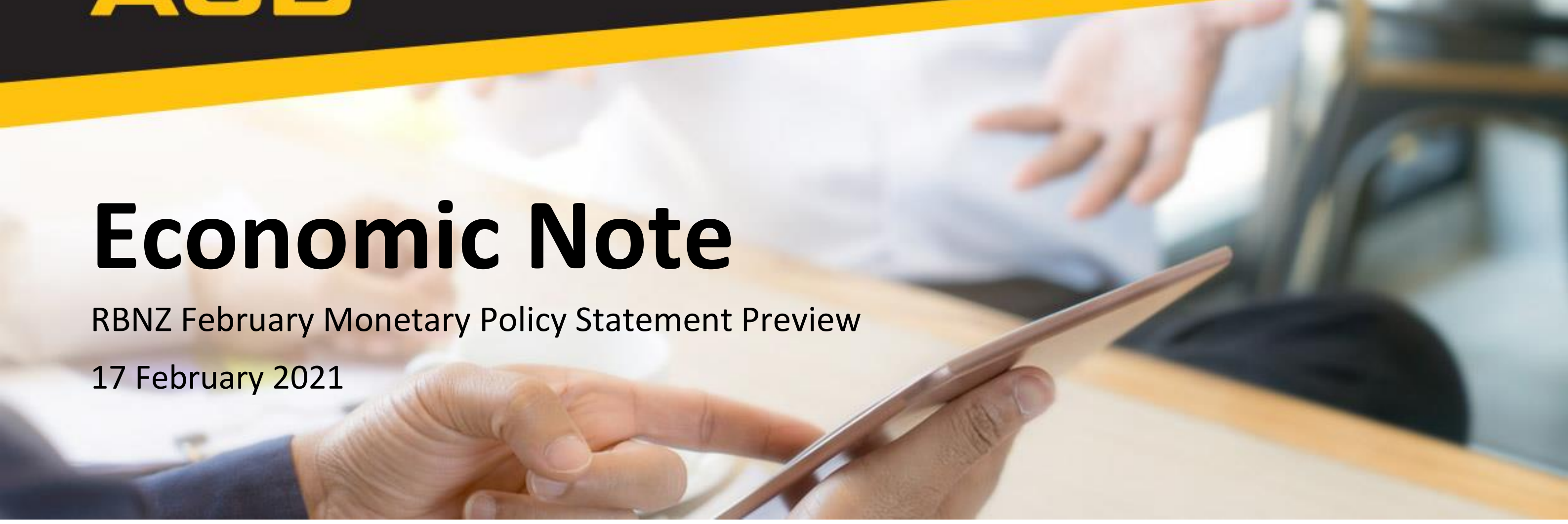

Economic Note

RBNZ February Monetary Policy Statement Preview

17 February 2021

Understate the upside, accentuate the downside

- The starting point for the RBNZ's economic outlook is much better than was assumed late last year.
- The RBNZ's medium-term economic objectives look to be much closer to being met and we expect the OCR to move up from the second half of 2022.
- Nevertheless, we expect the RBNZ will keep the emphasis on the continued risks, challenges and uncertainties.

The NZ economy is currently in a much better position than many had earlier envisaged, including the RBNZ. Its dual inflation and maximum sustainable employment targets are that much closer to being reached again on a sustained basis. In our view, the huge monetary policy stimulus in place at present is likely to start getting unwound a little sooner than anyone would have contemplated even late last year.

Consequently, **we now expect the RBNZ to start lifting the OCR gradually from the second half of next year** (we have pencilled in August 2022). At that point drawdowns for the first tranche of the Funding for Lending Programme will have closed, leaving only the 'bonus' portion based off banks' new lending growth to be drawn down before year-end. We also see no need for the Large Scale Asset Purchase programme (i.e. quantitative easing) to have its limit increased from the current $100 billion cap, though expect that at some point the RBNZ will extend the end date of asset purchases from mid-2022.

That is our current take on what the RBNZ will do in the future. **But in the here and now, life remains uncertain – and we expect that message will be the one the RBNZ will want to emphasise** despite the better starting point. More virulent strains of COVID-19 are appearing and could derail the world's efforts to get on top of the pandemic. NZ's borders will remain heavily restricted for the rest of this year at least, holding back a full recovery.

So expect a message of not counting your chickens before they hatch, that monetary policy needs to remain stimulatory for some time, and that the RBNZ will remain prepared to provide additional support if necessary.

Starting from a less bad place

The position NZ finds itself in at present looks to be ahead of even the dizziest of high expectations. The list of pleasant surprises includes:

- The level of GDP in the September 2020 rebounding 14% to be higher than the pre-pandemic level, something that was previously expected to take years to happen;
- Employment lifting off its September low and (fingers crossed) trending higher from here;
- The unemployment rate already falling from what might turn out to be its peak (5.3%);
- Business confidence back up near average levels after shattering records for how far it fell;
- The housing market being simply on fire, helping to boost dwelling consent issuance to the highest levels since the 1970s; and finally
- Multiple COVID-19 vaccines being rolled out already.

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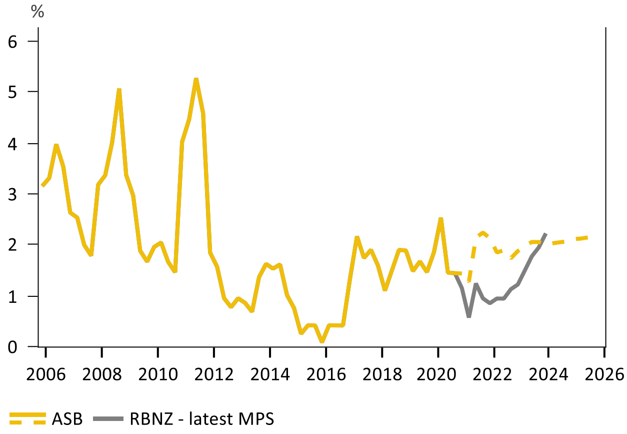
Closer to target

The recent performance of the economy has moved the RBNZ's objectives that much closer to being reached. Our forecasts have consumer price inflation rising above the 1-3% target mid-point in early 2022. Although inflation is likely to dip slightly below 2% around late 2022, the medium-term outlook is consistent with circa 2% inflation outcomes. In contrast, the RBNZ's last forecasts had inflation holding around 1% – the bottom of the target band – through to late 2022. The contrasting (and still highly uncertain) outlook really flags that weak inflation looks to be of far less of a threat than it seemed. 'Cost-push' inflation from the current global logistics challenges is part of the near-term picture, but more enduring skill shortages, wage inflation and other capacity pressures are set to lift inflation.

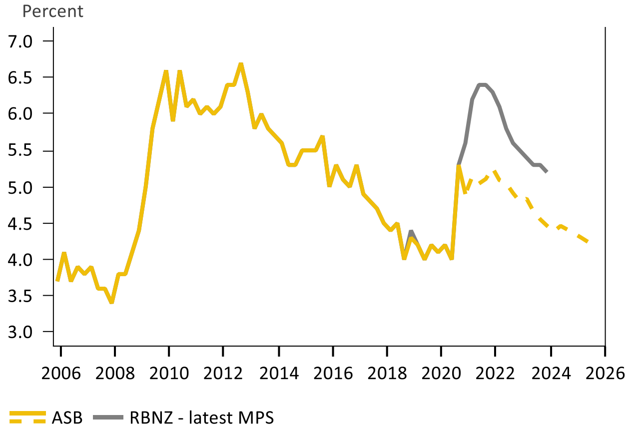
NZ Annual CPI Inflation Forecasts



Source: Macrobond, ASB

And Maximum Sustainable Employment must be a lot closer to being reached than it appeared last year: the RBNZ's November forecasts had the unemployment rate peaking at 6.4% in the middle of this year and still holding above 5% at the end of 2023. The rate at the end of 2020 was an astonishing 4.9%. The RBNZ's updated forecasts should – like ours – show that labour market slack is disappearing much sooner than its November forecasts suggested.

NZ Unemployment Rate Forecast

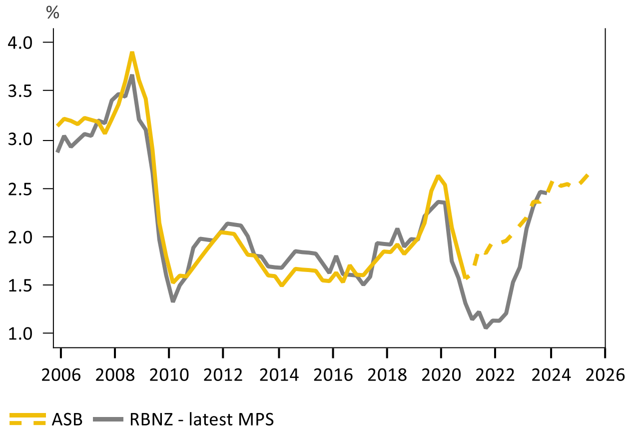


Source: Macrobond, ASB

There be dragons…still

As good as the starting point is, NZ is a bit like a plane with 3 engines at full throttle while the fourth is belching smoke and flames. Having another engine of growth cut out would set NZ's Flight of the COVIDs back. We expect the RBNZ will go to great lengths to emphasise ongoing and potential challenges that NZ still faces, including:

NZ Annual Labour Cost Inflation Forecasts



Source: Macrobond, ASB

- The new virus strains (which are more contagious) have caused setbacks to the global recovery, particularly in Europe where strict lockdowns have gone into force again. NZ's own responses to community outbreaks could be more severe, longer lasting, or more frequent. Even though last August's lockdown didn't seem to do much lasting damage, more frequent lockdowns could be a different story;
- The latest NZ lockdown, even if it ends before the MPS release, serves as a salutary reminder of the unpredictability of the current pandemic;
- There is concern that some of the vaccines that have been developed and ready for use are not as effective against the new virus strains. While some producers have indicated they have begun work to tweak the vaccine for the new, more virulent, strains – this will slow down efforts this year to mitigate COVID-19 spread through vaccination;

- The Government has effectively confirmed that the border will remain closed this year, and there are some big question marks around how soon the Government would be prepared to open up the border next year if NZ hasn't reached a sufficiently high rate of vaccination;
- Housing market risks will be acknowledged and the RBNZ will try to water down housing prospects given demand, supply and policy changes.
- The NZ border restrictions have resulted in a sharp slowdown of net immigration inflows which will sharply slow population growth, helping to cool demand pressures in cyclical parts of the economy (housing).
- The NZ Traded Weighted Index exchange rate has already firmed compared to the RBNZ's outlook (about 75 at present compared to the 71.5 expected). If NZ continues to look in a rosy place compared to other countries, the NZ dollar could continue firming and tighten monetary conditions.

In short, a lot can still go wrong, and the path of least regret for the RBNZ is to continue signalling – as other central banks have – that considerable monetary support will be needed for quite some time.

RBNZ could extend timing of the LSAP

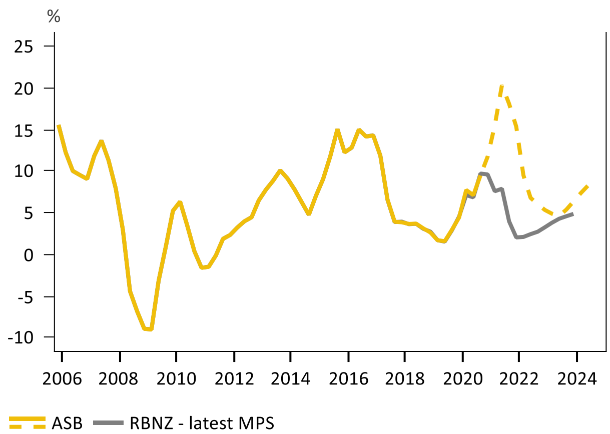
The RBNZ Large Scale Asset purchase programme has been a key part in the RBNZ's policy arsenal with the $46.1bn in purchases to date, keeping yields lower than they would otherwise have been and bolstering liquidity. At its current $570m pace, weekly purchases are outstripping the weekly bond tender ($450-$500m per week) but are expected to remain comfortably below the 60% Crown Indemnity, with cumulative purchases below the $100bn cap by mid-2022. With the RBNZ unlikely to feel the outlook is sufficiently strong to reduce policy stimulus, there is the possibility that the timing of the LSAP programme will be extended beyond mid-2022 and the cap raised. In our view, however, we expect that the RBNZ will taper the LSAP with a view to halting the programme ahead of OCR hikes later in 2022.

Watch for the RBNZ's take

Either in the Statement or the subsequent media conference there are a few areas for which it will be interesting to see how the RBNZ views them:

- Loan to Value Ratios (LVRs) and the housing market – both are topics du jour. The RBNZ's housing outlook will get updated substantially. And, although LVRs are primarily a financial stability tool, they (and other measures to 'fix' housing) are likely to get airtime during the media conference. Governor Orr may well call for other policy tools to 'fix' housing.
- What the RBNZ's thinking was behind its decisions on the LSAP programme and what the conditions are for the programme to be extended (as the Reserve Bank of Australia has done), tapered, or halted.

NZ Annual House Price Inflation Forecasts



Source: Macrobond, ASB

- Cost-push inflation – logistics challenges are both increasing the cost of landing goods and reducing choice/competition. Is the RBNZ comfortable these impacts will be short-lived?
- Funding for Lending Programme (FLP) – it is early on, but is the RBNZ comfortable with the uptake? Are there any views on the differing ways the FLP is being used e.g. targeting housing, environmental outcomes, specific sectors and not necessarily across-the-board application of the low funding costs?

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