Economic Bulletin.

6 August 2020

Stay on target – Preview of RBNZ August 2020 Monetary Policy Statement.

- The RBNZ will aim to keep the stance of monetary policy unchanged at next week's MPS.
- The OCR will remain at 0.25%, and the RBNZ will commit to keeping it there until at least March 2021.
- The RBNZ may keep the LSAP at $60bn to May 2021, without any guidance on what will happen beyond then.
- An *equivalent* alternative would be to extend the LSAP to August 2021 and lift the cap to $70bn.
- We expect that the LSAP will last for two years and will eventually total $90bn (previously $100bn).
- We expect that the OCR will fall to -0.5% in April next year, because there is a need for more monetary stimulus than the LSAP alone can provide.

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When the Reserve Bank releases its Monetary Policy Statement on Wednesday next week, we expect that it will keep the overall stance of monetary policy unchanged. There have been both positive and negative developments recently, and the overall balance has been roughly neutral so far as monetary policy is concerned.

The RBNZ is currently holding the OCR at 0.25%, and is buying about $0.93bn worth of bonds per week in an effort to supress longer term interest rates. We expect next Wednesday's primary message to be that both measures will continue for the foreseeable future.

A subsidiary message will be that the Reserve Bank has options if more vigorous monetary stimulus is required in the future, for example if COVID-19 returns to our shores. The Reserve Bank has said that it will provide more details on the possible options of dropping the OCR below zero, expanding the LSAP by buying foreign government bonds, or making direct loans to banks. This will be an articulation of possible future options, not a signal of impending action.

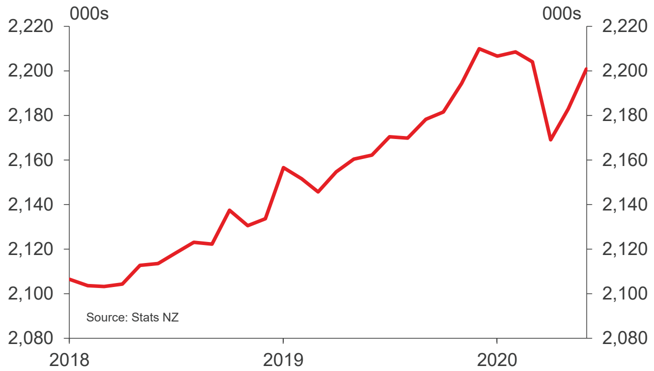
Our own assessment is that the Reserve Bank will have to provide a great deal of monetary stimulus for an extended period to achieve its targets – probably more, and for longer, than the RBNZ itself currently expects. Consequently, over the coming year we expect to see the RBNZ progressively extend the timeframe of the Large Scale Asset Purchase Programme (LSAP), while also expanding the cap to an eventual $90bn. We also expect the RBNZ to lower the OCR to -0.5% in April next year. However, this is all something for future Monetary Policy Statements – next week we are expecting a very straight bat from the central bank.

Why won't the stance of monetary policy change, when the data have been strong?

In our assessment, the outlook for medium-term inflation has not changed since the May MPS was published. True, the economy has stunned everyone with its resilience recently, and on its own this suggests less need for monetary stimulus. But there have also been counterbalancing developments that are negative for the medium-term inflation outlook. The RBNZ is likely to reach the same conclusion, and therefore will not change the stance of monetary policy.

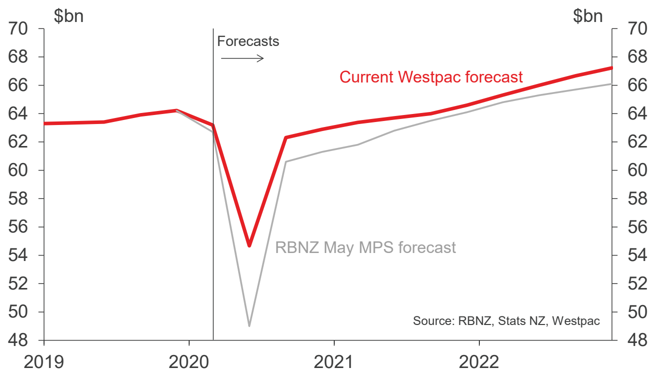
There has been a swathe of better-than-expected economic data recently. Consumer spending and various gauges of economic activity are now similar to year-ago levels. The decline in employment has, to date, been much smaller than forecast, and unemployment has remained far lower than expected. The housing market has held up better than anticipated. And export commodity prices haven't fallen at all, whereas we expected the weak global economy would spark a downturn for farmers.

Monthly Employment Indicator filled jobs



The surprising strength of the economy is particularly important for the Reserve Bank, given than its economic forecasts were so much more pessimistic than ours in the first place.

Forecasts of real GDP level



The other recent developments have been positive for the medium-term inflation outlook are higher-than-expected June quarter inflation, and a big drop in mortgage rates. The latter will reassure the RBNZ that monetary policy is working normally.

But there are equal and opposite negatives to counterbalance the above positives, leaving the overall outlook for medium-term inflation unchanged relative to the May MPS.

First and foremost, it is becoming obvious that New Zealand's borders are going to stay more-or-less closed for longer than previously anticipated. This means New Zealand will have virtually no revenue from international tourism for significantly longer. Which in turn means that although the economic hit from COVID has been less severe, it could be longer-lasting than previously thought.

The second "negative" for the RBNZ is the exchange rate. Back in May the RBNZ assumed that the exchange rate would fall from its already-low level, and would stay low for years. That was always wishful thinking. Instead of falling, the TWI has risen to 8% above the RBNZ's May forecast, and is showing no sign of falling.

Third, the Government has reacted to the surprising resilience of the economy by holding back $14bn worth of the $50bn fiscal stimulus package. From the RBNZ's point of view, this will cancel out some of the recent upside surprise on the economy – less fiscal stimulus, on its own, means a weaker economic outlook.

Putting all of this together, we would say there have been both unders and overs as far as the RBNZ is concerned. Given the massive uncertainties inherent in any forecast at present, there really isn't a compelling reason to change the stance of monetary policy.

How will the RBNZ signal "unchanged monetary policy"?

The RBNZ is sure to leave the OCR at 0.25%, and will issue a reminder that it is committed to keeping the OCR at that level until March 2021.

At present, the RBNZ's official stance is that it will buy a cumulative total of $60bn worth of NZ Government Bonds (NZGB) and local government debt between the start date of the Large Scale Asset Purchase Programme (LSAP) and May 2021. This translates to a weekly pace of about $900m worth of bonds per week.

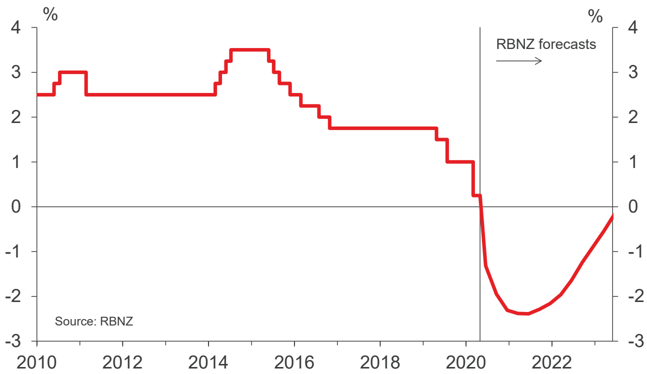
The RBNZ may simply to restate that it will buy $60bn of bonds by May 2021. This would be simple, but it would provide no guidance to markets about what the RBNZ expects will happen after May 2021.

The alternative option is for the RBNZ to state that it intends to buy up to $70bn between the start of the LSAP and August 2021. $70bn is sufficient for the RBNZ to continue buying roughly $900m of bonds per week for this extended period. In that sense, the two announcements would be equivalent – they both imply the same pace of bond buying for the foreseeable future. (The August 2021 date makes sense because it is one year from now, and previous LSAP announcements have referred to the year ahead.)

Which option the RBNZ chooses is a matter of their preferences – the two options are equivalent so far as interest rates are concerned. If we had to choose, we would say that the $60bn by May 2021 is slightly more likely. The RBNZ can afford to kick the can down the road, and does not need to make a decision about what it is doing beyond May 2021. However, we do note that at some point the RBNZ will have to provide guidance about the future of the LSAP beyond May 2021, and when it does so it will lift the cap on the LSAP.

One key communication tool that the RBNZ used in the May MPS was its "unconstrained OCR forecast." This is the OCR forecast that drops out of the RBNZ's modelling, and it gives an indication of how much monetary stimulus is required overall. In May, the unconstrained OCR forecast implied that the RBNZ needed to provide monetary stimulus equivalent to an OCR of -2%, over a period of two years. We think the unconstrained OCR forecast in the August MPS will be similar.

RBNZ unconstrained OCR forecast, May MPS

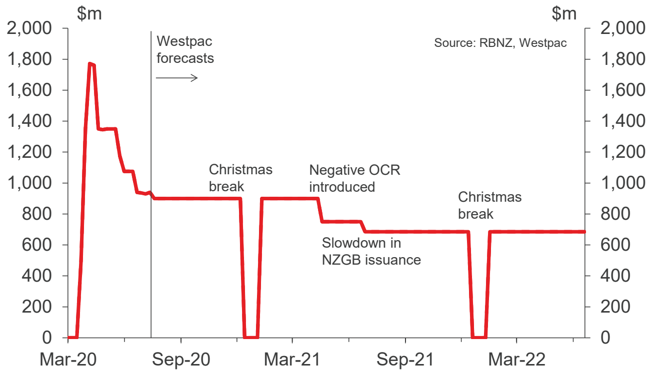


The longer term outlook for monetary policy.

We expect that the RBNZ will continue to buy NZGBs under the LSAP for around two years, and will also reduce the OCR to -0.5% in April 2021.

The RBNZ plans to by $60bn of bonds by May 2021. Clearly, extending the LSAP beyond that date will require the RBNZ to lift the cap. We expect that the cap will eventually be $90bn. That is lower than our previous forecast of a $100bn cap, because we now expect the RBNZ to buy bonds at a slower weekly pace than we previously forecast. Previously, the RBNZ was buying bonds at more than $1bn per week. But the RBNZ has already managed to slow the weekly pace to just above $0.9bn without suffering an unwanted increase in interest rates, and there will be two more opportunities to slow the pace again next year: (1) when a negative OCR is introduced; and (2) when the NZ Government slows the pace of bond issuance because the budget deficit is shrinking.[1] If the weekly pace of bond buying is slower than we previously thought, then it follows that the total size of the programme will also be smaller.

Westpac forecast of weekly RBNZ bond purchases



This is fortunate, because it is now also looking like there is less *scope* for the RBNZ to expand the LSAP. The Government has announced that it is holding back $14bn of previously-planned expenditure, and the stronger-than-expected economy means that Government revenue is on track to far exceed the Treasury's pessimistic forecasts. With more revenue and less expenditure, there will be less need for the Government to issue debt. We think the Debt Management Office will announce that its bond issuance programme is being reduced to around $50bn this fiscal year, and $35bn next (previously $60bn and $40bn). The RBNZ needs to leave enough bonds in the private sector to ensure market liquidity, so if fewer bonds are issued, the RBNZ has less scope to buy. Our new forecasts of NZGB issuance and LSAP purchases imply that the RBNZ will eventually own 54% of the NZGB market, which is about the maximum.

Westpac forecasts of bond issuance and LSAP

Year to June	NZGB issuance		LSAP		
	Year total	Average weekly pace*	Average weekly pace*	Cumulative total, end of June year	% of NZGBs in RBNZ ownership, end of year
2021	$50bn	$1042	$871	$58bn	43.1%
2022	$35bn	$680	$685	$91bn	54.3%

*Excluding four week break over Christmas

The above discussion illustrates that the RBNZ is likely to max out its ability to provide monetary stimulus by buying NZGBs under the LSAP. But our analysis suggests that further monetary stimulus will be required. Before COVID-19 struck, inflation was already low. The COVID shock will massively reduce aggregate demand in the economy, which in turn will cause inflation to drop below 1% by the middle of next year. A great deal of monetary and fiscal stimulus will be required to dig the economy, and inflation, out of such a deep hole.

1 A slowdown in the pace of NZGB issuance would tend to reduce the interest rate on NZGBs by reducing supply in the market. The RBNZ could counterbalance this by reducing the pace of NZGB purchases under the LSAP. We estimate that the LSAP has about twice the impact on interest rates as the pace of NZGB issuance. This implies that the LSAP can slow by about half as much as issuance while keeping interest rates unchanged.

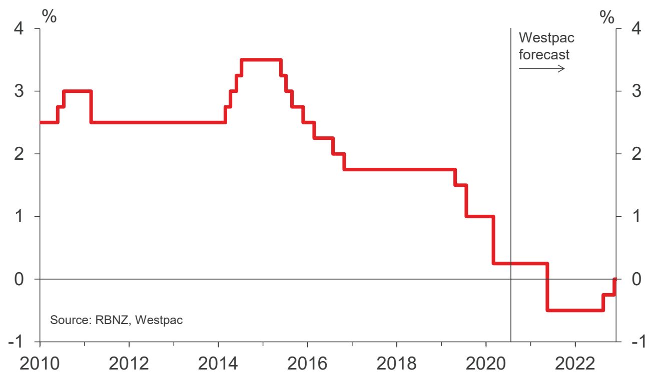
Consequently, we have concluded that the RBNZ will cut the OCR to -0.5% in April next year (which is the first opportunity after its commitment to keep the OCR at 0.25% expires).

The RBNZ has a menu of tools it could, in theory, use to provide the required monetary stimulus. However, the other two main items on this menu are less suited to the current situation than a negative OCR:

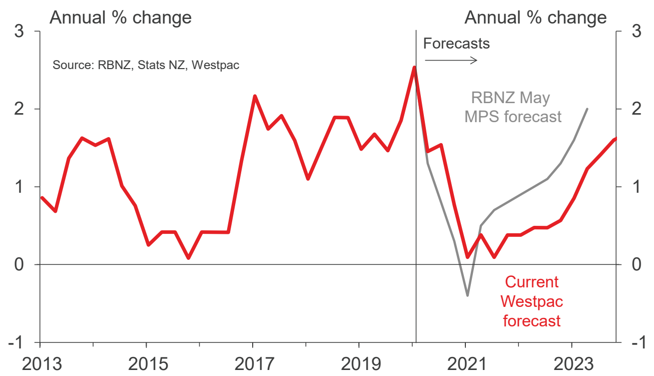
- The RBNZ could start buying foreign bonds under the LSAP. But this option is best reserved for times when the exchange rate is unusually high. Buying foreign government bonds when the exchange rate is below average, as it is today, risks the RBNZ losing money.
- Lending money directly to banks is another option. But this policy is best suited to supporting the banking system during a banking crisis. New Zealand's banks are currently in good health, so this would seem like a solution in need of a problem.

We expect that the OCR will remain at -0.5% until late 2022, before normalising very gradually.

Westpac OCR forecast



Inflation forecasts



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Past performance is not a reliable indicator of future performance. The forecasts given in this document are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

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