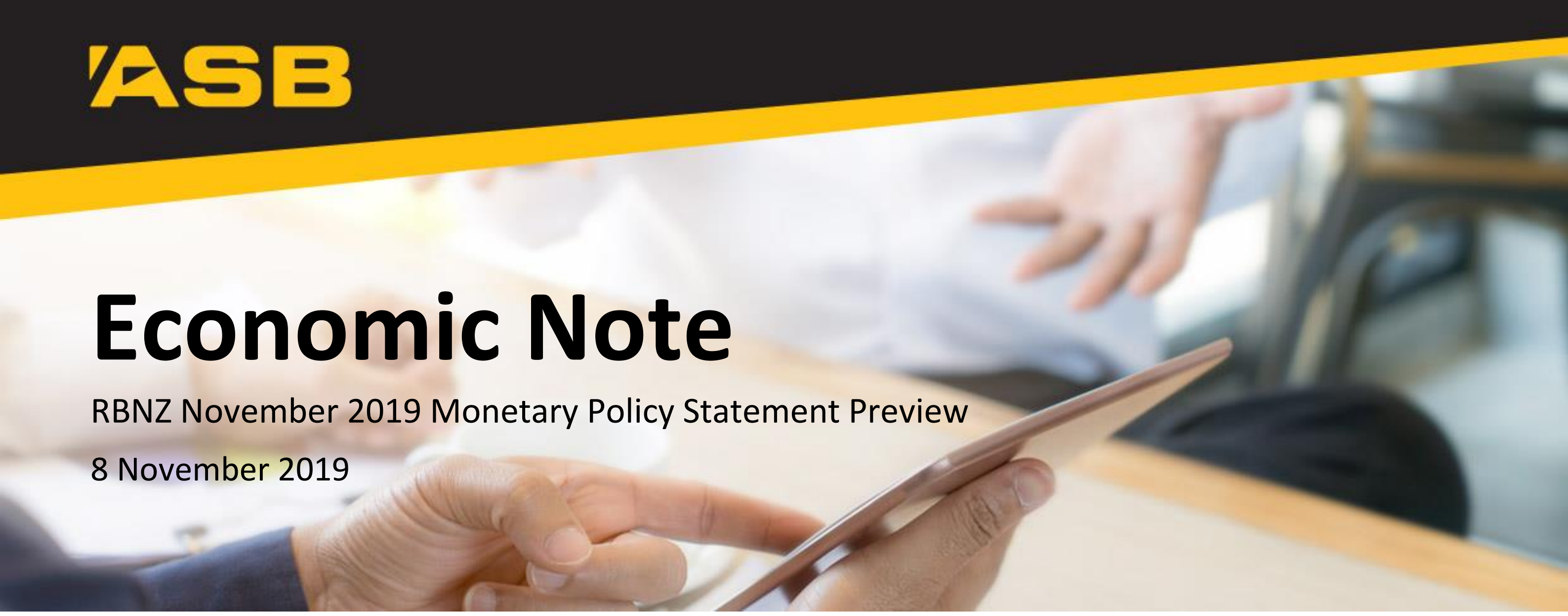

Economic Note

RBNZ November 2019 Monetary Policy Statement Preview

8 November 2019

Pre-emption over sitting on the fence

- Our conviction is that the RBNZ should (and likely will) cut the OCR by 25bps in November.
- The short-term growth outlook is subpar and risks are skewed to the downside, with the RBNZ needing to take out more insurance to prevent a more protracted undershoot of its employment and inflation objectives.
- We expect the RBNZ to hold out the prospect of further policy stimulus, if needed. To us, 0.75% is unlikely to be the OCR floor and a move lower in 2020 beckons.

Summary and key take outs

Current market pricing is sitting on the fence, **but we believe there is a strong case for cutting the OCR**, with the RBNZ to follow through and deliver a 25bp cut in the November Monetary Policy Statement (MPS).

Recent financial market sentiment has perked up, the global scene is looking a little brighter and global interest rates have firmed. The message from global central banks is becoming more nuanced. Interest rate sensitive pockets are stirring, and the housing market is looking perkier. The NZD is lower and the inflation starting point looks a little firmer than the RBNZ has previously factored in.

However, the growth outlook for the NZ economy still looks subpar, which should prompt the RBNZ to consult its regrets analysis manual and decide to take out additional insurance to keep the economy on track. Global growth is still slowing. Subdued domestic business sentiment is a signpost of the pressures weighing on the economy and the risk remains that firms retreat into their shells, cutting back on investment and employment activity and slowing growth and employment. Despite the OCR being at a record low, the pending introduction of higher bank capital requirements already looks to be hampering credit availability for key sectors of the economy. In the absence of additional monetary stimulus, (already low) medium-term inflation looks set to move lower and spare capacity in the labour market is likely to increase.

After delivering a further 25bp cut, we expect that the Statement will leave the door open to prospective further easing. Not doing so would see both the NZD and NZ wholesale interest rates shoot higher. We do not expect 0.75% to be the lull in the OCR this cycle, with several catalysts that could prompt follow-up action next year. Recent global optimism looks unlikely to be sustained and NZ's growth is likely to continue to disappoint. There is also the risk that (higher) bank capital requirements have a greater dampening impact on the economy than what the RBNZ expects.

Some evidence that OCR cuts are getting traction

In the September OCR Review, the RBNZ held the OCR at a record low 1.00%, and noted that new information since the 50bp OCR cut in August did not warrant a significant change to the monetary policy outlook. However, the RBNZ left the door open to a lower OCR, with the concluding statement reiterating "there remains more scope for more fiscal and monetary stimulus".

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There are signs that the monetary policy transition mechanism is working and the RBNZ will be pleased to see the OCR cuts are starting to get some traction:

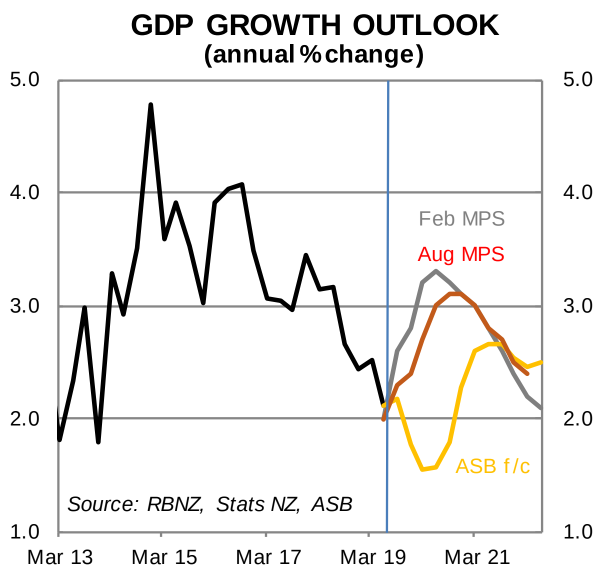
- Interest rates for retail lending and deposits are lower. Since early August, retail variable mortgage rates have fallen by around 50bps, whereas rates on 6-month to 2-year special mortgage interest rates have fallen by 40-45bps. On the flipside, term deposit rates have dropped from around 3% prior to the August OCR cut to around 2.5% currently.
- The housing market looks to be responding. Circa 3½% fixed mortgage interest rates have provided a tailwind to the housing market, with sales turnover and household lending strengthening and house prices picking up. Vehicle registrations have also firmed. Construction sector activity is going from strength to strength and the recent OCR cuts look to have supported confidence in the sector.
- There are tentative signs that consumer spending has also turned the corner, albeit modestly. Overall consumer confidence is still weighed by pessimism over the NZ economic outlook, but household sentiment about their own financial position has improved and may indeed support future consumer spending.
- The NZ dollar, at around 70.4 on a Trade Weighted Index basis, is nearly 4% weaker than the Q4 assumption in the August MPS.

However, more OCR stimulus is needed

In our view there remains a strong case for the RBNZ to cut the OCR by a further 25bps in November.

Despite brighter signs of late in global markets, NZ's trading partner growth is slowing. Chinese GDP growth is now the lowest since the early 1990s and the fiscal boost to the US economy is waning. **A lot needs to go right to prevent the global economy from slowing from here.** A conclusive breakthrough on the US-China trade war remains elusive despite the upbeat posturing of late. Risks of a hard Brexit have retreated for now, but with a UK election on December 12, the outlook is still murky. A resurfacing of downside risks is likely to see markets swing back to pricing in more interest rate cuts. We expect policy interest rate cuts by the Reserve Bank of Australia (RBA) and the US Federal Open Market Committee over the next few months.

The outlook for economic growth looks to be considerably weaker than the RBNZ forecast in August. Subdued business confidence and consumer disquiet over the economic outlook suggest a protracted run of sub-par outcomes for economic growth are in store that will translate into weaker labour demand and medium-term inflation. There is daylight between our forecasts for GDP and the August MPS forecast (see chart). Moreover, our estimates suggest that the risks of the NZ economy entering recession remain high (around 30%). The RBNZ seems to be of the view that fiscal and monetary stimulus will be sufficient to dig the economy out of a hole. **We are not so sure.** According to Budget 2019, the fiscal impulse is currently neutral and it will take time for any additional fiscal easing to boost the economy. Capacity constraints in construction, the reluctance to push for tax cuts and concerns over the quality of additional government spending could result in a likely pre-election fiscal easing taking time to impact on the economy. That would leave more of the burden of policy support falling on the RBNZ in the interim.

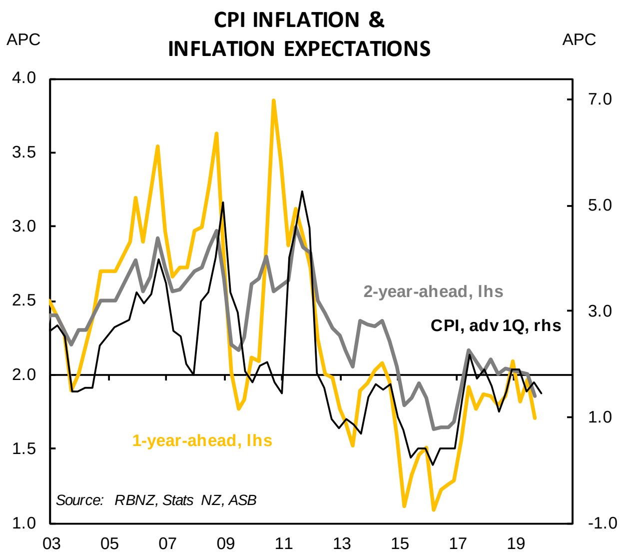


A lower OCR may support additional support for credit, but this added demand would need to be met by more credit availability to boost economic activity. **To us, it looks as though the proposed increases in bank capital requirements may already be playing a role in tightening financial conditions, via impacting credit availability.** Despite 75bps of OCR cuts since the last survey in March, the September 2019 RBNZ Credit conditions survey confirmed financial institutions feel that credit conditions have tightened over the last 6 months. Moreover, there is the expectation that credit availability will become more challenging for non-housing sectors including agriculture, commercial property and corporate/institutional. The survey respondents have increasingly highlighted regulation, bank risk tolerance and risk perceptions as headwinds to credit availability.

The RBNZ currently looks to be meeting its labour market objectives, but we think it has more work to do to ensure this remains the case. A 4.2% unemployment rate is still reasonably low and measures of labour underutilisation and underemployment have tightened. However, annual employment growth (+0.9% yoy) has fallen behind growth in the labour force (1.1%) and working age population (+1.7% yoy) and forward-looking indicators point to increasing labour market slack. Admittedly nominal wage inflation has risen to a decade high, but at 2.4% yoy remains modest in relation to the unemployment rate. Stripping out rises due to the higher minimum wage and major pay settlements leaves annual wage inflation at a much more modest 1.8%. Moreover, firms continue to struggle to push through cost increases into consumer prices.

From a regrets type analysis viewpoint, pre-emption – the rationale for the 50bps August MPS cut – still looks more optimal than delay. The recent mantra from the RBNZ and other global central banks has been to acknowledge the risk profile and cut first rather than pause and reflect. Structurally low inflation, slowing domestic/global growth and a negatively skewed risk profile all argue in favour of pre-emption. Our recent work suggests that the OCR could go as low as -0.75%. With the neutral OCR being as low as 2½%, current settings are not significantly lower than neutral and there is still plenty of ammunition in store. **Building a fence at the top of the cliff is more preferable to having to wait in the ambulance at the bottom.** Furthermore, it is close to 3 months until the next OCR decision (February 12) which significantly reduces the option value of waiting. While the financial market backdrop currently looks settled, it could be completely different in a month or so if downside risks flare up again.

Moreover, the trend in inflation has remained low. Core inflation from the RBNZ Sectoral Inflation Model (1.7% yoy) has been stuck below the 1-3% inflation target midpoint for a decade. Our analysis suggests that annual tradable inflation is likely to remain muted despite the lower NZD. Much of the lift in annual non-tradable CPI inflation (3.2% yoy) was driven by one-offs, with core non-tradable inflation stable at 2.7% yoy. Recall that the RBNZ has been putting considerable weight on (currently low) inflation expectations, with weak Q3 readings from the RBNZ survey likely to have played role in the 50bp August OCR cut**. The Q4 survey results are not published until November 12, but will be available when the November OCR decision is made**. The risks are skewed to expect inflation readings from this survey to remain low given lower annual headline CPI inflation. The RBNZ will be keen to prevent inflation expectations from slipping further below 2%.



Message kept simple and RBNZ to maintain a modest easing bias

We expect the policy assessment to be direct, outlining the rationale for the November cut. **Importantly, we expect the Statement to keep the door open to further policy stimulus, if necessary to meet the RBNZ policy objectives**. To close that door would put a rocket under the NZD and push NZ wholesale interest rates higher at a time when the RBNZ wants to keep monetary conditions accommodative. Moreover, we anticipate the RBNZ will reiterate that a prolonged period of highly accommodative OCR settings will be required.

RBNZ unliklety to revisit key policy judgements but to revise forecasts

The format of the MPS has changed significantly, becoming more issues-based and topical and less paint-by-numbers. This has helped to provide a more thorough assessment of policy relevant issues. **We expect that the key policy judgements from the RBNZ to be similar to those in August.** GDP growth has slowed and is expected to remain subpar in the early part of the projection period. Slowing global growth and still-heighted uncertainty is likely to continue to impact the broader NZ economy via a variety of channels – the August MPS highlighted trade, financial market and confidence/uncertainty. The NZ economy is heavily dependent on monetary and fiscal policy stimulus.

There will be some tweaks to the published forecasts relative to August. Critically, the starting point for growth is likely to be lower, and we can see clear downside risks behind the August MPS forecasts of a 1.1% rise in H2 2019 GDP and 3% yoy growth for much of 2020. We also expect a modestly firmer inflation starting point and a marginally lower unemployment rate profile. **The published OCR projections** are expected to show a floor of about 0.6%-0.7% by late 2020, before the OCR gradually firms from 2021.

What is in and what is out

A key focus for us is what is not in the MPS as well as what it contains. There are three key bits of information that the MPS is likely to omit:

- First, the RBNZ is set to unveil the (close to) final version of the proposed (higher) bank capital requirements in early December. Crucially, the November MPS is unlikely to include an assessment of what these will mean for the cost of bank funding, economic activity or inflation. If the capital requirements are adopted in their currently-proposed form, the RBNZ's own estimates suggest they could add arounds 20-40bps to retail lending rates. Our research suggests a larger potential impact (50bps+) and we are already seeing what they might be doing for credit availability. The OCR would need to move lower in time to compensate.
- Second, the RBNZ is unlikely to make many changes to its estimates of the Neutral OCR. RBNZ estimates (circa 3.2%) remain too high in our view (2.50%). We note the NZ Treasury looks to be coming around to our view.
- Third, the RBNZ's estimates of the Non Accelerating Inflation Rate of Unemployment (NAIRU) are likely to be too high (see our recent research here). A higher threshold for Maximum Sustainable Employment (MSE) could mean more policy stimulus is needed to meet it, all else equal.

These considerations point to a lower OCR profile than implied by current market pricing and by the RBNZ's likely OCR forecast track. **The 25bp cut we have pencilled in for 2020 is a nod towards these influences that will contribute to a lower-for-longer profile of the OCR.**

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