Economic Bulletin.

23 September 2020

Next cab off the rank – a Funding for Lending Programme by November.

- **We now expect the RBNZ will introduce a Funding for Lending Programme (FLP) in November this year.**
- **The FLP will reduce term deposit rates, mortgage rates and business interest rates in New Zealand.**
- **This will stimulate asset prices and suppress the exchange rate, thereby boosting inflation.**
- **We think the RBNZ is too pessimistic on the economy and the housing market.**
- **But we concur that the inflation outlook requires a massive monetary response, so we support the introduction of an FLP.**
- **More will be needed, so we continue to expect that the RBNZ will reduce the OCR to -0.5% next year.**

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Today the Reserve Bank announced that it is developing a Funding for Lending Programme (FLP) that will be ready to deploy before the end of this year.

Consequently, we are now forecasting that an FLP will be announced at the Monetary Policy Statement on 11 November.

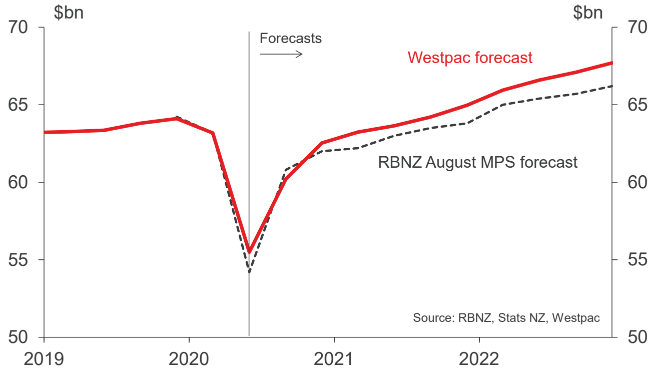
The FLP will cause a reduction in retail mortgage rates, term deposit rates and business lending and deposit rates, at the time it is introduced. The main impact of this will be to further stimulate asset prices, particularly the housing market. In turn, higher asset prices will stimulate consumer spending and therefore boost inflation and employment. The secondary impact of the FLP will be to suppress the exchange rate, which also tends to boost inflation and employment.

It is difficult to predict the extent of any decline in these interest rates or the exchange rate without seeing the details of the FLP, but we do outline the theoretical maximum impact below.

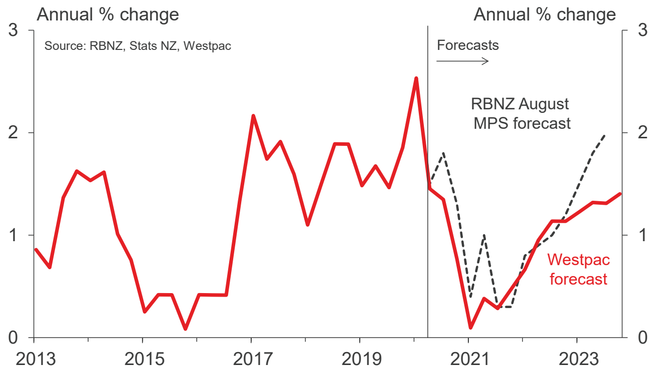
Today's press release from the RBNZ was incredibly downbeat. There was very little acknowledgement that the economy has exceeded expectations, and at least some members of the Monetary Policy Committee doubted the durability of the housing market upturn.

The outlook is highly uncertain, but we think that the risks are to the upside of the RBNZ's dour economic expectation, particularly on house prices. Despite that, we agree with the RBNZ's assessment that "further monetary stimulus may be needed". In fact, we would go further – massive monetary stimulus is required to prevent inflation from lingering too low. Therefore, we support the RBNZ's move to introduce an FLP this year, and we continue to expect that the RBNZ will reduce the OCR to -0.5% in April next year.

Forecasts of real quarterly GDP



Inflation forecasts



Why the need to introduce an FLP?

Left unchecked, the massive economic hit from Covid-19 could cause inflation to remain below the RBNZ's target for years, or even cause deflation. The size of the monetary stimulus required for New Zealand to avoid this fate is hard to overstate.

Consequently, the Westpac Economics Team has long predicted that the RBNZ would have to loosen monetary policy much further than their initial measures. Back in April we identified that the Large Scale Asset Purchase programme was incapable of providing sufficient stimulus. We predicted that the LSAP would be expanded to $100bn. We noted that that would not be sufficient to plug the hole in inflation, but we also noted that the LSAP could not practically be expanded beyond $100bn. We therefore concluded that the RBNZ would need another tool. The RBNZ has now also reached this conclusion, but for this year the RBNZ has ruled out the most obvious option – a negative OCR. Hence the FLP has come into the frame.

What an FLP may look like.

An FLP is essentially cheap loans for banks.

Currently, banks source their funds from a mix of transactional deposits (at zero interest), term deposits (currently approximately 1.2%), and wholesale funds (currently about 1%). Under an FLP, the RBNZ would offer funding to banks at a low interest rate – perhaps close to the OCR, which is currently 0.25%, or close to current swap rates which are zero.

If banks can bring in money more cheaply, they can subsequently lend it out more cheaply while maintaining the same bank margin. So by providing these cheap loans to banks, the Reserve Bank will engineer a decrease in mortgage rates. There will also be an indirect effect – banks will compete less vigorously for term deposits and wholesale funds, so the interest rates on these will also fall, further reducing banks' funding costs.

The impact of the TLF on actual interest rates in New Zealand would depend on its size, so is impossible to anticipate. If the FLP was so huge that banks had no reason to source wholesale funds at all, term deposit rates could conceivably drop to almost zero. So long as the OCR is 0.25%, the upper bound for the impact of the FLP on mortgage rates is smaller – perhaps in the order of 65 basis points. This is because only two-thirds of the banks' funding costs would actually be affected by the FLP (the remaining third that is already sourced at zero interest rates would not be affected). An FLP combined with an OCR of -0.5% could have a larger impact on mortgage rates than that. However, these numbers are theoretical maximums. What we are likely to see is a smaller FLP that has less effect on term deposit rates and mortgage rates.

Details of the FLP design.

The most important design element of the FLP is how the interest rate is set. One option is for the RBNZ to lend to banks at or near the current swap rate, which is lower than banks currently pay on wholesale markets. Another option is lending for a fixed term at a floating interest rate, set at or near the OCR. The latter is in line with the European Central Bank's term lending facility, which has been in use for several years. To provide extra stimulus in response to the Covid-19 shock, the ECB has provided two further sweeteners: the interest rate is set 50 basis points below the cash rate for the first year, and is capped at that level (i.e. future rate cuts would be passed on, but any future rate hikes would not).

The second important design element is any conditions that the RBNZ attaches to the FLP. FLPs were originally conceived as a means to un-gum clogged banking systems – the Bank of England provided cheap loans to banks in return for banks lending more to businesses during the Global Financial Crisis. But we don't expect the RBNZ's scheme will have many conditions attached. New Zealand doesn't currently have an issue with the provision of credit, so such conditions are less necessary. And if the RBNZ attaches too many conditions to the cheap funding banks might not take it up, and the scheme would then lose its effectiveness.

How a negative OCR and an FLP would work together.

The RBNZ has reiterated that it remains prepared to lower the OCR below zero, if required. However, this would only occur after 16 March 2021, when its one-year commitment to keep the OCR at 0.25% expires. Our view is that the need for a negative OCR will be abundantly clear by early-2021, and the OCR will be cut to -0.5% at the April Monetary Policy Review.

The FLP and next year's OCR cut interact with one another. Assuming that the FLP interest rate is close to the OCR, then the OCR cut would reduce the interest rate at which the RBNZ lends to banks under the FLP. That would certainly increase the potency of the FLP, and arguably could increase the effectiveness of the OCR cut.

Full RBNZ Press Release.

Prolonged Monetary Support Necessary

Release date 23 September 2020

Tēnā koutou katoa, welcome all.

The Monetary Policy Committee agreed to continue with the Large Scale Asset Purchase (LSAP) Programme up to $100 billion. This action is necessary to further lower household and business borrowing rates in order to achieve the Committee's inflation and employment remit. The Official Cash Rate (OCR) is being held at 0.25 percent in accordance with the guidance issued on 16 March.

Reflecting the possible need for further monetary stimulus, the Committee noted the progress being made on the Bank's ability to deploy additional monetary instruments. The instruments include a Funding for Lending Programme (FLP), a negative OCR, and purchases of foreign assets. The Committee agreed that these instruments can be mutually supportive in bolstering economic activity. Members also agreed that the alternative instruments can be deployed independently, and noted that the FLP would be ready before the end of this calendar year.

Economic information available since the August Monetary Policy Statement, both international and domestic, has confirmed the level of economic activity remains significantly below that experienced prior to the COVID-19 economic disruption. The ongoing virus-led activity restrictions – most notably in Auckland – had also continued to dampen economic activity, and business and consumer confidence.

Any significant change in the global and domestic economic outlook remain dependent on the containment of the virus, which is highly uncertain. International border restrictions will continue to significantly curtail migration and tourism, and lead to the activity outlook being uneven across industries and regions. Commodity prices for New Zealand's exports remain robust, but this has been partly offset by the New Zealand dollar exchange rate moderating the return to local export producers.

Ongoing support for domestic economic activity is being provided through significant government spending on business assistance and household income support. This will be accompanied by a rising level of government investment. However, the removal of temporary support policies has commenced. For example, the Wage Subsidy scheme is now closed to new entrants.

In line with the weak underlying international and domestic economic conditions, the Committee expects a rise in unemployment and an increase in firm closures, as resource reallocation continues. Members agreed that monetary policy will need to provide significant economic support for a long time to come to meet the inflation and employment remit, and promote financial stability. They also agreed they are prepared to provide additional stimulus.

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