Economic Bulletin.

19 June 2020

Steady tiller in a rough sea – OCR Preview, June 2020.

- The outlook for inflation has not materially changed.
- The economy is proving more resilient than expected, but this is offset by a higher exchange rate.
- Therefore, we expect the RBNZ to keep its monetary policy stance unchanged.
- We expect that the weekly pace of bond buying under the LSAP will stay slightly above $1bn for the foreseeable future.
- The RBNZ will have to lift the $60bn cap on the LSAP at some point, just to allow headroom for that pace of bond buying to continue.
- There is a chance that the cap will rise to $70bn next week. But more likely, the RBNZ leave the cap unchanged this time, and lift it to $80bn in August in a single hit.
- The RBNZ is likely to reiterate that it has other monetary tools available, but will not signal that these are necessary at this point.
- We continue to expect that the OCR will remain at 0.25% until April next year, and will then fall to -0.5%.

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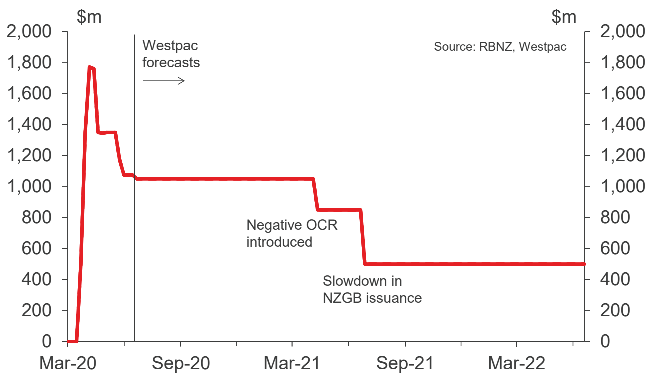
Monetary policy stance to remain unchanged.

We expect that the RBNZ will leave its monetary policy settings essentially unchanged when it delivers its OCR Review next week.

The most important variable for monetary policy at present is the weekly pace at which the RBNZ purchases Government Bonds under its Large-Scale Asset Purchase programme (LSAP). This is a decision that is made on a week-by-week basis by RBNZ staff. But the OCR Review is the Monetary Policy Committee's (MPS's) opportunity to either refresh or alter its instructions to staff.

At present, the staff have simply been instructed to purchase sufficient bonds to "keep interest rates low across the yield curve". We think that mandate will be left unchanged.

Westpac forecast of weekly RBNZ bond purchases



On May 21st we forecast that the RBNZ would slowly reduce the weekly pace of bond buying from $1.35bn at the time, down to $1.1bn. The RBNZ has hewed very close to that, actually reducing the pace to $1.075bn. We now expect that the weekly pace of bond buying will average $1.05bn until April 2021, only a slight tweak to our previous forecast.

The RBNZ will also review the maximum cap on the LSAP next week. At the May *MPS*, the MPC said that it would:

"expand the LSAP programme to purchase up to a maximum of $60b over the next 12 months."

From that wording, it is not clear whether the $60b figure includes or does not include the $10bn of bonds the RBNZ purchased *before* the May *MPS*. We are assuming that prior purchases are included, making the $60b a cumulative total for the LSAP programme.

If we are right about the pace at which the RBNZ will buy bonds, then the $60bn cap will be exhausted by early April 2021. But by the RBNZ's own reckoning, it is going to have to continue delivering substantial monetary stimulus until the end of 2021 (and we concur). Clearly, the cap on the LSAP is going to have to be progressively increased if the RBNZ is to maintain a constant pace of bond buying for that long.

It is possible that the RBNZ will lift the cap on the LSAP to $70bn next week. That would give it sufficient headroom to maintain the $1.05bn pace of weekly purchases for twelve months. However, we judge it slightly more likely that the RBNZ will wait until August before expanding the cap to $80b, as August is a full Monetary Policy Statement (by August, $80bn will be required to give twelve months' worth of headroom).

Either way, the anticipated expansion of the cap on the LSAP would be a technicality rather than a change to the stance of monetary policy – the cap needs to be lifted simply to maintain the same weekly pace of bond buying. Failure to lift the cap by August would be more of a change – that would signal that the RBNZ intends to taper the pace of its bond purchases.

If the cap is not lifted next week, the RBNZ is likely to repeat its comment that "the LSAP can be scaled as needed in future" that appeared in the Summary Record of Meeting in May.

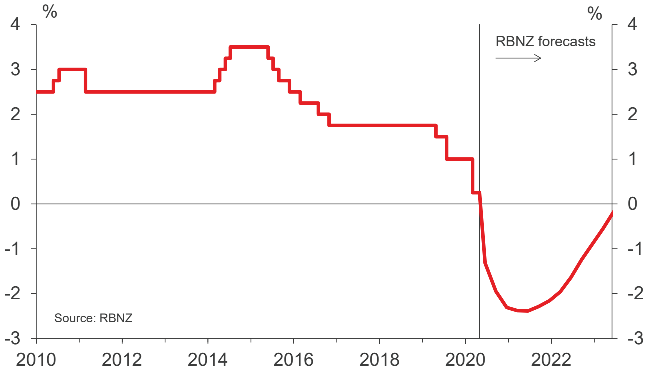
The RBNZ has repeatedly stated that if it runs out of New Zealand Government Bonds bonds to buy, it has other options to deliver monetary stimulus, including a negative OCR (after March next year), purchasing foreign Government bonds, or making direct loans to banks. Next week the RBNZ will probably repeat that it has these options available if required. However, it will not deem any of these options necessary at this point.

In particular, we expect the RBNZ to repeat that it has committed to keeping the OCR at 0.25% until March 2021. We continue to expect that the OCR will drop to -0.5% in April 2021.

The outlook for inflation and unemployment.

Back in May the RBNZ's assessment was that it would have to provide monetary stimulus equivalent to an OCR of -2%, for a period of two years, in order to meet its inflation and unemployment targets.

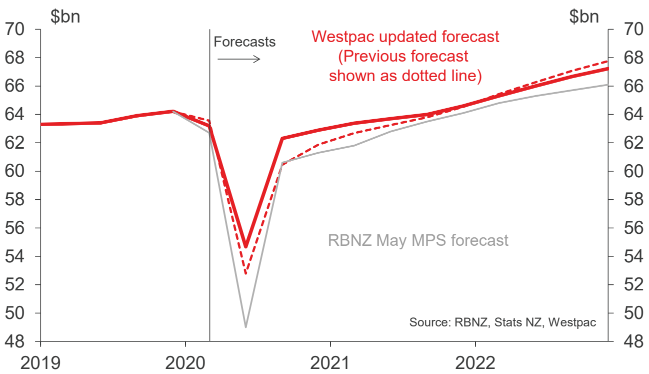
RBNZ unconstrained OCR forecast, May MPS



Since May, the outlook for GDP has improved: the country has moved to Covid Alert Level 1 earlier than previously anticipated; a range of data has shown that after the lockdown the economy bounced back to a higher level of activity than was forecast; and global prices for key export products like dairy, meat, forestry and kiwifruit have held up a bit better than anticipated.

Our response to all of this was to upgrade our forecasts of economic activity and downgrade our forecast of unemployment from a peak of 9.5% to 8%. Although we still expect a very severe recession, the chart below shows that our expectations are now more moderate than they were. Recent comments from Treasury Secretary Caralee McLiesh suggest that the Treasury is thinking the same way, and the RBNZ is highly likely to follow suit. It is worth noting that the RBNZ was significantly more pessimistic on GDP than us to start with, so their forecast upgrade could be larger.

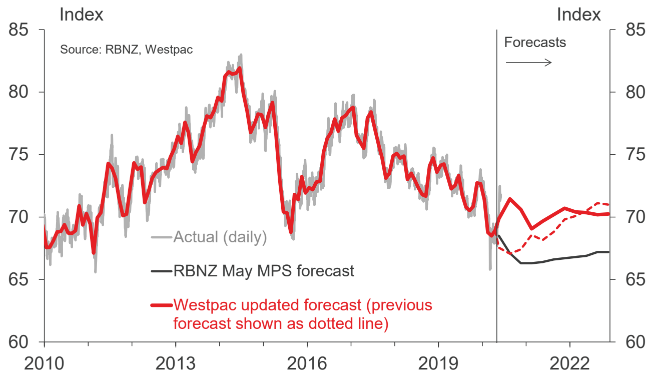
Westpac and RBNZ forecasts of real GDP, quarterly level



The RBNZ will also be pleased to see that mortgage rates and term deposit rates have fallen substantially since the May *MPS*. In May, the RBNZ expressed concern that although it had engineered a reduction in wholesale interest rates, this had not fully passed through to retail rates. But since the May *MPS*, the average advertised two-year fixed mortgage rate has fallen 33 basis points. That amounts to a substantial monetary easing without the RBNZ having to do anything.

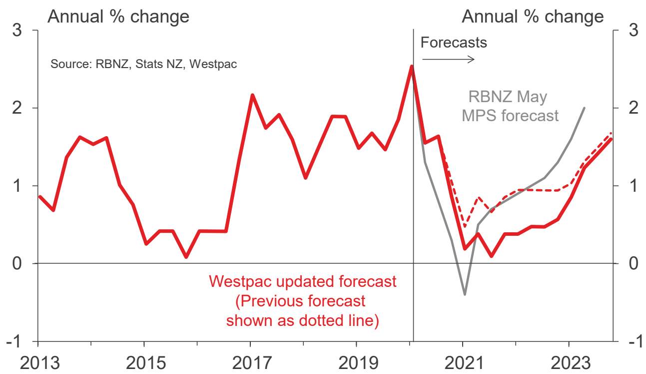
The offset to all of this is the exchange rate, which has risen by 4.5% on a trade weighted basis since the May *MPS*. This is a stark contrast to the RBNZ's expectation that the exchange rate would fall over the course of this year. We have upgraded our exchange rate forecast, and the Reserve Bank will probably do the same.

Westpac and RBNZ forecasts of TWI exchange rate



The not-as-bad GDP outlook will tend to mean more inflation, while the higher exchange rate outlook will tend to suppress inflation. The key for monetary policy is to weigh these forces against one another to come up with an overall gauge of how much monetary stimulus is needed. Our own assessment is that two forces are roughly equal and opposite – we have not changed our medium-term inflation forecast. If the RBNZ comes to the same conclusion, then it won't need to alter the monetary policy outlook.

RBNZ and Westpac forecasts of inflation



Even if the RBNZ weighs things up a little differently, it is fair to say that the outlooks for both the economy and the exchange rate are wildly uncertain. With such uncertain and offsetting forces affecting the outlook, it seems unlikely that the RBNZ will change the stance of monetary policy.

Market reaction and RBNZ key messages.

The headline next week will be the RBNZ's announcement on the LSAP cap. But whether the RBNZ maintains the cap at $60bn or increases it to $70bn, markets are unlikely to react much. Markets understand that the RBNZ is going to have to lift the cap at some point – whether that is next week or in August is of only passing interest. (However, if the cap was not lifted by August, markets would assume that the RBNZ intends to taper the pace of bond purchases and interest rates would rise).

Markets would react more to any RBNZ signal that it was changing the weekly pace of bond buying and/or intended to use some other monetary policy tool. As explained above, we expect no such announcement.

Finally, markets will be interested in the RBNZ's commentary and assessment of the outlook. The RBNZ will no-doubt mention the not-as-bad economic outlook, the reduction in mortgage rates, and the higher exchange rate. Market pricing could move a little depending on which of those gets the most air-time.

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