Economic Note

RBNZ November Monetary Policy Statement Review

11 November 2020

Being non-negative

- The RBNZ's economic assessment was as expected: resilient in the short term, but plenty of risks still lingering.
- The RBNZ will implement its Funding for Lending Programme in December, with details to come soon.
- We have nonetheless changed our view on the OCR outlook to expect no further OCR cuts – though the direction of risk will remain firmly in that direction.

We have changed our outlook for the OCR. We no longer expect further OCR cuts in the new year, but that's conditional on the Funding for Lending Programme (FLP) being effective in lowering interest rates in the economy. The economy still needs stimulus, but the FLP may now be enough. Our previous forecast of a 75bp OCR cut in April to -0.5% looks too big and too soon.

News of late shows **the NZ economy has held up surprisingly well in the near term**. The household sector, in particular, is on a tear. We still have question marks about how long this momentum can be sustained and how much is a short-term sugar rush. However, it is clear that fiscal and monetary stimulus is already having a marked effect. And development of an effective vaccine is a strong signal that – eventually – borders will indeed open up and economically-damaging social distancing restrictions can be eased.

The risks are still skewed towards a lower OCR than the current 0.25%. If the FLP turns out to be a damp squib, then the RBNZ may need to resort to cutting the OCR to get the desired impact on bank lending rates. Furthermore, there is still a lot that can go wrong yet, such as a serious community outbreak in NZ or risk of more marked global economic impacts from the current renewed wave of COVID infections in Europe and the US. And, vaccine hopes could end up being dashed.

But for now, we expect the RBNZ will implement the FLP, and reassess developments next year. The effectiveness of the FLP in lowering NZ interest rates, the extent to which the current household-led uptick can sustain itself, how comfortable the RBNZ is with managing any financial stability risks from the booming housing market will all matter for whether the RBNZ sees the need to cut the OCR any further.

New OCR view: a non-negative OCR

We now expect the RBNZ will get through the COVID-19 crisis without needing to cut the OCR further. But we emphasise the risks in the current environment all lie to OCR cut(s), dependent on how effective the FLP is and also on how much further stimulus the RBNZ judges the economy needs. In the November Monetary Policy Statement (MPS), the RBNZ went to great pains to keep the door open to potential OCR cuts. But, when reassessing next year, we now see the RBNZ keeping the OCR steady and its limited OCR powder dry for any marked turns to the worst.

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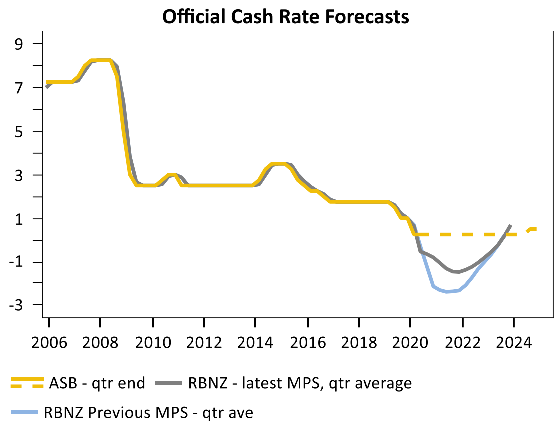
Some more stimulus needed, hence the Funding for Lending Programme

The economy does need more stimulus, or at the very least for the current degree of stimulus to be maintained through keeping a lid on bank funding costs. The RBNZ has continued to express its desire to get interest rates within the economy even lower, in order to do its part in hastening the economic recovery. The pandemic will be with us for some time yet, and the NZ economy is not likely to return to its pre-COVID size until the second half of 2022, roughly two years away.



Source: Macrobond, ASB

The Funding for Lending Programme is one way for the RBNZ to keep the lid on interest rates, through providing a backstop of cheap funding and enabling banks to cut term deposit rates with less fear of the consequences of any outflow of deposit funding. The other viable option is lowering the OCR from its current 0.25% rate, which we think the RBNZ will hold in reserve.

But potentially not too much more stimulus

Recent events had us question exactly how much more stimulus the RBNZ is likely to deliver. When we moved in August to forecast a -0.5% OCR (75bp down from the current rate), the domestic situation did not look as strong as it is now. Since then, Q2 GDP has held up better than expected, and job losses have been small in comparison to initial pandemic predictions. Households are in very good heart: the housing market has taken off like a rocket in response to lower mortgage rates and retail spending has been astonishingly robust. This morning's announcement by the RBNZ that it will consult over reintroducing the Loan to Value Ratio (LVR) restrictions on mortgages from March 1 highlights that monetary stimulus to date has been far more effective amongst households than contemplated.

There is a light shining at the end of the COVID tunnel, and it is the reflection off a vaccination needle. This week's news of Pfizer's successful vaccine development is significant in that it puts down a marker for the beginning of the end of the pandemic, along with the travel and social restrictions we have seen. It will still take some time for this vaccine (and others) to enable low-risk travel and build up herd immunity, but now there is some greater certainty about overcoming COVID-19. Nevertheless, the global outlook for the next little while remains dogged by renewed social restrictions in Europe and a spiralling pandemic in the US, against which the incoming president may lean harder against. It will get worse before it gets better.

It is business credit where monetary policy has been less effective. That appears more a reluctance to borrow – particularly while businesses have boosted their cash deposits at bank – than a lack of supply or a cost issue. But the RBNZ increasingly needs to balance further stimulating the credit-hungry household sector against encouraging business borrowing and hastening that part of the economic recovery. Sustainability of the recovery also maters, and overdoing the stimulus risks turning the household-led recovery into a soufflé.

Some FLP details provided, more to come

Today the RBNZ unveiled some more information around its Funding for Lending Programme (FLP) but remained light on specific details. These are due to be released prior to the launch of the scheme in early December.

The RBNZ reiterated that the goal of the FLP would be to lower funding costs and encourage declines in these costs to be passed through to lower household and business borrowing costs.

This is via three channels:

- the provision of cheaper FLP funding to finance lending by eligible participants,
- dampening interest rates on other forms of funding (particularly term deposits),
- boosting credit supply via the provision of another funding stream.

If all of these three channels work as desired, the potency of the FLP (to bring borrowing costs lower) will be significantly enhanced. Term deposit rates will also be lower as a result.

The RBNZ unveiled key design features of the scheme, including the cost of funds, size of programme, term of lending, how long the programme is available for, eligible collateral, and specific incentive mechanisms. These features were guided by the RBNZ's principles for alternative monetary policy, including effectiveness, efficiency, financial system soundness, public balance sheet risk, and operational readiness. Appendix 1 (page 4) provides a high-level comparison of the RBNZ FLP with an equivalent scheme in Australia, the RBA Term Funding Facility (TFF).

Our take on FLP

It is still early days, and we need to see the full details to ascertain what the full impacts of the FLP might be.
It is clear, however, that the RBNZ has pinned its colours to the mast in noting that the aim of the FLP was to support the economy via lowering borrowing costs for businesses and households. This is the metric against which the effectiveness of the FLP will be judged rather than the direct take-up of the scheme. We concur.

While the FLP is comparatively modest (up to 6% of bank lending), the intent of the FLP is to get considerably more bang for policy buck. The RBNZ has been explicit in speculating that the FLP may help lower system-wide funding costs, and benefit all financial institutions, rather than those utilising FLP funds.

The RBNZ has thrown down the gauntlet to banks, with the message being that customer lending rates will need to come down further. What's more, the RBNZ made the comment it is not just the rates for programme participants that it would like to see fall.

We note that the RBNZ has kept the FLP as simple and open as possible to maximise the effectiveness of the scheme. There was a sweetener, tying the provision of more funding from the FLP to increased lending, similar to schemes in place overseas. However, the FLP differs from comparable schemes overseas, providing no specific incentives to business lending. This may reflect the fact that a lot of SME lending in NZ is secured on housing, so curbs on housing lending may be counter-productive in supporting small businesses. Furthermore, it will be up to banks (and government) rather than the RBNZ to decide where the funds should go. **This is the RBNZ putting considerable onus on the banks to do the right thing for the economy, in effectively allocating credit.**

The FLP also increases the options available to the RBNZ in terms of **OCR settings. We note having an effective FLP in place would also help to mitigate some of the pitfalls of negative interest rates,** including the potential for contractionary impacts on credit supply and bank profitability.

The RBNZ's economic assessment is stronger

The **RBNZ has revised up its economic forecasts**, prompted by recent developments and noted that developments, both domestically and internationally (particularly China), have been more positive than expected.

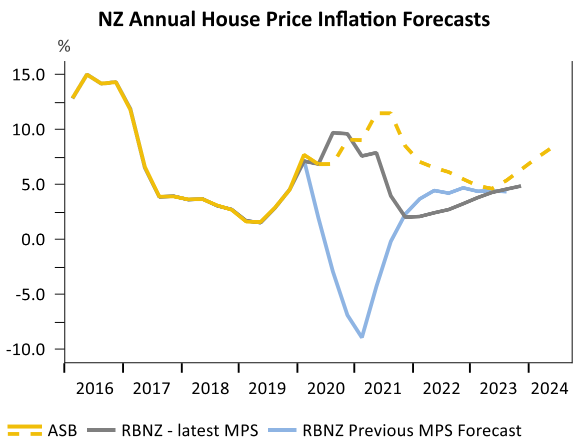
Interestingly, the **RBNZ noted that the impact of global economic weakness on the NZ economy has been less than expected,** with commodity and asset prices remaining firm. Indeed, the RBNZ commented further that resilient demand from China and robust global demand for food products have supported NZ goods exports in the near term. At the August MPS, the RBNZ had placed a large degree of emphasis on global downside risks vs. NZ domestic resilience. While it the downside risks to the global economic outlook remain and will continue to concern the RBNZ, the November MPS suggests a subtle shift in the RBNZ's focus back towards domestic economic resilience. In particular, **the RBNZ noted a number of times throughout the MPS that the "wealth effect" from rising house prices could stimulate NZ domestic spending more than expected**.

The RBNZ's economic forecasts are broadly consistent with our own, albeit it some minor timing differences. As a result, the RBNZ's estimate of how much stimulus is required to support the economy (its unrestrained Official Cash Rate forecast) has been revised significantly, with a low of -1.5% in November vs. -2.4% in August.

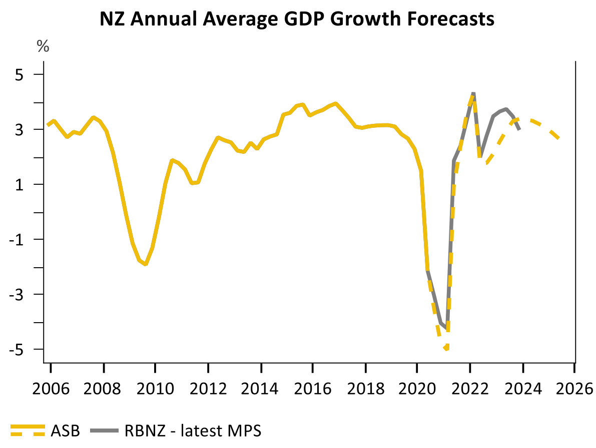
The key changes include:

- The **RBNZ has revised its labour market forecasts considerably** with a lower peak in the unemployment rate (unemployment rate peaks at 6.4% mid next year, vs 8.1% peak forecast at the August MPS).
- **House price growth is expected to be stronger** (peaking at 10% annual growth by the end of the year, vs. ASB's forecast of 12% annual growth by mid-next year).

- **Inflation pressures to hold up**, with annual CPI inflation to mostly stay inside the RBNZ's 1-3% target band, albeit at the bottom of this range.



Source: Macrobond, ASB



Source: Macrobond, ASB

Appendix - Table 1: Features of funding for lending schemes in Australia and NZ

Features	**Australia** **Term Funding Facility (TFF)**	**NZ** **Funding for Lending Programme (FLP)**
Established	March 2020 and subsequently extended on September and amended in November.	November 2020.
Dates	From April 2020 until Sep 2020 for initial facility. From Oct 2020 to June 2021 for supplementary facility	From December 2020. Initial allocation of 18-months followed by an extra 6 months for additional allocation.
Eligibility	Authorised deposit-taking institutions (ADIs) in Australia that extend credit (130+ in Australia)	Authorised institutions.
Interest Rate	0.10%. Payable on maturity of facility or when TFF is terminated. ADIs who fixed earlier at 0.25% have option of terminating existing TFF and to enter new 0.1% TFF.	Floating rate at prevailing OCR (and any point in time).
Size	Initial allowance of 3% of participants total credit as at Sep 30 (AUD575bn in total). A supplementary allowance is set at 2% of total credit outstanding. Also added is an additional allowance based on a 1 for 1 increase in business credit, with heavier weighting (5:1) in favour of SME loans. Estimated to be at least 7% of total bank credit (up to AUD200bn out of roughly AUD3 trillion).	Initial allocation of 4% of each eligible participant's total loans and advances to New Zealand households, private non-financial businesses, and non-profit institutions serving households ('eligible loans'). A conditional additional allocation of 2% of eligible loans will then be made available. Total size of 6% of eligible loans (around $29bn). Banks or govt to target specific sectors.
Term	3 years for each drawing by an ADI.	3 years.
Collateral	ADI must nominate 'Eligible Securities' that it wishes to sell under repo. This consists of all securities currently eligible for domestic market operations.	High-quality collateral – e.g. New Zealand government bonds, Kauri bonds, and Internal Residential Mortgage- Backed Securities (I-RMBS).
Conditions/ Incentives	ADIs have access to additional low-cost funding if they expand their lending to businesses. The scheme encourages lending to all businesses, although the incentives are stronger for small and medium-sized enterprises (SMEs).	Additional allocation can only be accessed when participants increase their provision of credit to the economy. The FLP provides 50 cents of funding for every $1 increase in their stock of eligible loans. The additional allocation is capped at a limit of 2% of the participant's eligible loans at launch of the FLP.

Source: RBA, RBNZ, ASB

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