Economic Bulletin.

11 November 2020

FLPing houses – Review of RBNZ November MPS.

- The RBNZ introduced a largely no-strings-attached Funding for Lending Programme.
- We estimate that this will push mortgage rates down by roughly 25bps, over time.
- We were surprised by the RBNZ's dovishness – they are quite prepared to risk an inflation overshoot.
- This stimulus was introduced despite RBNZ analysis showing that the expected need for monetary stimulus had diminished since August.
- We predict that the economy and house prices will be much stronger than the RBNZ expects over the coming six months.
- Despite that, we still expect that the RBNZ will lower the OCR below zero next year.
- The LSAP is going to run out of fuel and will need to be replaced by another form of monetary stimulus.
- And the RBNZ has today demonstrated its determination to boost inflation.

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The RBNZ has further loosened monetary policy by introducing a Funding for Lending Programme (FLP), maintaining the $100bn bond-buying programme, and continuing to talk about the possibility of lowering the OCR below zero next year.

The Funding for Lending programme basically consists of cheap loans to banks. Banks will initially be able to borrow up to of 4% of their outstanding loans at a floating interest rate equal to the OCR for a term of three years. They will then be able to borrow up to a further 2% on the condition that they increase their lending. For every $1 increase in its loan book, a bank will be able to borrow an additional 50 cents under the FLP.

We expect that the FLP will reduce mortgage rates by around 25 basis points, and will reduce term deposit rates by more (noting however, that some of these interest rates may already have moved in anticipation of the introduction of an FLP).

These announcements were broadly what financial markets were expecting.

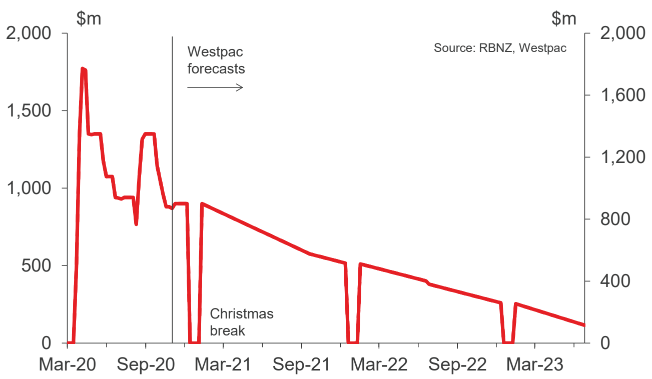
We had expected a smaller FLP with incentives to increase lending to business rather than housing. We also expected that the RBNZ would focus more on providing *ongoing* monetary stimulus, rather than dialling up the stimulus further. So we were surprised by the RBNZ's dovishness at the MPS (although today's earlier announcement that the RBNZ would reintroduce LVRs and delay bank capital requirements were a nod to addressing the balance between housing and business lending).

Where to from here.

We continue to expect that the RBNZ's next monetary policy step will be a series of OCR cuts through the middle of next year, taking the OCR to a low of -0.5%. Today the RBNZ once again emphasised that it sees the FLP and a negative OCR as a package deal, noting that the two instruments can be mutually supportive. The RBNZ also noted that banks are on track to be operationally ready for a negative OCR, and the Monetary Policy Committee (MPC) agreed that it was prepared to lower the OCR if required. To us, the RBNZ's dovishness today reinforces the idea that next year they will continue to provide monetary stimulus, even if that risks an overshoot on the inflation target or inflaming the housing market.

We expect OCR cuts next year despite our firm expectation that the economy and housing market will outperform the RBNZ's expectations over the coming six months. This is because another of the RBNZ's tools for providing monetary stimulus – the Large Scale Asset Purchase Programme (LSAP) – is going to run out of fuel and will have to be scaled back. The Government is likely to borrow significantly less than previously expected, meaning less bond issuance and therefore fewer bonds for the RBNZ to buy. If stimulus via the LSAP is reduced, the RBNZ will have to find another means of providing monetary stimulus.

Westpac forecast of weekly LSAP bond purchases



We therefore expect that as the FLP takes effect and the OCR is gradually reduced, the LSAP will be simultaneously scaled back, with the weekly pace of bond purchases gradually slowed. This will amount to a monetary switch over time.

The other thing to bear in mind is that inflation next year will be in the order of 0.6%, compared to the RBNZ's target of 2%. And employment will be clearly below the maximum sustainable level. The RBNZ will still have every reason to provide ongoing monetary stimulus.

Less stimulus needed, more delivered.

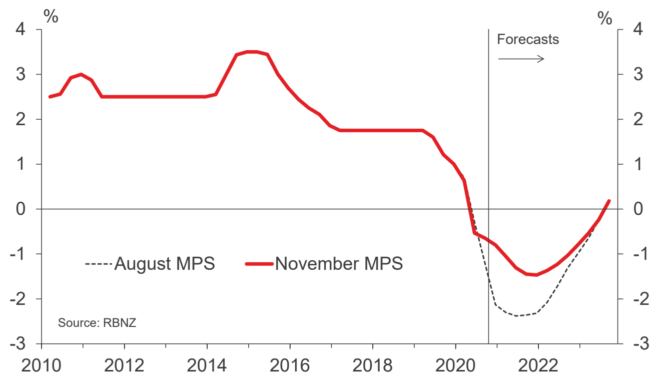
The RBNZ's decision to add more monetary stimulus today came despite the RBNZ's own analysis indicating that less monetary stimulus would be needed relative to what the RBNZ thought in August. The RBNZ's unconstrained OCR forecast gives an overall estimate of how much monetary stimulus is needed to meet the inflation and employment targets. Back in August, the unconstrained OCR forecast was -2.4%, but in today's document it was -1.5%. There could be two explanations:

(1) The RBNZ has divined that the LSAP is not providing enough stimulus to generate an unconstrained OCR of even -1.5%, let alone 2.4%; or

(2) The Monetary Policy Committee made a captain's call to provide more stimulus despite staff advise.

Either option suggests that there is plenty of scope for the RBNZ to continue providing monetary stimulus next year.

RBNZ Unconstrained Official Cash Rate forecasts

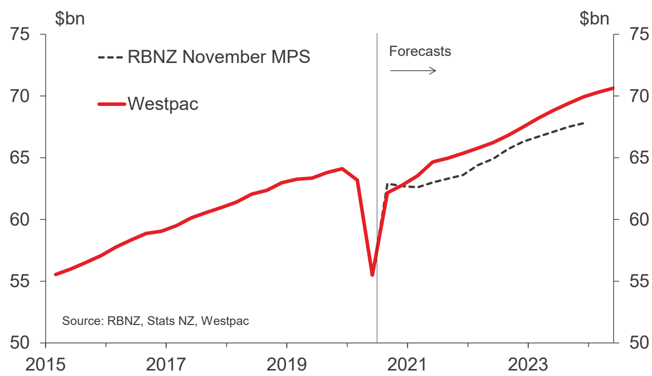


Wildly pessimistic… or optimistic?

The RBNZ paid little heed to the fact that the economy has, to date, dramatically outperformed their prior expectations. They did acknowledge that the recent economic rebound has been far stronger than they anticipated, so their near-term GDP forecast was revised up. But the RBNZ has become even more pessimistic about the pace of recovery, so their forecast of the level of GDP is no different to their August assessment.

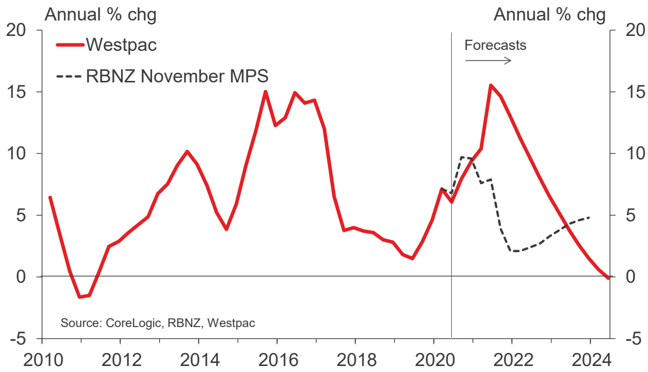
We find the RBNZ's economic forecasts unrealistic. There is now abundant evidence that, outside of tourism, the economy has proven surprisingly resilient, even after the wage subsidy has completely wound down. We think this evidence has been sufficient to warrant an upgrade to our forecast of the level of GDP. We strongly suspect that the economy will outperform that RBNZ's pessimistic expectations over the coming six months.

Quarterly GDP forecasts



On the housing market, we think the RBNZ is being wildly *optimistic* about a spontaneous cooling. Quarterly house price inflation in the September quarter was 4.4%, but the RBNZ forecasts that it will suddenly plunge to 2.4% in the December quarter and 0.6% in March 2021.

House price forecasts



We expect the opposite – house price inflation is set to accelerate further, and will be well into double digits by the middle of next year.

Recent experience is proof-positive that mortgage rates are far more influential for house prices than physical supply and demand factors. House prices are rocketing higher in response to a drop in mortgage rates, despite zero net migration, booming construction activity, and a weak economy. The RBNZ's decision to push mortgage rates even lower will further fuel house prices. The renewed LVR restrictions announced today might take the froth off, but will not be game-changing. We therefore expect the housing market will be at least as strong early next year as it has been late this year.

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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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