: +64 27 432 2769
Email: david.croy@anz.com

Susan Kilsby
Agricultural Economist

Primary industry developments and outlook, structural change and regulation, liaison with industry.

Telephone: +64 21 633 469
Email: susan.kilsby@anz.com

Liz Kendall
Senior Economist

Research co-ordinator, publication strategy, property market analysis, monetary and prudential policy.

Telephone: +64 27 240 9969
Email: elizabeth.kendall@anz.com

Miles Workman
Senior Economist

Macroeconomic forecast co-ordinator, fiscal policy, economic risk assessment and credit developments.

Telephone: +64 21 661 792
Email: miles.workman@anz.com

Kyle Uerata
Economic Statistician

Economic statistics, ANZ proprietary data (including ANZ Business Outlook), data capability and infrastructure.

Telephone: +64 21 633 894
Email: kyle.uerata@anz.com

Natalie Denne
PA / Desktop Publisher

Business management, general enquiries, mailing lists, publications, chief economist's diary.

Telephone: +64 21 253 6808
Email: natalie.denne@anz.com

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