Economic Note

RBNZ November Monetary Policy Statement Preview

6 November 2020

Marking time ahead of the FLP

- The RBBZ is expected to unveil the details of its Funding for Lending Programme (FLP), which should be operational by the end of the year. Details will be key.
- Otherwise, we expect the RBNZ to leave its OCR, forward guidance, and LSAP parameters all unchanged next week.
- Despite brighter signs of late, we expect the Bank to highlight the downward skew to risks and signal the intent to increase policy accommodation, including keeping live the option of a negative OCR in early 2021.

Most of focus in the November Monetary Policy Statement (MPS) will be the release of key design elements on the Funding for Lending Programme (FLP), which looks set to be launched before the end of the year. We earlier released a note on the FLP, which covered the technical details. Its size and design will have a key bearing on its take-up and effectiveness in lowering borrowing costs and stimulating the economy. We expect the RBNZ to design the FLP so as to be able to operate effectively in a negative OCR environment. Our initial view is that the FLP is unlikely to deliver sizeable and swift interest rate relief to borrowers, but it would be nice to be proved wrong.

Elsewhere, we don't expect the RBNZ to markedly shift the tone from recent policy announcements, with the Bank to maintain its broad policy parameters. It will likely hold the OCR at 0.25% and reaffirm the March 16 guidance (on hold until March 2021) and will maintain its $100bn Large Scale Asset Purchase (LSAP) package. The published projections are expected to adhere to recent RBNZ practice and not publish the OCR beyond the March 2021 quarter (0.25%). Moreover, we expect the RBNZ to signal the intent to increase policy accommodation and keep other policy options on the table, including pushing the OCR below zero after the period of forward guidance expires. The message for banks will be: be prepared.

We also expect the RBNZ to downplay potential (short-term) upside risks to the outlook, but to focus on more (predominantly downside) medium-term risks. The NZ economy and labour market have held up much better than expected, the domestic economy has shown signs of life, the housing market is going gangbusters, and sentiment measures are well above early 2020 lows. However, uncertainty is still pronounced and with fiscal tailwinds set to abate this improvement could easily stall. The global outlook is tenuous with COVID-19 headwinds arguably getting stronger. NZ's border restrictions may have helped contain the spread of the virus here but will pose more of an economic headwind going forward.

Our current view is that the RBNZ will move the OCR below zero in April, although the timing and extent of OCR moves will depend on the effectiveness in the FLP in supporting the economy, the impact and duration of COVID-19 and the path of the NZ and global economies, all of which remain highly uncertain.

2020 has been a busy year and we don't expect the RBNZ to relax just yet

It has been a busy year for central banks, with a lot going on at Number 2 The Terrace. We have seen the OCR cut to a record low 0.25%. The Bank has got through a mountain of work putting in place a number of measures to bolster

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monetary policy implementation and expand the policy toolkit, including getting the LSAP up and running and preparing the groundwork for a negative OCR. Far from resting on its laurels, we expect the November MPS to keep the policy treadmill running at a frenetic pace.

FLP details to be announced

The major focus will be on what the RBNZ announces for its Funding for Lending Programme (FLP). By offering banks stable and cheap lending (at or near the policy rate), the intent of the policy would be to lower bank customer interest rates and to provide additional stimulus to the economy. As we have discussed in our note on the FLP, the size/design of the programme and how quickly it is launched and adopted will have a key bearing on its take-up and effectiveness in quickly lowering borrowing costs and stimulating the economy. We expect the FLP to be operational before the end of the year, to be sizeable (in the region of $30bn), longer-term (3-5 years), offer attractive rates to banks (possibly a floating rate capped at current OCR) and to offer sweeteners to entice more take-up for business/SME lending. We also expect the FLP will include features that will make it effective to operate in a negative OCR environment.

The true test will be what the FLP will do to lending rates within the economy and credit growth in general. Beyond an initial announcement-type fall in bank lending interest rates, we expect the FLP will only have a modestly stimulatory impact on the economy and not the big bang some would have hoped for. Moreover, the impacts of the FLP could take time to fully accrue and the RBNZ is unlikely to have the luxury of waiting. Let's not forget that the LSAP and the RBNZ talking up the potential for a negative OCR have already resulted in material falls in lending and deposit interest rates, which have relaxed financial conditions.

RBNZ to stick to the script and keep its options open

Elsewhere, we expect the November MPS to reaffirm key messages:

- The RBNZ is expected to maintain the cap of $100bn by June 2022 for its Large-Scale Asset Purchase (LSAP) programme. Cumulative purchases are approaching $40bn, with the 60% indemnity limit agreed with the Finance Minister more of a constraint thus far. The stronger than expected fiscal position and solid demand for syndicated issues has resulted in a slowing pace of government bond tenders. This, in turn, has enabled the RBNZ to scale down its weekly LSAP programme, and we expect the RBNZ to be flexible in altering asset purchases in the coming months so as to cap yields.
- The Bank will likely stick to its forward guidance that the OCR will be held at 0.25% until March next year. Any shift to this would likely be an unwelcome distraction for markets.
- The RBNZ to reiterate that further policy stimulus will likely be needed. The path of least regrets is still to do too much too soon rather than too little too late. The RBNZ will be mindful of the actions of other central banks (notably the Reserve Bank of Australia, which now has a cash rate of just 0.1%) and will not want to get out of synch and put a rocket under the NZD.
- Other options are likely to remain under consideration, including a lower or negative OCR, with purchases of foreign assets and interest rate swaps also under consideration. In the RBNZ's view, these policy measures would likely add to the potency of the packages already being announced.
- The message for banks will be to prepare for a negative OCR. We expect that the policy assessment will continue the line in the September Monetary Policy Review that further progress was being made in deploying additional monetary instruments. Of note will be signalling that the RBNZ has been making progress on setting up the financial system to be operationally ready for a negative OCR, given that the December 1 deadline imposed by the RBNZ on banks is less than a month away.

RBNZ to acknowledge brighter domestic signs but to focus on the medium term

The RBNZ will acknowledge the brighter signs of late but will remain cautious, noting the high degree of uncertainty and risk that the improvements seen can stall. Courtesy of extraordinary fiscal and monetary policy stimulus, the NZ economy looks to be rebounding from the record Q2 fall in activity, with business and consumer sentiment now above earlier 2020 troughs. Moreover, the economy and labour market are not looking as dire as they did a few months ago (Q3 unemployment rate of 5.3% versus the 7.0% Q3 August MPS pick and 8.1% Q4 forecast). Returns for commodity exporters have been resilient. The RBNZ will nonetheless be looking warily at the NZD, hoping its recent climb against the USD runs out of puff.

The RBNZ will seek to downplay recent housing market buoyancy. The RBNZ would have expected the housing market to respond to record low mortgage interest rates and the removal of LVR restrictions but it may have been a tad surprised with how robust things have turned out**.** Still, this represents a much better outcome than if the housing market was tanking and demonstrates the potency of monetary policy settings. The RBNZ would want the housing market on more of an even keel, and may remind borrowers that property is not a one-way bet, that some of the tailwinds (including net immigration) are set to recede, and that the Bank has the tools to slow the market if needed. If this reminder and a quiet word to the banks does not do the trick, the next step will likely be the re-imposition of loan-to-value restrictions for housing investors, with the risk this comes in sooner than the 12 month timeframe that was signalled at the end of April this year.

Importantly, the RBNZ will flag more medium-term risks, which are still tilted to the downside. The global outlook has arguably worsened and the COVID-19 situation in Europe and the US is troubling despite some improvement in recent data. The headwind being generated by this global pandemic also looks to be longer-lasting than seemed the case a few months ago. NZ border restrictions look set to remain for a while yet, turning off the tap of two key supports to the NZ economy, net immigration inflows and inbound tourism (circa 5% of GDP). What's more, the headwind from the closed border is likely to intensify in the NZ summer months and remain sizeable beyond then. The degree of fiscal policy support looks set to wane, placing more of the onus on monetary policy settings. Job numbers are declining, and spare capacity within the labour force is pronounced. Inflation and inflation drivers look to be subpar and are likely to get weaker before they get stronger. All up, the NZ economy is still climbing out of a deep hole, but the pace of recovery could slow, with entrenched low inflation and with heaps of spare capacity in the labour market and economy in general for a while to come. In short, the RBNZ will have more work to do.

With less focus on the published projections

The focus for markets will be on the published OCR track. We expect the RBNZ to stick to recent practice and not publish the OCR beyond the March 2021 quarter. Its forecast track for the unconstrained OCR track will likely be published, highlighting the preference for the RBNZ to increase policy accommodation.

Other published projections are unlikely to receive as much attention, with the extraordinary swings in the dataflow around the lockdown periods and heightened level of uncertainty diminishing the value of point forecasts. Nevertheless, we do expect the brighter signs we have observed of late to translate into a modest upward revision of the Bank's near-term forecasts for economic activity and the labour market. Projections beyond then are expected to be subpar given the medium-term headwinds to the outlook. The forecasts will also highlight the highly uneven nature of the current rebound, illustrate the conditional nature of the outlook (including when COVID-19 Alert Level restrictions will be removed) and the inherent uncertainty dominating the projections.

Market implications and our OCR view

Market pricing has about 30bps of OCR cuts priced in by April 2021, with the OCR set to end 2021 just under -0.25%. It would take a gloomy RBNZ assessment and a signal that a negative OCR is very much in the RBNZ's policy crosshairs to see the market rally, pushing yields and the NZD down. This is not outside of the realms of possibility. Conversely, yields could rise and the NZD move higher if the market detects more signs of optimism from the RBNZ assessment or it obtains greater confidence that the FLP will provide a material relaxation in financial conditions and reduce the need for a lower OCR. We expect the RBNZ will be careful in its messaging to reduce the likelihood of this occurring.

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