# Economic Note

RBNZ February 2020 Monetary Policy Statement Preview

7 February 2020

## Watching and waiting

- We expect the RBNZ to hold the OCR at 1.00% and reiterate that developments do not warrant a change in the monetary policy outlook but to signal their preparedness to lower the OCR if needed.
- The coronavirus outbreak has increased uncertainty over the policy outlook. At this point we doubt that the RBNZ will incorporate potential impacts of the outbreak in its central published forecasts and OCR track. The outbreak may, however, influence the RBNZ's characterisation of the risks.
- We still expect the RBNZ to hold out the prospect of further policy stimulus and have pencilled in a 25bp cut in 2020. Provided the economy smoothly navigates various headwinds, 1% may be the floor in the OCR this cycle.

### Summary and key take outs

We expect the RBNZ will hold the OCR at a record low 1% on Wednesday and to reiterate that developments do not warrant a change to the already stimulatory monetary setting at this time.

The RBNZ will be quietly satisfied and feel vindicated that its previous policy actions have helped meet its dual inflation and employment mandates. The economy has responded to the 75 basis points (bp) of OCR cuts delivered over 2019. Growth looks to have picked up after a quiet start to 2019, the economy is close to full employment and inflation is near the midpoint of the inflation target. Some of the negative risks to the outlook have dissipated. As such we suspect that the RBNZ may nudge its published OCR track fractionally higher.

The issue will be the extent to which the RBNZ incorporates the (still highly unknown) impact of the coronavirus outbreak. We do not expect the RBNZ will have enough valid information to explicitly account for its impact in its published forecasts or OCR deliberations. The virus, however, may play a role in the RBNZ's regrets analysis and framing of the risks. When the outlook is uncertain but the economy appears well placed, the best course of action from a regrets type analysis viewpoint is to wait for more information before deciding on a course of action.

We expect that the RBNZ will keep its options open, leaving the door open to further monetary easing if economic conditions warrant them. Our forecasts have pencilled in a 25bp cut in 2020, with potential bank capital impacts a factor. But, providing the economy smoothly navigates various headwinds, 1% may be the floor in the OCR this cycle.

### RBNZ will feel vindicated

In the November Monetary Policy Statement, the RBNZ held the OCR at a record low 1.00%, and noted that developments since the 50bp OCR cut in August had been offsetting and did not warrant a change to the already-stimulatory monetary settings at this time. The Monetary Policy Committee agreed that the 75bp of OCR cuts delivered over 2019 was supporting the economy, but maintained a modest short-term easing bias in acknowledging that near-term risks to the economy were tilted the downside and they would cut the OCR if economic conditions warranted it. The published OCR track signalled slightly less than 50% odds over a 25bp cut in 2020.

Where are we now? From all intents and purposes the NZ economy is travelling OK and the RBNZ will be quietly

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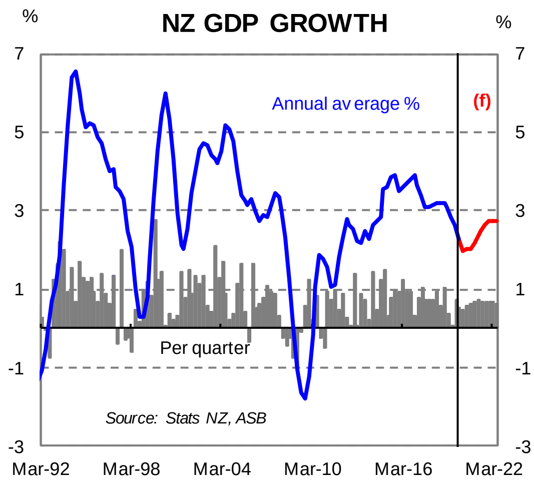
chuffed with how things have turned out.  A number of global uncertainties have abated. Global growth looks to have plateaued, and global data predating the outbreak of the coronavirus were starting to look more encouraging. Key risks posed by the US-China trade war and a hard Brexit look to have been averted for now.

Revisions to NZ GDP have rewritten history, with the economy accelerating in 2019Q3 after very little growth in the first half of 2019. The domestic growth outlook is reasonable, if not spectacular. Business sentiment appears to have turned the corner, and the lower OCR looks to be encouraging consumers to bring spending forward.  Fiscal policy will likely be playing more of a supporting role in the medium term, with the Government announcing increases in infrastructure spending.  The Terms of Trade and export commodity export prices are generally firm.




The housing market also looks to be responding. Circa 3½% fixed-rate mortgages have provided a tailwind to the housing market and we expect circa 7-8% rises in house prices for 2020. Construction sector activity is going from strength to strength and the recent OCR cuts look to have supported confidence in the sector. Housing credit growth is also gently stirring.

Moreover, headline inflation looks set to remain close to 2% for a while yet. Core inflation is low and stable, and very close to the midpoint of the inflation target. We suspect that surveyed Q1 inflation expectations from the RBNZ survey will move closer to 2%, following the lift in Q4 headline inflation.

The box is also ticked for the employment objective.  Employment is close to its maximum sustainable level, with the unemployment rate at the lower bound of the RBNZ's estimate of the rate that is consistent with inflation not accelerating.  Wage growth is gradually lifting, though remains moderate and is partly driven by government-driven pay settlements and minimum wage increases.

The NZ dollar, at around 72 on a Trade Weighted Index basis, is slightly above the 71.4 level assumed in the November MPS.  We note NZD strength against the AUD (96.4) partly reflects the higher interest rates on offer in NZ.

However, there are still grounds for the RBNZ to remain watchful. The (highly) uncertain impact of the worsening coronavirus outbreak represents a speedbump to growth prospects and is a new risk that the RBNZ will have to address. Unfortunately for NZ, the epicentre of outbreak is our largest trading partner (China), with Australia also having the bush fire impacts to contend with.  Bank capital impacts on credit need to be watched for, notwithstanding the RBNZ's view that the economic drag from the lift in capital will be minimal.

## RBNZ mindful of coronavirus impacts but will not explicitly include them

The most recent development has been the outbreak of the coronavirus. To date, the spread of the virus shows few signs of slowing and its effects are inherently uncertain.  Global bond yields, commodity prices and the NZD have softened in anticipation of the hit to the NZ and global economy.  Dairy prices slipped in the first auction after the seriousness of the outbreak became more apparent and began to rock financial markets.

Last month's RBNZ speech by Assistant Governor Hawkesby set out the framework the Bank used to analyse global influences, highlighting the trade, financial and uncertainty channels.  Given it is early days, we don't expect that the RBNZ will include an economic assessment of the impacts of the virus in the MPS, although the virus might play a role in the RBNZ's regrets analysis and characteristics of the risks. The RBNZ will maintain the commitment to adjust policy settings if the economic outlook warrants it.

We note that typically viral outbreaks over the past two decades have typically resulted in a sharp, but relatively brief, shock to both the NZ and global economies, although outcomes are highly sensitive to the severity and duration of the outbreak and measures taken to control it.  The RBNZ will be especially careful and will not rush its assessment given how fluid the situation currently is, with the epicentre of the outbreak (China) NZ's largest trading partner and a key engine for global growth.

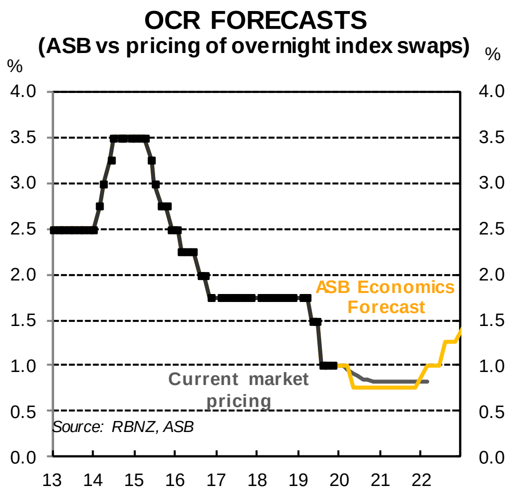
## Message kept simple

We expect the policy assessment to be concise, outlining the rationale for the on-hold decision and to reiterate that a prolonged period of highly-accommodative OCR settings will be required. Given the uncertain policy outlook, we expect the RBNZ would leave all of its options on the table, including further policy stimulus if required. There appears a structural element to low inflation which should see the RBNZ not seriously entertain the prospect of OCR hikes over 2020.

## Modest tweaks to forecasts and OCR path

There will be some modest tweaks to the published forecasts relative to November. The GDP revisions will facilitate a different growth profile. Annual growth over much of the projection period is expected to lie in a 2½% - 2 ¾% range. The unemployment rate is expected to remain in the low 4's. CPI inflation is expected to remain close to the inflation target midpoint. The published OCR projections will be in a similar ballpark to November, showing a modest dip over 2020, before the OCR gradually firms from 2021.

## However, more OCR stimulus might be needed




In our view, there is still the risk that the OCR could move lower in 2020 and we have pencilled in a 25bp cut. The impacts of the coronavirus are a key uncertainty and could well turn out to be significant and have persistent effects. The Chinese economy is five times the size it was at the time of the 2003 SARS outbreak and China is NZ's now largest trading partner, accounting for 22% of total NZ exports. Other risks to the global outlook remain downwardly skewed. The US and China trade truce could unravel.

The NZ economy looks to be in a better placed than it did during last year's winter of discontent but remains vulnerable. An adverse global shock could be the trigger. Drought in NZ remains a risk. It will take time for any additional fiscal easing to boost the economy given capacity constraints, the reluctance to push for tax cuts and concerns over the quality of additional government spending. Proposed increases in bank capital requirements could potentially tighten financial conditions, via impacting credit availability. The RBNZ may also be concerned if the Reserve Bank of Australia follows through with rate cuts (we expect 50bps of RBA cuts in 2020). That outcome would widen yield differentials to underpin the NZD/AUD, potentially seeing parity party champagne corks being popped at the expense of the NZ export sector.

Then again, it is still possible that the NZ economy manages to navigate it may through the myriad of downside risks and that 1% could be the floor in the OCR this cycle. Time will tell.

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