Economic Bulletin.

18 September 2020

A lull in the lowflation battle – Preview of RBNZ Monetary Policy Review, September 2020.

- We expect no change in monetary policy next week.
- Data has been to the strong side, but the RBNZ will bank that without reaction.
- The RBNZ will reiterate that it intends to provide substantial monetary stimulus for as long as necessary.
- The RBNZ will remind us that it is preparing to deploy a negative OCR combined with cheap funding for banks, in case this is required in the future.
- We continue to expect that the bond buying programme will run out of ammo before the battle is over.
- We therefore expect that the RBNZ will indeed have to deploy a negative OCR, in April next year.

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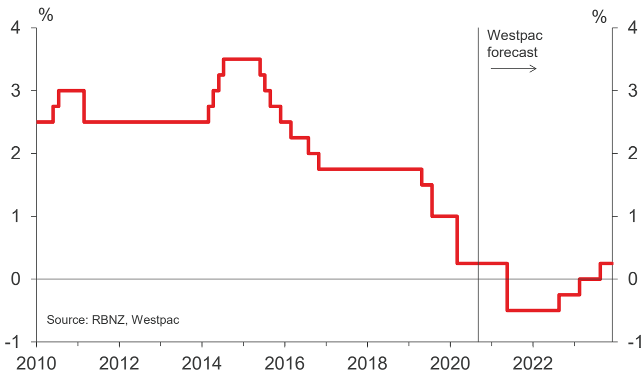
The Reserve Bank's latest Monetary Policy Review (MPR) will be on Wednesday next week. MPRs were previously known as OCR Reviews, and are cut down versions of the RBNZ's quarterly Monetary Policy Statements. The RBNZ undertakes less analysis and has briefer meetings. The published material consists of a press release and a summary record of the Monetary Policy Committee's (MPC) meetings, but there is no press conference, no forecasts are issued, and there is no Monetary Policy Statement booklet.

We expect no change in the stance of monetary policy at this MPR – the RBNZ will probably keep the OCR at 0.25% and the Large Scale Asset Purchase programme at $100bn. We also expect the RBNZ will repeat the same communication themes from the August Monetary Policy Statement: Covid has seriously dented the economy; the least regret strategy is to provide substantial monetary stimulus; and the RBNZ is readying additional monetary tools in case even more stimulus is required.

Westpac Official Cash Rate forecast



Past behaviour indicates no change.

The RBNZ's past behaviour makes it seem unlikely that they would alter monetary policy at an MPR, shortly after a big change in monetary policy, and when the data has been on the positive side of expectations.

The new MPC structure for making monetary policy decisions has been in place for a year and a half now, and some clear patterns have emerged. The MPC has a predilection for making big bold changes to monetary policy, less frequently. The gradual approach is not favoured. When the need for a change in monetary policy has been identified, the MPC has tended to frontload the entire change into a single large move (this contrasts to previous RBNZ Governors, who tended to move part way and signal there was more to come). Given that a big bold change was made at the August MPS, it seems less likely that the MPC will make another change now.

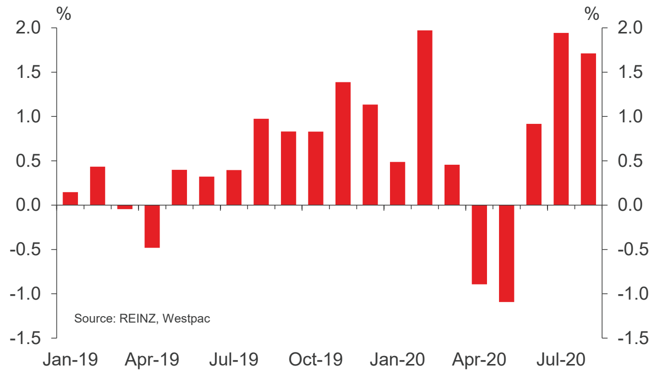
Another pattern is that the MPC has never changed monetary policy at an OCR Review or MPR. Monetary policy has been altered at four out of six Monetary Policy Statements decided by the MPC, and there were two unscheduled changes during the most dramatic days of the Covid-19 epidemic. But of the four OCR Reviews or MPRs, one was cancelled and the other three have featured no change in monetary policy. This makes a change in monetary policy next week seem even more unlikely.

Finally, the recent period of stronger data means the RBNZ won't see any need to loosen monetary policy further at this stage. In normal times, a period of stronger data could prompt a tightening of monetary policy, or at least a change in communications. But these are not normal times. The risks to the outlook are huge, swamping the significance of the recent stronger data. Also, the RBNZ is operating a "least regrets" strategy – it is happy to take the risk of inflation and employment overshooting target, but wants to do everything possible to avoid major undershoots on either target. That means it will happily bank the news of stronger data rather than reacting to it.

Still, it is worthwhile covering what the upside surprises are, because the RBNZ might mention them in their press release.

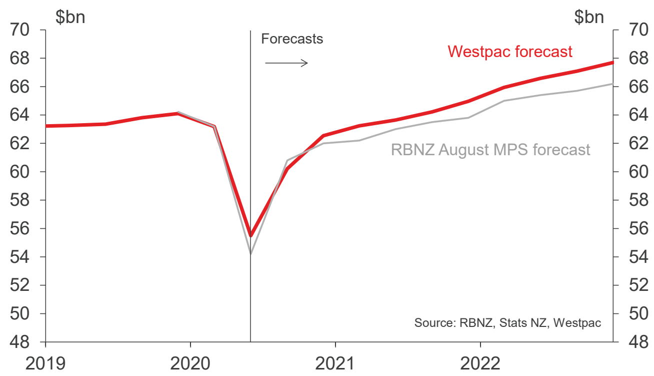
The most important recent development for the RBNZ is the surprising resilience of house prices. House prices fell modestly over April and May, but then rose rapidly over June, July and August. They are now 2.6% higher than in March. In the August MPS the RBNZ forecast a 9.2% fall in house prices between March and December this year, but that is now looking inconceivable. Our own forecast for that nine-month period is now +3.5%, and the RBNZ's short-term house price forecasting is usually fairly similar to our own. This is crucial. For better or for worse, monetary policy these days mostly works through its influence on asset prices. The RBNZ can now take comfort that its interest rate reductions have stimulated asset prices in the normal way, and the next step will be stronger asset prices supporting consumer spending.

Monthly seasonally adjusted change in House Price Index



The second recent development is that indicators of economic activity have been stronger than the RBNZ anticipated (and more in line with our own more moderate views of how Covid would affect the economy). In August, the RBNZ forecast that GDP would shrink 3.5% through 2020. But June quarter GDP turned out stronger than the RBNZ anticipated, and more timely indicators also strongly suggest that GDP over the September quarter has been north of the RBNZ's expectation. Our own forecast is now for GDP to shrink just 2.2% through 2020.

Westpac and RBNZ GDP forecasts



The one partial offset to these "upside" surprises is inflation. Near term indicators suggest that inflation in the September quarter will undershoot the RBNZ's forecast, most notably among non-tradable items. This will be of concern to the RBNZ.

LSAP cap to remain at $100bn.

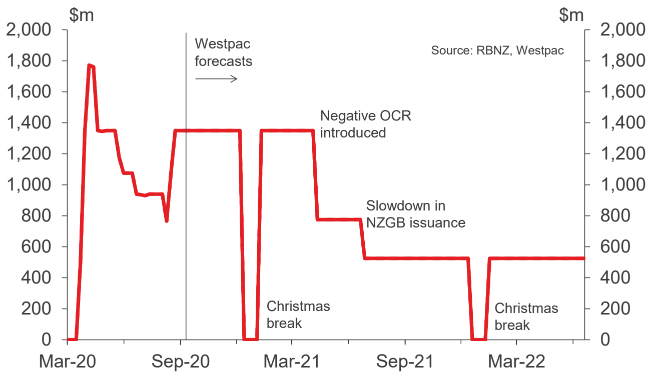
In August, the RBNZ set the limit for bond purchases at $100bn by June 2022, matching the number we predicted back in April. By our calculations, this is the absolute maximum for government bond purchases under the LSAP – there is no room for further quantitative easing.

As expected, last week the Treasury reduced its planned issuance of Government bonds to $50bn for the year to June 2021, and $35bn for the following year. This means that by June 2022 there will be $172bn of Government bonds on issue.

In order to ensure that there is sufficient liquidity in the bond market, the RBNZ must leave about $70bn in the private sector. That means that the maximum it can purchase by June 2022 is $100bn.

Recently the RBNZ stepped up the pace of bond buying to $1.35bn per week. Continuing to purchase at this pace would exhaust the $100bn limit well before June 2022. This is the key reason that we have long been forecasting a negative OCR. We expect that the RBNZ will have to "switch" next year, slowing its bond purchases at the same time as opting for a negative OCR, in order to maintain a constant degree of monetary stimulus.

Westpac forecast of weekly RBNZ bond purchases



Alternative tools.

In August the RBNZ said that it if further monetary stimulus was required, it would consider a package of cutting the OCR below zero and initiating a Term Lending Facility. The latter consists of low-interest loans to banks, in the expectation that the banks pass that on as lower interest rates for retail and business borrowers.

The RBNZ is currently working on the best design for this package, and is currently consulting with banks on the topic.

On Wednesday next week, we expect the RBNZ to simply state that this design work is ongoing. The RBNZ will reiterate that if the economic situation warrants it, there are tools with which it could ease monetary policy. But there will be no signal that these tools are about to be deployed. Back in March the RBNZ committed to keeping the OCR unchanged at 0.25% for a year – we firmly expect the RBNZ issue a reminder of that commitment on Wednesday next week.

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