Economic Note

RBNZ November 2019 Monetary Policy Statement Review

13 November 2019

Whoops: RBNZ holds, market tightens

- The RBNZ surprised most people by keeping the OCR on hold. In response, wholesale interest rates have soared.
- Yet the RBNZ's growth outlook remains on the optimistic side, and it has yet to factor in the economic impact of its looming bank capital increases.
- We still expect the RBNZ will eventually need to cut the OCR twice further in 2020, and still expect a 0.5% low.

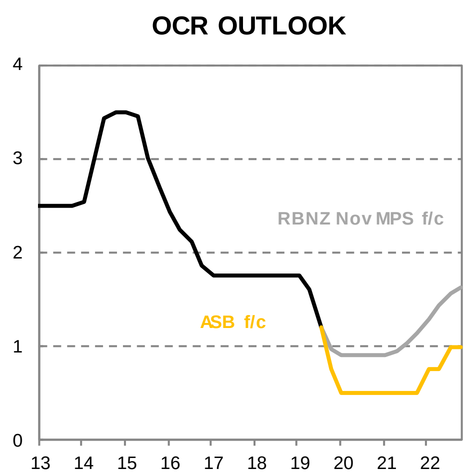
Summary and key take outs

The RBNZ surprised by keeping the OCR on hold. It assessed that developments since August had an offsetting impact on the monetary policy outlook. Yet its growth forecasts have been trimmed and assessment of capacity constraints in the economy has also been trimmed.

But to us, the RBNZ's new growth outlook still appears too rosy and it will eventually revise them down – meaning future inflation pressures will take longer to build up. Moreover, the RBNZ has yet to factor in the economic impact of its impending bank capital increases, for which we expect a bigger economic impact than the RBNZ. The RBNZ continued to forecast a low in the OCR of 0.9% (as it did in August). For these reasons, we continue to expect the OCR will eventually fall to 0.5%. The most likely timing for cuts is the February and May MPS releases.

Tactically, today's decision has back-fired. The interest rate market reaction has been sizable, with the 2-year swap rate up 21 basis points in the immediate aftermath. Wholesale interest rates are back to where they were before August's 50bp OCR cut, just ahead of a crucial period for the mortgage market and with the RBNZ's next decision window 3 months away.

What was behind the on-hold decision?



The key drivers for remaining on hold stem from an outlook that changed little in terms of its monetary policy assessment: the floor in the RBNZ's OCR remained at 0.9%. That implies some risk that a further cut may be needed, but evidently wasn't compelling enough for the RBNZ to act right now. Evidence of that is in the Monetary Policy Committee's view that "keeping the OCR at 1.0 percent versus reducing it to 0.75 percent" were both "broadly consistent with the current OCR projection". The policy assessment did keep the door open to further policy stimulus, if necessary to meet the RBNZ policy objectives.

Although the RBNZ noted that economic growth had slowed, it remained confident that growth would pick up next year. It also noted signs that past drops in interest rates were flowing through to the economy. But it has trimmed its growth forecasts, albeit not to the extent we have. And along with the weaker growth outlook, the RBNZ's assessment of capacity

Nick Tuffley – Chief Economist (649) 301 5659 nick.tuffley@asb.co.nz
Mark Smith – Senior Economist (649) 301 5657 mark.smith@asb.co.nz

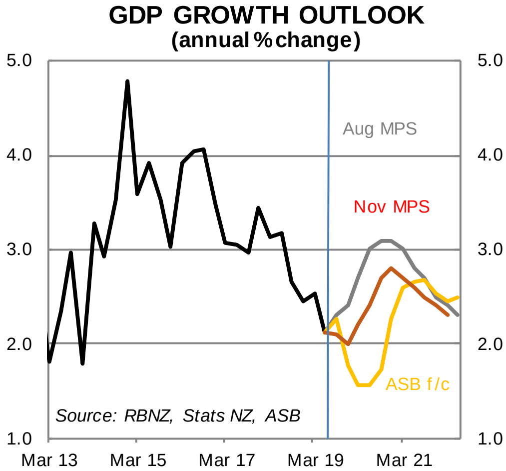
constraints in the economy has also been trimmed.

The RBNZ noted the robustness of NZ's export prices and positive outlook for NZ's Terms of Trade – NZ's trade performance is pretty good despite the Donald and Boris double-act. The RBNZ is also talking up the prospect that fiscal stimulus could be greater than it is currently assuming. That may turn out to be the case, but to date the Government has given no clear public indication.

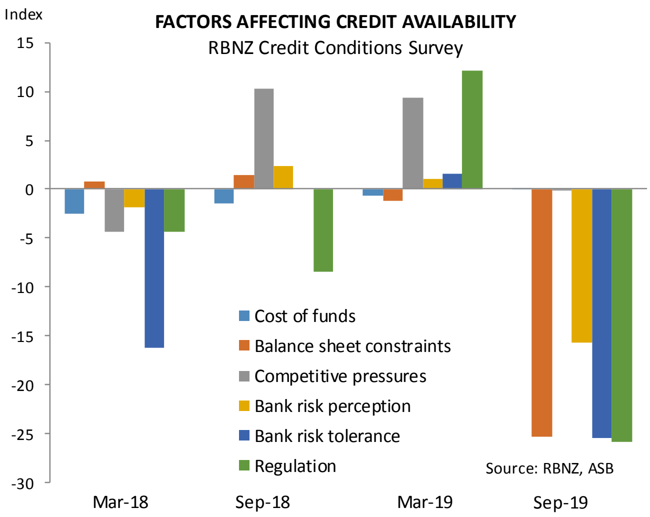
Inflation expectations have also continued to fall, although the RBNZ still sees expectations as anchored "close to the 2 percent target mid-point". Unlike back in August, the RBNZ appears less concerned even though some measures of inflation expectations are at 4½ -year lows.

Where to now?

Notwithstanding today's decision, we still expect a further 50bp of OCR cuts to a low of 0.5%, with 25bp cuts in February and May. It would be stating the obvious that for further cuts to occur, the RBNZ's stance would need to shift to seeing a clear need for further monetary stimulus. Below are some key reasons we see why the RBNZ will eventually lean that way:



- Economic growth: the RBNZ appears optimistic that growth will pick up quickly from the end of this year. We see that pick-up as more gradual, noting that business opinion surveys still point to a lot of caution;
- Labour market: 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;
- Credit supply: the stimulatory impact of lower interest rates will need to be facilitated by the sufficient availability of credit. **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.** 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 which will work against the OCR cuts and slow the economy.**
- Higher wholesale interest rates: the market reaction today, and the lift in interest rates that had been occurring in preceding weeks, have unwound much of the impact of past OCR cuts.



Talking tactics

It is always hard satiating markets, which have a habit of pricing in 4 of the next 2 OCR cuts at the mere sniff of weak economic data. And to be fair to the RBNZ today, its long-term outlook didn't give a firm case for cutting the OCR further at this point.

However, we do think the RBNZ could have taken a different tactical path today and cut anyway, particularly given that the risks will remain tilted towards the need for a lower OCR at some stage. A cut would at least have kept interest rates anchored low.

In contrast, the market has pushed wholesale interest rates substantially higher in the immediate aftermath of the decision. To put things into context, the 2-year swap rate is now 1.23% and it was 1.25% *before* the RBNZ's surprise 50bp OCR cut back in August. From a low of 0.82%, the 2-year rate (and the entire interest rate curve) have ground higher as global optimism around trade tensions and Brexit has improved. But around half of that rates rebound has occurred in response to the RBNZ's OCR decision.

The RBNZ now enters a 3-month decision-making hiatus. That hiatus starts with wholesale interest rates up markedly, with the risk that mortgage rates start to lift (and fuel FOMO) just as the seasonal spring upswing in housing activity hits its straps. Crucially, a lot of mortgage rate re-fixing will be happening in coming months. The associated balance sheet risk management of that re-fixing will in itself put upward pressure on wholesale swap rates, compounding the recent wholesale market pressures. Keeping the OCR on hold is not without its risks.

Monetary Policy Committee: High level policy considerations

Nov MPS Record	**Sep OCR Record**	**Risks to OCR (ASB view)**
Tactical considerations 0.75% and 1.00% OCR both broadly consistent with current OCR projection, but suitable to wait for full impact of past OCR cuts to take effect.	*Tactical considerations* Developments had not changed significantly since the August 50bp cut to consider other OCR paths.	*Tactical considerations* Downside. RBNZ look to have underestimated market response to on hold OCR decision. Significant tightening in financial conditions post OCR decision likely to result.
OCR settings and bias Offsetting developments since August MPS. Will cut OCR if conditions permit. Monetary policy would need to remain accommodative to meet objectives. Some grounds to hold OCR given financial stability considerations.	*OCR settings and bias* Developments had not significantly changed the outlook for monetary policy since August. Consensus to keep the OCR at 1.0%. Scope for more fiscal and monetary stimulus if necessary.	*OCR settings and bias* Downside. RBNZ growth projections look optimistic and do not make allowance for higher bank capital requirements. We still expect 50bps of OCR cuts over 2020.
Global prospects and trade Global growth has continued to slow, but some offset from elevated terms of trade, strong commodity export prices.	*Global prospects and trade* Global trade and other geopolitical tensions remain elevated, dampening the global growth outlook and demand for NZ exports.	*Global prospects and trade* **Balanced.** Have similar view to RBNZ on the outlook for trading partner growth and export price environment.
NZD and overseas central banks MPC expect low global interest rates would persist for some time.	*NZD and overseas central banks* MPC pleased to see the exchange rate decline since the August OCR cut.	*NZD and overseas central banks* Some upside. RBNZ technical assumption for TWI is higher than ASB forecast view until 2021.

Nov MPS Record	Sep OCR Record	Risks to OCR (ASB view)
Domestic outlook Near term risks to downside Signs recent monetary/fiscal stimulus supporting medium-term growth. More discussion on fiscal stimulus, with both upside and downside risks outlined.	*Domestic outlook* Slower GDP growth over H1 2019. Demand pressures and low interest rates, supportive fiscal policy to boost domestic demand. Weak business confidence is impacting investment.	*Domestic outlook* Downside. RBNZ November growth projections still look too optimistic as they assume significant traction from policy stimulus and do not incorporate bank capital impact.
Labour market Employment remains close to its maximum sustainable level. Soft demand expected to reduce capacity pressure and ease labour market tightness.	*Labour market* Employment remains close to its maximum sustainable level. Scope for more fiscal and monetary stimulus to support RBNZ employment objectives.	*Labour market* Downside given risks to growth outlook.
Inflation Inflation, inflation expectations low, but still in 1-3% target band. Monetary stimulus is lifting wage and CPI inflation.	*Inflation* Rising capacity pressures and increasing import costs, higher wages, and pressure on margins expected to lift inflation gradually to 2%. Both upside and downside risks to inflation outlook.	*Inflation* Downside. Low NZ inflation looks be structural. Some of the lift in non-tradable and wage inflation looks transitory, with sub-trend growth to cool inflationary pressures.

Statement

The Monetary Policy Committee has decided to keep the Official Cash Rate (OCR) at 1.0 percent. Employment remains around its maximum sustainable level while inflation remains below the 2 percent target mid-point but within our target range. Economic developments since the August Statement do not warrant a change to the already stimulatory monetary setting at this time.

Economic growth continued to slow in mid-2019 reflecting weak business investment and soft household spending. We expect economic growth to remain subdued over the remainder of the calendar year. We will continue to monitor economic developments and remain prepared to act as required.

Trading-partner growth has also slowed. Growth in global trade and manufacturing is weak and uncertainty remains high, dampening global business investment. However, New Zealand's export commodity prices have been robust, underpinning a positive terms of trade. The lower New Zealand dollar exchange rate this year is also providing a useful additional offset to the weaker global economic environment.

Domestic economic activity is expected to increase during 2020 supported by low interest rates, higher wage growth, and increased government spending and investment. The low level of the OCR has flowed through to lower lending rates more generally, which support spending and investment. Rising capacity pressures are projected to promote a pick-up in business investment.

Interest rates will need to remain at low levels for a prolonged period to ensure inflation reaches the mid-point of our target range and employment remains around its maximum sustainable level. We are committed to achieving our inflation and employment objectives. We will add further monetary stimulus if needed.

Summary Record of Meeting - November 2019 Statement

The Monetary Policy Committee agreed that economic developments since the August Statement had been offsetting for the monetary policy outlook. The members discussed the projections and agreed that they formed a sound basis for their monetary policy decision, but noted the near-term downside risks to the economy.

The Committee agreed that accommodative monetary policy remains necessary to continue to meet their inflation and employment objectives.

The members noted that employment remains close to its maximum sustainable level while consumer price inflation remains below the 2 percent target mid-point but within the 1 to 3 percent target range.

The Committee noted that global growth had continued to slow. The members noted the weak global trade growth and continued elevated uncertainty.

The Committee discussed the impact of the global slowdown on New Zealand through trade, confidence, and financial channels. While the impact on New Zealand was seen to be negative overall, some members noted that our export commodity prices remained elevated which was boosting our terms of trade and national income.

The Committee noted the slowdown in domestic GDP growth. They also noted that business surveys suggest weak growth has continued over the second half of 2019. The members discussed the slowdown in potential output growth, which may explain the economy remaining near capacity over this time. Weaker demand was expected to reduce capacity pressure in the near term, and ease some of the recent labour market tightness.

The members anticipated a lift in economic growth during 2020 from the easing of monetary policy that has taken place since early 2019 and from stronger fiscal stimulus.

The Committee noted the signs that recent monetary stimulus was flowing through the economy and supporting the medium-term growth projections. The members noted that the reduction in retail lending rates over the past year would support the outlook for consumption and broad investment. The Committee noted the lower exchange rate this year as another channel supporting the economy.

The Committee discussed the impact of fiscal stimulus on the economy. The members noted that fiscal stimulus could be greater than assumed. The members also discussed the potential delays in implementing approved spending and investment programmes.

The Committee discussed the recent inflation developments and, in particular, the recent increases in wage and non-tradables inflation. The members noted the increase in inflation and wages is an expected outcome of monetary stimulus transmitting through the economy. Some members noted the pick-up in non-tradables inflation in the September 2019 quarter was partly due to administrative prices.

The Committee also noted the slight decline in one- and two-year ahead survey measures of inflation expectations. Nevertheless, long-term inflation expectations remain anchored at close to the 2 percent target mid-point and market measures of inflation expectations have increased from their recent lows.

The Committee members discussed some of the reasons why long-term interest rates were near secular lows. They noted the contributions from global factors, including ongoing low inflation, declining neutral interest rates, and policy uncertainty. Given this, the Committee expected that low global interest rates would persist for some time.

The Committee discussed the effect of low interest rates on financial stability. The members noted the risks to the soundness of the financial system. They discussed the relationship between financial stability and the employment and inflation objectives, noting the current deployment of financial stability policies. The Committee agreed it was appropriate to continue to set interest rates to meet its inflation and employment objectives.

The Committee noted the Bank's work programme assessing alternative monetary policy tools in the New Zealand *environment, as part of contingency planning for an unlikely scenario where additional monetary instruments are required.*

The Committee agreed that it was necessary for monetary policy to remain stimulatory for some time to meet its employment and inflation objectives. In terms of least regrets, the Committee discussed the relative benefits of inflation ending up in the upper half of the target range relative to being persistently below 2 percent.

The Committee debated the costs and benefits of keeping the OCR at 1.0 percent versus reducing it to 0.75 percent. The Committee agreed that both actions were broadly consistent with the current OCR projection. The Committee agreed that the reduction in the OCR over the past year was transmitting through the economy and that it would take time to have its full effect.

The Committee reached a consensus to keep the OCR at 1.0 percent. The Committee noted that the risks to the economy in the near term were tilted to the downside and agreed it would add further monetary stimulus if economic developments warranted it.

ASB Economics & Research			**Phone**
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659
Senior Economist	Mark Smith	mark.smith4@asb.co.nz	(649) 301 5957
Senior Economist	Jane Turner	jane.turner@asb.co.nz	(649) 301 5853
Senior Economist	Mike Jones	Mike.jones@asb.co.nz	(649) 301 5660
Senior Rural Economist	Nathan Penny	nathan.penny@asb.co.nz	(649) 448 8778
Senior Economist, Wealth	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 301 5915
Data & Publication Manager	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660

www.asb.co.nz/economics **@ASBMarkets**