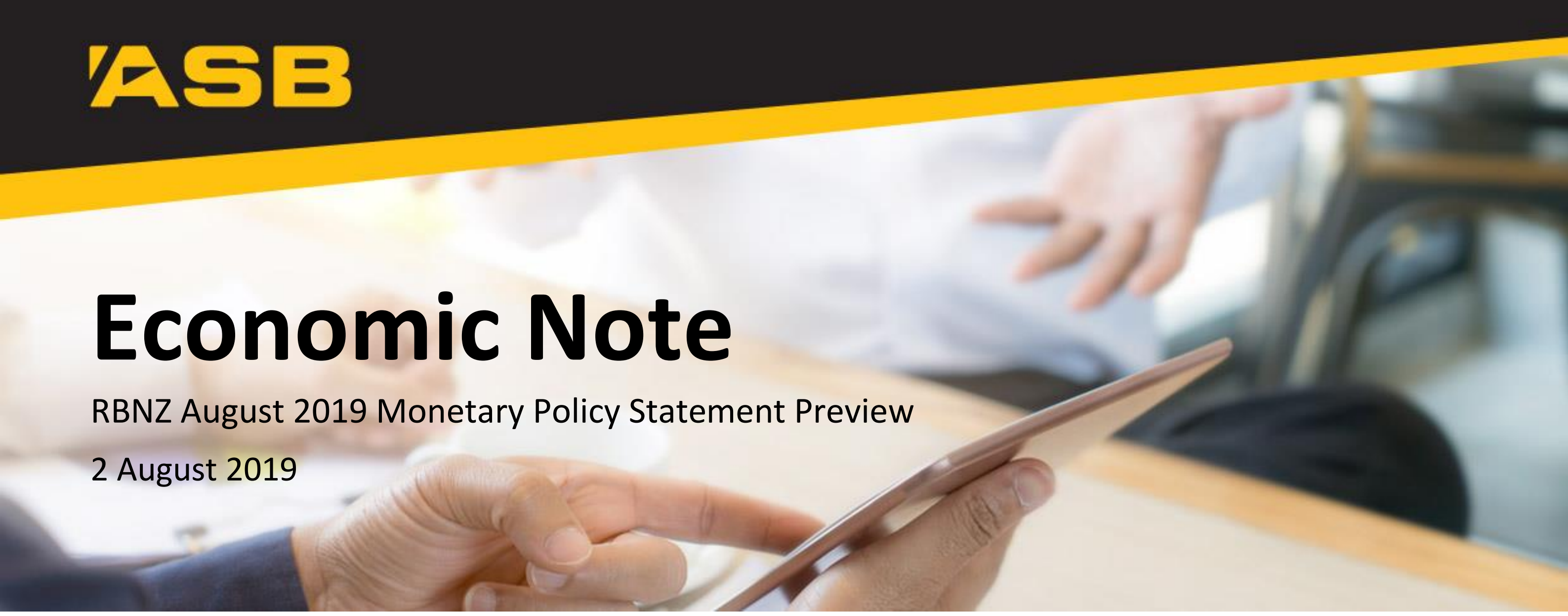

Economic Note

RBNZ August 2019 Monetary Policy Statement Preview

2 August 2019

MPC to reach consensus and cut OCR to record low

- We expect the Monetary Policy Committee (MPC) to reach consensus and to cut the OCR by 25bps to 1.25%.
- The MPC is expected to reiterate a “more balanced” policy outlook, but we expect that they will retain an easing bias that will open the door to at least one further cut.
- We still expect a follow-up 25bp OCR cut in November and 1% OCR to be the trough this cycle, but the risk is that the OCR is cut earlier, and the OCR trough is deeper if the RBNZ front foots policy easing.

We expect a 25bp OCR cut to be delivered next week (to 1.25%), with the Monetary Policy Committee expected to reach a consensus decision. A number of domestic and global catalysts look to have sanctioned more monetary stimulus. We expect the RBNZ to reiterate that the OCR outlook remains “more balanced” following the August cut, but with the published OCR track to highlight the possibility of a follow-up cut by late 2019/2020.

The RBNZ’s economic projections are expected to signal a pick-up in growth from late this year, from which we see some downside risk. Slower domestic growth and the likelihood of more spare capacity within the labour market relative to the RBNZ’s view heighten the risk of more policy stimulus being needed and will likely have a bearing on how low the OCR does in fact go. We expect a follow-up 25bp OCR cut in November and 1% OCR trough, with the risk that OCR is cut earlier and the OCR trough is deeper. This still looks dependent on more downside risks crystallising.

RBNZ to cut to the chase

In the June OCR Review, the RBNZ set the scene, reiterating that a lower OCR may be needed “over time” to meet the RBNZ’s twin monetary policy objectives. That time has come and we expect the period of a 1.50% OCR to be brief, with the **newly-formed RBNZ Monetary Policy Committee to act upon its easing bias and to reach a consensus decision** that a further 25bp cut to the OCR cut was necessary.

Pushing the RBNZ over the rate cut line will be a combination of global and domestic catalysts. **The global scene is troubling.** The global economy is slowing, with risks around the sub-par outlook tilted to the downside. Forecasts for global growth continue to be trimmed. Chinese GDP growth is the weakest since the early 1990s, while growth across the ditch has slowed to the lowest in a decade. Growth in the Eurozone is barely positive with a weak outlook. Even growth in the US economy is slowing. Global trade growth has slowed to a crawl, with China and the US still engaged in a costly trade war. Risks of a hard Brexit are growing, with UK Prime Minister Johnson digging his heels in and refusing to compromise, and with the European Union remaining steadfast for now. New Zealand’s Terms of Trade look set to remain in the stratosphere, but there seems to be a limited flow-through into domestic economic activity as farmers are ‘encouraged’ to reduce debt to bolster their financial resilience and as cheaper imports do not boost overall GDP.

We share the MPC’s characterisation of the state of domestic growth as being “subdued” and have flagged persistently-weak business sentiment and slowing momentum in the services sector as flash points. **However, the NZ**

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economy looks to have slowed by more the RBNZ would have anticipated. In fact, both the ANZ and NZIER business confidence surveys have weakened appreciably since the June OCR decision. Business sentiment is undoubtedly soft, but we note that construction sector activity continues to go from strength to strength. Low customer interest rates are a boon for borrowers and provide support to the housing market, much less so for savers. Worries over the economic outlook continue to weigh on consumer sentiment (and potentially consumer spending). Capacity constraints and policy lags currently look to have tempered the boost provided from Fiscal stimulus**. We continue to see more downside risk than up to the RBNZ's inflation outlook** and believe there is a structural (longer-lasting) component to current low inflation outturns, both here and abroad.

Linked to the policy outlook, will be the RBNZ's characterisation of the economic outlook. The August MPS will include detailed economic projections, which are expected to show a weaker growth outlook over calendar 2019, with GDP growth expected to pick up towards the end of the year. The unemployment rate is expected to drift slightly higher, but then ease over the projection period. After some volatility, annual CPI inflation is expected to settle around the midpoint of the 1-3% inflation target at the end of the projection period. **The published OCR track is expected to flag the likelihood of at least one further OCR cut by late 2019/2020, with the OCR edging up towards the end of the projection period.**

The RBNZ will be closely following the actions of oversea central banks, particularly with exchange rates taking direction from changes in respective monetary policy stances. Much of the reason why the NZD has not been higher is the expectation that the RBNZ will cut the OCR. Not cutting runs the risk of putting a rocket under the NZD. The US Federal Open market Committee has just delivered its first cut to the Federal Funds rate since the Global Financial Crisis, and may do more. With the RBA cash rate at a record low 1%, the RBNZ will be nervously looking across the Tasman, mindful that a dovish RBA policy outlook (and lower RBA cash rate) could drive the NZD/AUD higher still.

The MPS is unlikely to account for the impact of proposed impact of higher bank capital requirements, which is understandable given the proposals are still at the consultation stage. If these capital requirements are imposed, our work suggests they look set to add at least 50bps to customer interest rates. If we start to see customer borrowing rates move higher as a result of the capital requirements, this will likely necessitate a lower OCR, all else equal.

More capacity in the labour market

Our work also suggests that the economy is still close to maximum sustainable employment (MSE), with the trend in MSE likely to continue to head upwards. The demand for labour looks to be cooling (weak employment intentions from the July ANZ business outlook were especially troubling). **We see the risks as being tilted towards more spare capacity accruing in the labour market, with employment falling below its MSE, likely restraining wage inflation and weighing on medium-term inflation. This will likely have a bearing on how low the OCR does in fact go.** The Q2 labour market figures are published the day before the August MPS and look unlikely to shift the dial for OCR settings.

How low can the OCR go and how quickly?

This is the $64,000 question. NZ yields are hovering around record lows and our view is that they will likely move lower still. **Our core view is that the OCR will plateau at 1.00% in November (and possibly earlier).** This view assumes that the global economy holds together and the underlying supports to the NZ economy – including elevated terms of trade, low borrowing costs and fiscal stimulus – flow through into economic activity and employment and keep inflation centred around the midpoint of the 1-3% CPI inflation target.

However, we still see the balance of risks to the global and domestic outlook skewed to the downside, and the RBNZ could quite easily find itself needing to do more if downside risks materialise. The OCR could potentially move below 0% (-0.75% is the likely lower bound according to the RBNZ). There is scope for the RBNZ to adopt unconventional monetary policies, including for example, adopting negative policy interest rates, conducting large - scale asset purchases and imposing targeted term lending schemes to ease credit conditions. These measures may be of limited impact and carry risks, but it still encouraging for the RBNZ to be doing work investigating unconventional policy measures. Just in case.

When push comes to shove, we believe that the OCR could conceivably go as low as 0.5%. The depth and length of the trough in the OCR remains conditional on the global and domestic outlook, the extent of persistence of recent low inflation outturns, the actions of global central banks, the NZD, and whether bank deposit interest rates will be sufficiently high to attract funding for banks. We will be doing some work in this area in the coming months.

Market reaction

After earlier being on the front foot, market pricing has overtaken the RBNZ view. Current market pricing is close to fully priced for a 25bp cut in August, with close to 50bps of OCR cuts priced in by the end of the year, and with the OCR to trough at around 0.90% from mid-2020. If the RBNZ does not cut the OCR it goes without saying that both the NZD and short-term domestic interest rates will be higher. There could be a modest uptick in local yields if, as we expect, the RBNZ cuts the OCR by 25bps and flags the prospect of a further 25bp cut. There is still the risk the RBNZ gets on the front foot, cuts by 25bps and clearly signals imminent future cuts (i.e. likely September), in which case the NZD will likely fall and markets will rush to price in earlier cuts to the OCR and a lower OCR trough. Looking ahead, we will be closely monitoring the actions of global central banks (most notably the RBA and FOMC), the NZD, as well as developments pertaining to the domestic and global outlook.

Monetary Policy Committee: High level policy considerations

June OCR Record	Subsequent Developments	Risks to MPC View on OCR
Global prospects Global economic growth had continued to slow. Weakening in global trade and elevated trade tensions/ Overseas central banks expected to ease monetary policy	Continued slowing in global growth and trade. Cuts to global growth forecasts. Risks of hard Brexit growing. US and China trade dispute unresolved.	Further downside
NZD and overseas central banks TWI to average 72-73 over the projection period.	NZD TWI in line with May MPS projections. Market pricing skewed for more rate cuts	Risk of higher NZD/lower OCR
Domestic outlook Stronger starting point for Q1 GDP. Subdued domestic growth. Strong construction/weak services activity. Budget 2019 incorporated a stronger outlook for government spending than assumed in the May Statement. Softer house prices and impact on household spending.	Strong construction activity. Even weaker business (and consumer) sentiment. GDP growth unlikely to match 0.8% qoq average till late 2020 assumed in May MPS. ASB expects an average closer to 0.6-0.7% qoq per quarter.	Further downside
Labour market Employment is broadly at and expected to remain near its maximum sustainable level. Risks tilted to the downside.	Labour around MSE, but spare labour market capacity looks to increase over projection period.	Downside
Inflation Disconnect between capacity metrics and wages and subdued private sector wage growth. CPI inflation slightly below 2%. Risks to inflation outlook on downside	Q2 CPI inflation in line with RBNZ view. We view low inflation has being structural, with downside risk to RBNZ medium-term view.	Modest downside
OCR settings and bias Consensus to leave OCR on hold at 1.50% More support from monetary policy needed given weaker global growth and subdued domestic demand.	Conditions to cut OCR 25bps in August look to be met. OCR track to flag possible follow-up cut.	Downside

Source: ASB

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