Economic Bulletin.

1 December 2020

Update to Westpac's OCR and exchange rate forecasts, Dec 2020.

- We are now forecasting 25bps OCR cuts in May and August next year, taking the OCR to -0.25%.
- Previously we predicted that the OCR would reach -0.5% by August.
- We expect NZD/USD will reach 74 cents by the middle of next year.
- Our analysis clearly shows that further monetary stimulus will be needed to stabilise inflation.
- But the RBNZ is now expected to deliver that stimulus more gradually out of concern for house prices.
- The consequences will be lower inflation and a higher exchange rate.
- The RBNZ is most likely to deliver stimulus via OCR cuts, but foreign bond buying or increasing the size of the FLP are alternative possibilities.

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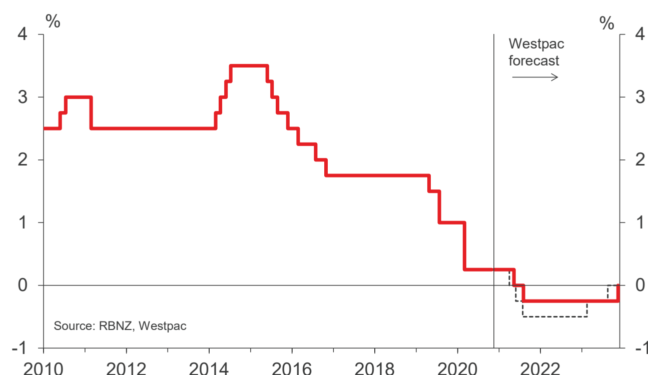
Last week's exchange of letters between the Minister of Finance and the Governor of the Reserve Bank was important. As mentioned in our bulletin last week, the exchange of letters caused us to put our OCR forecast under review.[1] If the Minister requires the central bank to avoid unnecessary instability in house prices when setting monetary policy, then the RBNZ is likely to become more cautious about further easing.

However, central banks cannot cheat nature. They must deliver the interest rates that the economy requires to balance inflation and employment, sooner or later. The key choice that a central bank makes is *how aggressively* to move interest rates, and therefore *how quickly* inflation and employment will return to target.

We now expect the RBNZ will choose a slower return to the inflation and employment targets, via more gradual interest rate adjustments. We are forecasting that the RBNZ will reduce the OCR twice next year, and the cuts will begin in May (previously three cuts beginning in April).

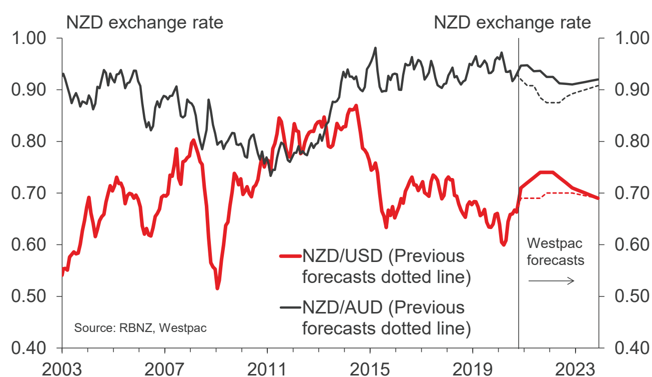
Westpac OCR forecast



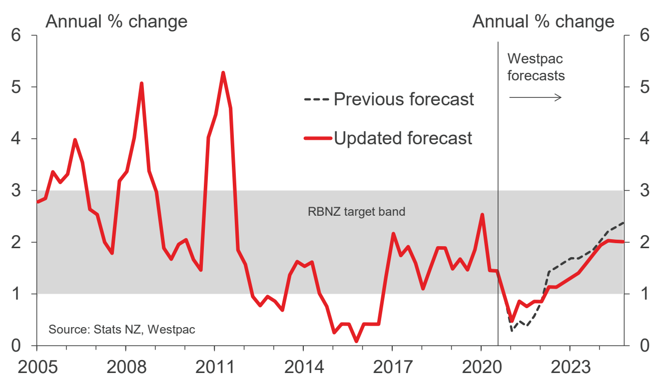
1 https://www.westpac.co.nz/assets/Business/Economic-Updates/2020/Bulletins-2020/RBNZ-commentary-Nov-2020-Westpac-NZ.pdf

This less-aggressive approach to interest rate cuts will also mean a higher exchange rate. Financial markets are already marking the Kiwi higher on the back of positive vaccine news, and the rise and rise of risk-sensitive currencies like the NZD is expected to continue. We are now forecasting that NZD/USD will rise to 74 cents by the middle of the year. That is mostly due to market dynamics, but the change in our OCR forecast is also a contributing factor. We now forecast that NZD/AUD will linger in the low-90s rather than dropping below 90 cents.

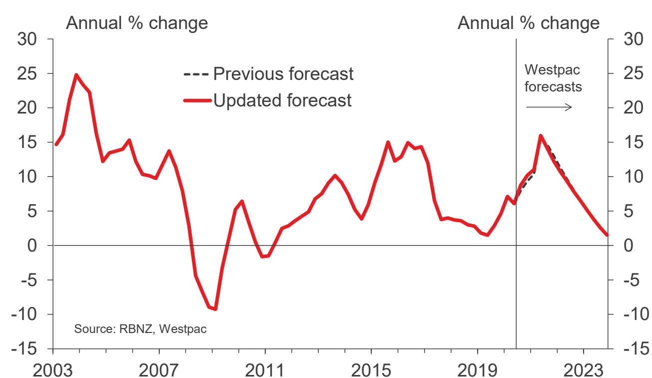
Westpac exchange rate forecasts



Westpac inflation forecast



Westpac house price forecast



The consequence of slower OCR cuts and a higher exchange rate will be that inflation remains lower for longer. Our updated forecast has inflation remaining below 1% until mid-2022, and reaching the 2% target focus only in mid-2024 (we have also upgraded our near-term inflation forecast in line with recent data). That will be just barely acceptable to the RBNZ, but will be justified on the basis of avoiding instability in the housing market. We have lowered our 2021 house price forecast, but only slightly, to 12.2% down from 13% (the new forecast balances recent stronger housing market data against the impact of slower interest rate reductions, hence only a small change in total).

Financial markets are too hawkish.

Financial markets are now priced for barely any move in the OCR next year. We disagree with that.

We have run an assessment of what would happen if the RBNZ kept monetary settings unchanged next year. Inflation would be significantly lower than the forecast charted above, and would remain below 2% for much longer. Inflation expectations would drop even further, raising the risk of deflation. Unemployment would remain higher for longer. And the exchange rate would rise into the mid-to-high-70s against the USD. We judge that these outcomes would be unacceptable to the RBNZ. The only silver lining would be a slower and more drawn-out episode of house price inflation, but that wouldn't be enough to compensate for the extra unemployment and risk of deflation.

Fundamentals at play.

We remain of the view that the RBNZ must deliver more monetary stimulus next year in order to stabilise inflation and employment. There remains a 5%-of-GDP sized hole in economic demand, in the shape of the devastated travel, international education and tourism industries. Such a huge dearth of demand was always going to be a very large drag on inflation – which was too low even before Covid struck.

True, there has been a swathe of strong data recently, including booming retail sales, an upgrade to our near-term inflation forecast, and a further upside surprise on the housing market relative to our already-bullish forecasts. These positive data surprises are important for the inflation and employment outlooks, and are the key reason that we now forecast less monetary stimulus in total.

But there have also been inflation-suppressing developments recently. Principally, the exchange rate is shooting much higher on the back of a risk-on sentiment developing around financial markets. Also, financial markets have marked swap rates 20-30 basis points higher in recent weeks. That will prevent fixed mortgage rates from falling in the way the RBNZ intended when it introduced its Funding for Lending Programme. The RBNZ will be very disappointed if it arrives at the February *Monetary Policy Statement* with mortgage rates no lower than they were in November. And we fear that is a very real possibility.

Finally, the RBNZ's quantitative easing programme (LSAP) is going to start running low on fuel next year. We expect the Treasury will reduce the bond issuance programme at

the Half-Year Economic and Fiscal Update later this month, meaning fewer bonds available for the RBNZ to buy. Therefore the RBNZ will have to reduce the pace at which it buys government bonds. And if it wants to avoid a taper-tantrum, it will have to replace the LSAP with some other form of monetary stimulus.

Choice of tools.

We have long been of the view that reducing the OCR below zero would be the RBNZ's unconventional monetary policy tool of choice, after the expiry of the one-year commitment to keep the OCR at 0.25%. We still think that a negative OCR is more likely than any other tool, but other options now look like more of a possibility.

With the exchange rate set to rise much higher than we previously anticipated, adding foreign bonds to the LSAP (which would directly reduce the exchange rate) is starting to look more like a sensible alternative option. The other advantage is that foreign bond purchases don't have an obvious "front page" link to the housing market.

Another alternative option would be for the RBNZ to expand the FLP further. The advantage would be that the FLP is already an established tool, so there is less risk of unanticipated consequences. But we are not convinced that increasing the size of the FLP would have much effect on interest rates – it is more the presence of any FLP that is going to cause term deposit rates and wholesale funding rates to come down, thereby reducing bank funding costs.

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