Economic Bulletin.

5 November 2020

Out of a tight spot – Preview of RBNZ November 2020 Monetary Policy Statement.

- We expect next week's MPS will be less dovish than markets expect.
- The key message will be that the RBNZ intends to keep interest rates low for a prolonged period, rather than pushing rates lower.
- We expect a Funding for Lending Programme (FLP) will be announced. It will be small and targeted at business lending.
- We now expect 25bps OCR cuts in April, May and August next year (previously one 75bps cut in April).
- As the FLP and negative OCR take effect, the pace of LSAP bond purchases will be gradually reduced in a switch of monetary tools.
- We expect no official change to the LSAP next week. Next year we expect the LSAP to be stretched to $100bn over three years (currently $100bn over two).
- Next year, we expect that the RBNZ will reintroduce LVR restrictions targeted at property investors.

Dominick Stephens, Chief Economist
+64 9 336 5671

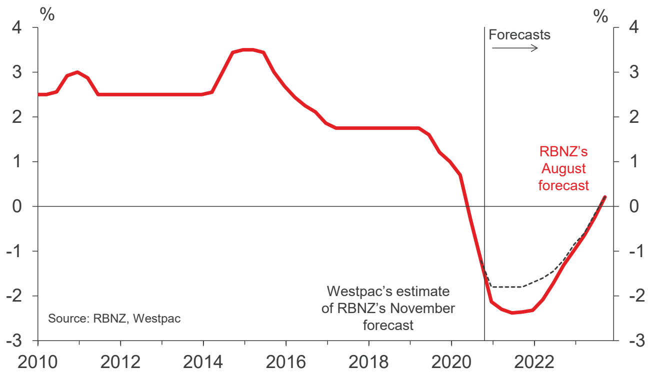
The situation facing the Reserve Bank has changed. The economy has proven far more resilient to Covid-19 than anticipated. The unemployment rate is only 5.3%, not 7% as the RBNZ anticipated. And most importantly, house price inflation will be around 9% this year, whereas the RBNZ was forecasting -7% as recently as August. A sixteen percentage point surprise on the level of house prices is unprecedented, and absolutely must cause the RBNZ to lift its assessment of medium-term inflation and employment. (These positive surprises far outweigh the recent negatives, which are that inflation proved lower than anticipated and the border seems likely to stay closed even longer than anticipated.)

Consequently, we anticipate a change in tone from the RBNZ. The RBNZ will still emphasise the downside risks facing the economy. But whereas back in August the RBNZ said that *more* monetary stimulus was needed, we think that the RBNZ will now say that it intends to provide stimulus for an *extended period*. The RBNZ will say it needs to keep its foot on the accelerator for a long period, rather than saying it needs to press down harder. Actually, we have already seen shades of this change of tone – the headline on the September Monetary Policy Review was "Prolonged Monetary Support Necessary", compared to headlines earlier in the year that advertised increases in monetary support.

Consistent with this change of tone, we expect that the RBNZ will lift its Unconstrained OCR forecast. In the past, the RBNZ estimated that monetary stimulus equivalent to an OCR of -2.4% would be required. We expect that the new Unconstrained OCR forecast will be about -1.8%. That is more moderate, but it is still a massive monetary stimulus, for a very long period.

The medium-term outlook may be looking better for the RBNZ, but it still faces two big conundrums. We think that the solution will be to gradually *switch* the tools for providing monetary stimulus. We expect the RBNZ will introduce a business-oriented Funding for Lending Programme next week and will cut the OCR below zero next year, while simultaneously slowing the pace of bond purchases under the Long Term Asset Purchase Programme (LSAP).

RBNZ Unconstrained Official Cash Rate forecast

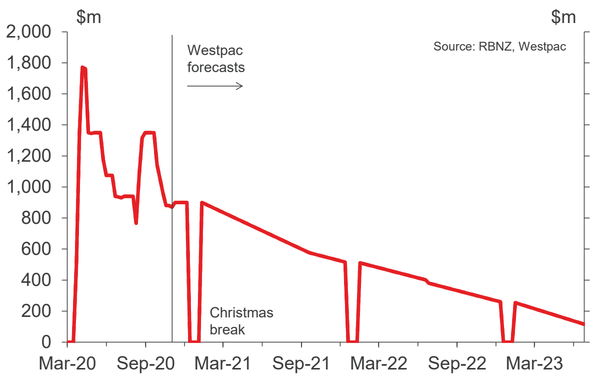


Conundrum 1: The RBNZ will run out of bonds to buy under the LSAP.

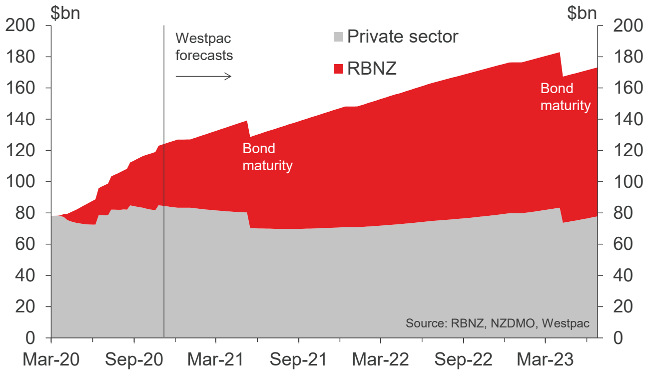
The RBNZ is on track to hit the maximum quantity of Government bonds it can practically buy, long before the need for monetary stimulus has expired. The RBNZ's problem is that if it buys too many bonds, the market will suffer illiquidity. If anything, this problem is going to get worse. The stronger-than-expected economy is shoring up the tax take and therefore reducing the Government's need to borrow through the Covid crisis. The Treasury is likely to attenuate its plan to issue new bonds over the coming two years, perhaps to $45bn this year and $30bn next (previously $50bn and $35bn). This means that the RBNZ will not be able to buy all of the $100bn it plans to purchase by June 2022.

To solve this conundrum, the Reserve Bank needs to introduce other monetary tools to take the pressure off the LSAP. The RBNZ could then stretch bond purchases over a longer timeframe while still keeping interest rates suitably low. Using many different monetary tools also reduces the risk of distortions arising in any one area of the economy.

Westpac forecast of weekly LSAP bond purchases



Government bonds owned by RBNZ and private sector



We do not expect any official announcement of a change in the LSAP at next week's MPS. Instead, we expect to see the pace of bond purchases gradually slow over the course of the coming year. Next year the RBNZ will probably officially stretch out the LSAP – on our estimates, it will have to stretch the $100bn out over three years rather than two.

Conundrum 2: Falling interest rates have sparked a house price boom.

The public has correctly perceived that the recent reduction in interest rates is fuelling house price increases. That is a threat to the RBNZ's political and social licence to operate monetary policy. Rising house prices may also become a threat to financial stability, which the RBNZ safeguards wearing a different hat. We therefore expect the RBNZ will craft next week's monetary policy decisions with one eye on dealing with both the perception and the reality that low interest rates boost house prices.

The initial solution: A business-focussed Funding for Lending Programme.

We expect that the RBNZ will announce the details of a new Funding for Lending Programme (FLP) at next week's MPS.[1] The actual go-live date for the FLP may be something like 1 December or 1 January. The principal aim of the FLP will be to take the pressure off the LSAP, allowing the RBNZ to continue delivering monetary stimulus over a longer period.

Because this will be a transition between monetary tools, rather than a monetary expansion, we expect that the FLP will start off small. Our rough pick is that the RBNZ will allow banks borrow from the FLP an amount equivalent to 3% of outstanding loans. Across the whole banking system, that would amount to around $15bn. Financial markets may be expecting something bigger.

In order to address the housing market issue, we expect the FLP will include strong incentives for banks to increase lending to businesses. Perhaps banks will be able to borrow more under the FLP if they increase their loans to business, or small businesses. This is the approach that the Reserve

1 An FLP basically provides cheap loans to banks. An explanation of the FLP and other alternative monetary tools can be found here.

Bank of Australia has taken. Attaching strings to the FLP in this fashion is likely to reduce the total effectiveness of the programme, but it will direct more of the monetary stimulus at businesses rather than at house prices. Most importantly, tying the FLP to business lending will publicly show that the RBNZ is sensitive to the impact monetary policy can have on house prices.

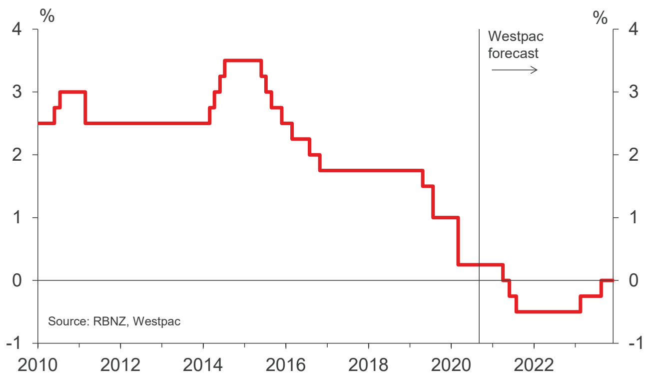
More will be needed: Negative OCR expected.

The RBNZ's effort to broaden the delivery of monetary stimulus is likely to continue next year. The RBNZ has repeatedly expressed a preference for a combination of OCR cuts and an FLP, albeit with the FLP introduced first. So we expect that the RBNZ will also cut the OCR below zero, after its commitment to keep the OCR at 0.25% expires in March.

When we first forecast a negative OCR in April, we envisaged a pressing need for monetary stimulus arising from a dire economic situation, so we predicted a 75bps cut to -0.5% all at once. Today, the surprisingly resilient economy and strong housing market call that into question. We now think that there is plenty of time for the RBNZ to take a gradual approach, cutting the OCR in increments while gradually reducing the rate at which it purchases bonds under the LSAP. We now expect that the OCR will be cut by 25 basis points at a time, in April, June and August next year.

We do not expect the RBNZ to directly signal OCR cuts next week – for example, there will be no official OCR forecast in the MPS beyond March. But we do anticipate that the RBNZ will repeat its previous message that it prefers a package of OCR cuts and an FLP, and that a negative OCR remains a live option if required.

Westpac OCR Forecast



Final leg of the trifecta: Loan to Value restrictions on mortgage lending.

Next week is about monetary policy, not financial stability. Therefore there will be no announcement about the reintroduction of loan-to-value restrictions on mortgage lending (LVRs). But there might be hints, because the RBNZ will be very keen to ward off accusations that it is fuelling a housing bubble.

We expect that the RBNZ will actually reintroduce LVRs next year. The new LVRs will be effective from 1 May, although they will be announced earlier than that.

The context here is that the RBNZ has previously committed to keeping the LVRs off until May 1 2021, to provide certainty to lenders. A central bank's word is its bond, so the LVRs cannot be reintroduced earlier than May 1. However, an early *announcement* would help get around this issue, because banks may then curtail lending in anticipation of the renewed LVR.

We expect that the LVRs will be targeted squarely at property investors, not first homebuyers. Experience last decade showed that investor restrictions were the most effective. Also, housing affordability is an extremely hot potato politically, and restricting first-homebuyers' ability to enter the market could leave the RBNZ with burned fingers.

Contact the Westpac economics team.

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Nathan Penny, Senior Agri Economist
+64 9 348 9114

Paul Clark, Industry Economist
+64 9 336 5656

Any questions email:
economics@westpac.co.nz

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.

Disclaimer.