ANZ Research

RBNZ Monetary Policy Statement

24 February 2021

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Something for everyone

- As expected, the RBNZ today retained a dovish tone about the medium-term outlook, while revising up its forecasts for growth, employment and inflation significantly.
- There was no change to the OCR. The RBNZ indicated that they do not expect to tighten settings "until it is confident that consumer price inflation will be sustained at the 2 percent per annum target midpoint and that employment is at or above its maximum sustainable level. Meeting these requirements will necessitate considerable time and patience".
- There were no changes to the LSAP or the bank Funding for Lending Programme.

The OCR outlook

As universally expected, the OCR was left unchanged today – the last Monetary Policy Statement to be released during the RBNZ's self-imposed moratorium of leaving the OCR unchanged for a year.

In terms of forward guidance, the OCR forecast remained cut off in Q1 2021, and there was only the most hand-wavy of signals in the text. However, the RBNZ will at its May MPS be obliged to return to its usual practice of presenting a conditional OCR forecast – or justify its absence. The unconstrained OCR track does show that a tightening of overall monetary stimulus is at this stage considered to likely be appropriate in 2022 (once the border is open), but this measure makes no commitment as to whether this would represent LSAP tapering or OCR hikes. Tapering is the most logical first cab off the rank, as explained in our recent Insight note.

Meanwhile, should the worst happen, "Members noted that the banking system is operationally ready for negative interest rates. The Committee assessed a negative OCR and the LSAP programme against its Principles for Alternative Monetary Policy. The Committee agreed that it was prepared to lower the OCR to provide additional stimulus if required."

RBNZ forecasts

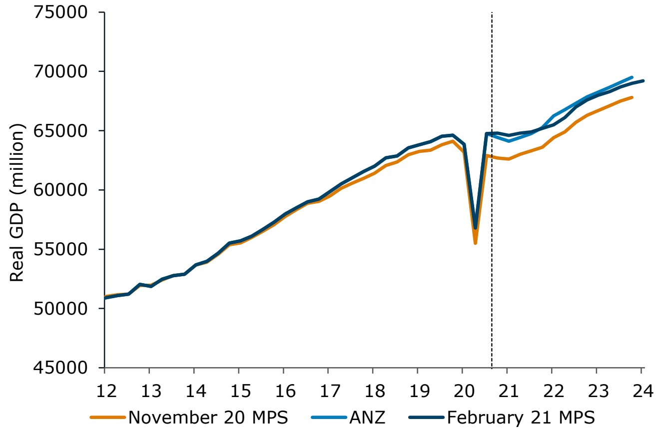
Data since November has been far more positive than the RBNZ anticipated in November – the housing market, the labour market, commodity prices, and inflation. It was therefore widely anticipated that the RBNZ would upgrade its forecasts, and they duly did.

The Bank's baseline economic outlook is similar to our own, with the stronger starting point supporting momentum and driving a material downward revision in their expectation for excess slack in the economy (and a stronger inflation outlook).

CPI inflation is expected to peak at 2.5% y/y in mid-2021 (reflecting base effects), before decelerating to 1.4% by mid-2022, and gradually lifting towards 2%, reaching this milestone in Q4 2023. Supply disruptions are assumed to resolve in 2021.

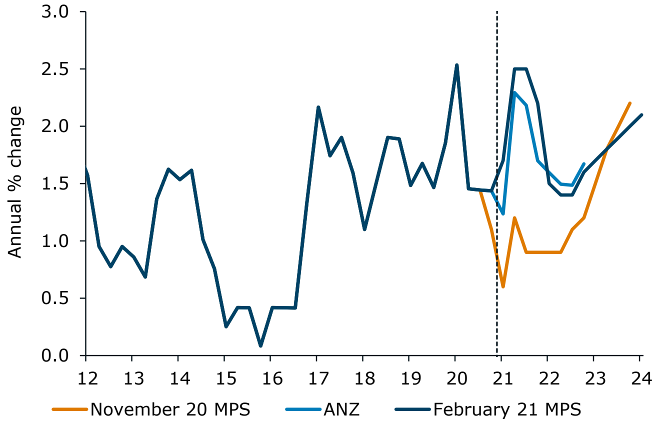
The higher inflation outlook was noted to be "in part" due to one-off factors, and that "the interaction between the headline, core, and wage inflation, and inflation expectations, will be important in determining the sustainability of inflation pressures in the medium-term". However, key for the medium-term outlook is the fact that the RBNZ has made a massive upward revision to its estimate of the output gap over the next 12 months, with a very similar profile to our own forecasts.

Figure 1. RBNZ GDP forecast



Source: RBNZ, Statistics NZ, ANZ Research

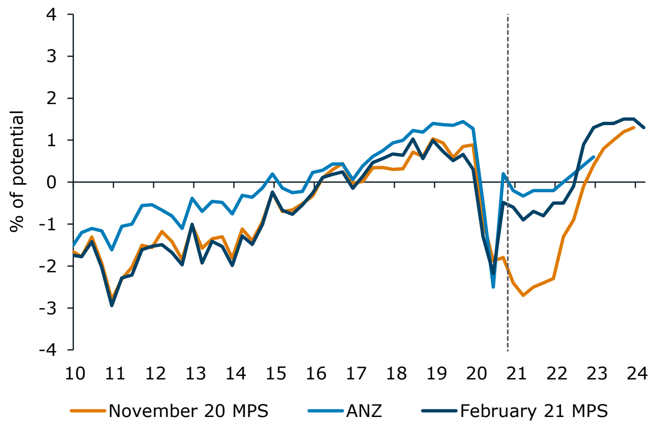
Figure 2. RBNZ CPI inflation forecast



Source: RBNZ, Statistics NZ, ANZ Research

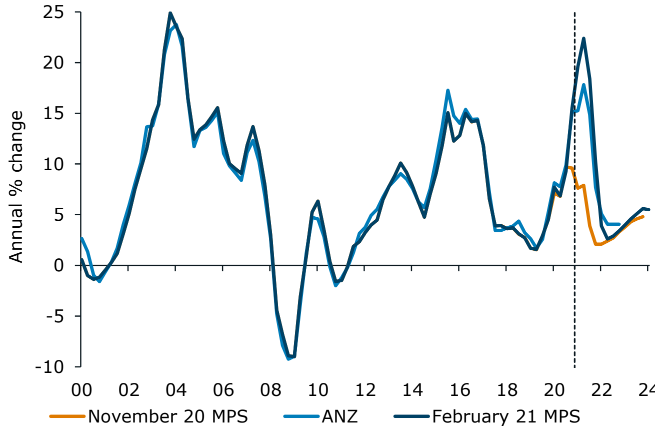
House price inflation is expected to moderate, reflecting "the fading impact of interest rate declines, low net migration over most of 2020 and 2021, elevated unemployment compared to before the pandemic, and the reintroduction of LVR restrictions." This view is also very similar to our own.

Figure 3. The output gap



Source: RBNZ, Statistics NZ, ANZ Research

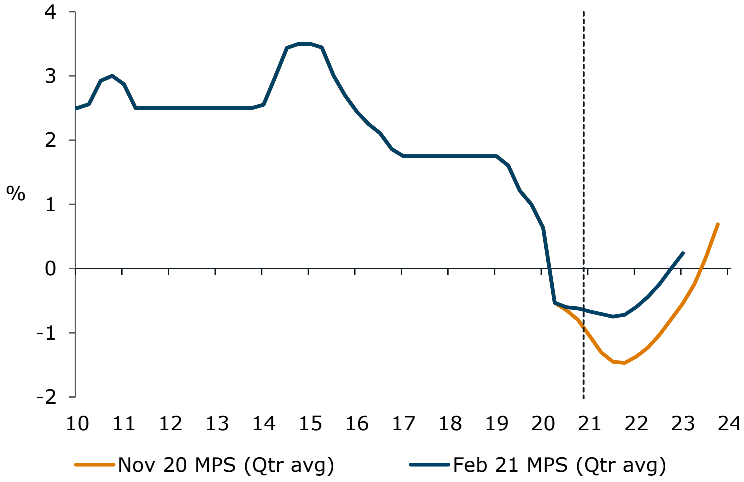
Figure 4. House price inflation



Source: RBNZ, CoreLogic, ANZ Research

The Bank's unconstrained OCR, which indicates the level of overall stimulus needed to achieve the Bank's policy objectives, troughs 72bps higher than at the November MPS (figure 5). This reflects the expectation that all else equal the Bank won't have to work as hard to achieve its targets (consistent with stronger underlying economic momentum).

Figure 5. The unconstrained OCR



Source: RBNZ

The unconstrained OCR remains broadly flat over 2021 from its starting point of around -0.7% over 2021, reflecting the Bank's desire to see a sustained return to target for inflation and employment before any monetary tightening is considered. However, it rises to zero by the end of 2022, suggests that less monetary stimulus is expected once the border opens. Those of a hawkish bent can certainly jump on this, but there were plenty of offsetting dovish words in the Statement about stimulus being required for a "considerable time" yet.

In the discussion of risks in the Summary Record of Meeting, "the Committee agreed that the risks to the economic outlook are balanced, in large part due to the anticipated prolonged period of monetary stimulus".

The LSAP

There was no change to the LSAP programme – it remains at $100bn and will continue through to 2022, with the pace of purchases determined by RBNZ financial markets staff, as opposed to the Monetary Policy Committee. Indeed, the Committee explicitly clarified that "weekly changes in the LSAP do not represent a change in monetary policy stance" and instead reflected changing market conditions. This ought to put to bed the idea that the Committee is removing stimulus because recent data has been better. It has been tapering (and the data has been better), but it is because there has been less issuance and markets are functioning well.

Next week's LSAP purchases of NZGBs remains the same, at $570m. That will exceed NZDM issuance, and will continue to exert downward pressure on the curve (or more so than if the LSAP wasn't there). However, there will be no LGFA purchases next week, which is again a sign that credit markets are functioning well, rather than a deliberate removal of stimulus.

We had been expecting an extension to the time-frame of the LSAP till the end of 2022 (because $100bn would exceed the indemnity cap by then) but that hasn't happened. Nonetheless, the market won't be too perturbed by that, as it has been obvious for some time that the RBNZ is unlikely to ever actually amass $100bn of bonds.

Weighing it up

The Reserve Bank finds itself somewhat at a delicate juncture. The economy does not require any more stimulus, but the Reserve Bank is not yet certain that employment and inflation are on a sustainable path to target. And they reiterated that they would rather take the chance on overshooting than undershooting their targets, given the challenges inherent in adding more stimulus from this starting point. The text of the Summary of Meeting reiterated the "least regrets" approach:

> *Overall, the Committee agreed that the risks to the economic outlook are balanced, in large part due to the anticipated prolonged period of monetary stimulus. The Committee reflected on the international experience of central banks following the Global Financial Crisis. The Committee agreed that it was important to be confident about the sustainability of an economic recovery before reducing monetary stimulus. Some members also reflected on the extended period of below-target inflation in many countries, including New Zealand, prior to the pandemic.*
>
> *The Committee agreed that, in line with its least regrets framework, it would not change the stance of monetary policy until it had confidence that it is sustainably achieving the consumer price inflation and employment objectives. The Committee expects that gaining this confidence will take considerable time and patience. While doing so, the Committee agreed to look through any temporary factors driving prices as required by the Remit, and noted that there will be periods during which inflation will be above the 2 percent target midpoint.*

Despite some dovish messaging, the omission of forward guidance or an OCR track suggests that the RBNZ hasn't felt the need to send a strong signal to push back against recent market moves, which is now pricing in some change of hikes in 2022. This gives conviction to recent market moves and suggests the RBNZ are happy to stand pat and not make waves for the time being, preserving their optionality. In line with retaining flexibility, there was no discussion of policy normalisation. They simply said, "The Committee agreed that it was important to be confident about the sustainability of an economic recovery before reducing monetary stimulus."

Recent market moves have seen wholesale rates rise, but the RBNZ still expects the FLP to exert downwards pressure on bank funding costs and retail borrowing rates. The RBNZ said "borrowing costs would need to remain low to achieve the Committee's objectives." And, "The Committee agreed it expects to see the full pass-through of lower funding costs to borrowing rates, and it will closely monitor progress". This suggests that although the RBNZ is not concerned around the recent lift in rates, they will not want it to undermine low borrowing costs to households and businesses.

The market by its nature is always looking for the next thing. "So if you're not cutting, when are you hiking?" Given increasing evidence of cost-push inflation pressures out there and a less negative output gap, this is a very reasonable question. But both we and the RBNZ expect the economy to suffer some decent wobbles this year, and that may see the market's enthusiasm for pricing OCR tightening wane. We're not out of the woods yet.

Market reaction

The dovish tone of today's Statement, which started with the title "Prolonged Monetary Stimulus Necessary" and included comments about looking through inflation, needing "patience" and a willingness to lower the OCR further if needed should have been well received by the short end, and potentially given the NZD a reason to level off.

At face value, the dovish tone of the comments suggest that short-end yields have scope to go lower, but the lack of firm dovish signal through forward guidance or OCR track, plus an upward sloping unconstrained OCR in 2022 has given conviction to market pricing and fuelled the NZD. Markets were always going to see what they wanted to see in today's MPS. This is a market that is in a glass-half-full mood, not a glass-half-empty mood.

Policy Assessment

Tēnā koutou katoa, welcome all.

The Monetary Policy Committee agreed to maintain the current stimulatory level of monetary settings in order to meet its consumer price inflation and employment remit. The Committee will keep the Official Cash Rate (OCR) at 0.25 percent, and the Large Scale Asset Purchase (LSAP) Programme of up to $100 billion and the Funding for Lending Programme (FLP) operation unchanged.

Global economic activity has increased since the November Monetary Policy Statement. However, this lift in activity has been uneven both between and within countries.

The initiation of global COVID-19 vaccination programmes is positive for future health and economic activity. The Committee agreed, however, that there remains a significant period before widespread immunity is achieved. In the meantime, economic uncertainty will remain heightened as international border restrictions continue.

Economic activity in New Zealand picked up over recent months, in line with the easing of health-related social restrictions. Households and businesses also benefitted from significant fiscal and monetary policy support, bolstering their cash-flow and spending. International prices for New Zealand's exports also supported export incomes, although the New Zealand dollar exchange rate has offset some of this support.

Some temporary factors were currently supporting consumer price inflation and employment. These one-off factors include higher oil prices, supply disruptions due to trade constraints, the recent suite of supportive fiscal stimulus, and a spending catch-up following the easing of social restrictions.

The economic outlook ahead remains highly uncertain, determined in large part by any future health-related social restrictions. This ongoing uncertainty is expected to constrain business investment and household spending growth. The Committee agreed that inflation and employment would likely remain below its remit targets over the medium term in the absence of prolonged monetary stimulus.

The Committee agreed to maintain its current stimulatory monetary settings until it is confident that consumer price inflation will be sustained at the 2 percent per annum target midpoint, and that employment is at or above its maximum sustainable level. Meeting these requirements will necessitate considerable time and patience.

The Committee agreed that it remains prepared to provide additional monetary stimulus if necessary and noted that the operational work to enable the OCR to be taken negative if required is now completed.

Meitaki, thanks.

Adrian Orr
Governor

Summary record of meeting

The Committee reviewed recent international and domestic economic developments, and their implications for the outlook for inflation and employment. Members noted the lift in domestic economic activity, as evident across a range of indicators including inflation, employment, household spending, GDP, and asset prices.

The Committee discussed the key factors supporting the pickup in economic activity. Household and business balance sheets have fared considerably better than was anticipated at the start of the pandemic. This is in part due to the responses of monetary and fiscal policy, but also due to a number of other factors, in particular the containment of COVID-19 that has enabled ongoing domestic economic activity. People who arrived in New Zealand during the early stages of the pandemic and subsequently stayed on, are contributing to both housing and broader demand pressures. New Zealand’s commodity export prices and volumes have also remained robust despite the global economic slowdown.

The Committee agreed that several of the factors supporting economic activity are likely to prove temporary. Fiscal policy will continue to support the economy, but its impulse is unlikely to be as strong as last year. In addition, economic uncertainty persists due to the sustained closure of international borders and the manifestation of new strains of the virus. These factors continue to weigh on business confidence and investment intentions.

Several members noted the projected increase in headline inflation can also in part be explained by one-off factors, particularly oil price increases. The Committee agreed that the interaction between the headline, core, and wage inflation, and inflation expectations, will be important in determining the sustainability of inflation pressures in the medium-term.

The Committee noted the labour market has proved more resilient than anticipated at the outset of the pandemic, although unemployment has risen. The Wage Subsidy scheme played an important role in helping businesses maintain employment. However, labour market conditions remain uneven across sectors and regions. Those sectors most reliant on tourism-related business activities continue to lag behind on job opportunities, with this likely to persist as long as international borders remain closed. Some members noted that labour effort is being reallocated to other activities and saw the potential for construction activity to remain strong. The Committee expects to see an ongoing gradual recovery in employment towards its maximum sustainable level.

The Committee noted that although the recovery in economic activity was uneven across countries, the performance of some of New Zealand’s main trading partners, in particular China, has been more resilient than expected. The stronger performance of economies geared more towards global goods demand, which has provided continued support to New Zealand’s commodity exports. However, the gains from higher export commodity prices have been somewhat offset by the stronger New Zealand dollar.

The Committee noted that the spread of more virulent strains of COVID-19 presents an ongoing risk to global economic activity. However, the development of effective COVID-19 vaccines has improved the medium-term economic outlook, helping to reduce uncertainty and boost confidence. Members noted the global economic recovery remains dependent on health outcomes and the success of the COVID-19 vaccine programmes.

The Committee noted that global financial asset prices have been inflated by both fiscal and monetary policy stimulus, and the expectations of the success of the vaccine programmes. Members also noted that long-term sovereign bond yields had increased, in part reflecting greater expected growth and inflation.

The Committee noted that domestic financial conditions remain highly stimulatory, that is, promoting spending and investing. Since the November Statement, international and domestic long-term interest rates have risen, driven by an improved growth and inflation outlook.

However, domestic borrowing rates faced by households and businesses have declined marginally. Members agreed that domestic borrowing costs would need to remain low to achieve the Committee's objectives.

The Committee discussed the effectiveness of monetary policy settings in delivering the necessary monetary stimulus. The level of Official Cash Rate (OCR) and forward guidance had helped anchor short-term interest rates. The Funding for Lending (FLP) programme had helped keep downward pressure on retail interest rates. The Committee noted that the Large Scale Asset Purchase (LSAP) programme had continued to apply a downward influence on long-term interest rates and provide bond market liquidity.

Members noted the FLP will continue to lower bank funding costs, even if international wholesale borrowing costs rise. The Committee noted that the decline in bank funding costs provides banks with scope to further reduce interest rates for household and businesses. The Committee agreed it expects to see the full pass-through of lower funding costs to borrowing rates, and it will closely monitor progress.

The Committee discussed how monetary policy settings were affecting financial stability. Members noted that monetary policy actions had supported financial stability as they have improved the cashflow positions of households and businesses. The Committee noted that the recent changes to the Bank's Loan-to-Value Ratio (LVR) requirements occurred to ensure that financial system soundness is maintained.

Overall, the Committee agreed that the risks to the economic outlook are balanced, in large part due to the anticipated prolonged period of monetary stimulus. The Committee reflected on the international experience of central banks following the Global Financial Crisis. The Committee agreed that it was important to be confident about the sustainability of an economic recovery before reducing monetary stimulus. Some members also reflected on the extended period of below-target inflation in many countries, including New Zealand, prior to the pandemic.

The Committee agreed that, in line with its least regrets framework, it would not change the stance of monetary policy until it had confidence that it is sustainably achieving the consumer price inflation and employment objectives. The Committee expects that gaining this confidence will take considerable time and patience. While doing so, the Committee agreed to look through any temporary factors driving prices as required by the Remit, and noted that there will be periods during which inflation will be above the 2 percent target midpoint.

The Committee discussed the range and settings of its monetary policy tools. Members noted that the banking system is operationally ready for negative interest rates. The Committee assessed a negative OCR and the LSAP programme against its Principles for Alternative Monetary Policy. The Committee agreed that it was prepared to lower the OCR to provide additional stimulus if required.

The Committee discussed the LSAP programme and noted that many factors influence domestic long-term bond yields, including expectations for monetary policy, global bond yields, and the economic outlook. The Committee noted staff advice that reduced government bond issuance was placing less upward pressure on New Zealand government bond yields, and that domestic bond markets had continued to function well. Members noted that staff had adjusted purchase volumes since the November Statement, in light of these conditions.

The Committee agreed to continue with the LSAP programme with purchases of up to $100 billion by June 2022. The Committee also endorsed staff continuing to adjust weekly bond purchases as appropriate, taking into account market functioning. The Committee agreed that weekly changes in the LSAP do not represent a change in monetary policy stance.

The Committee agreed that current monetary policy settings were appropriate to achieve its inflation and employment remit. The Committee agreed it would maintain monetary stimulus until it is confident that consumer price inflation will be sustained around the 2 percent target midpoint and employment is at or above its maximum sustainable level. The Committee expects a prolonged period of time to pass before these conditions are met.

On Wednesday 24 February, 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 staff: Adrian Orr, Geoff Bascand, Christian Hawkesby, Yuong Ha

External: Bob Buckle, Peter Harris, Caroline Saunders

Observer: Bryan Chapple

Secretary: Nicholas Mulligan

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[1 February 2021]

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