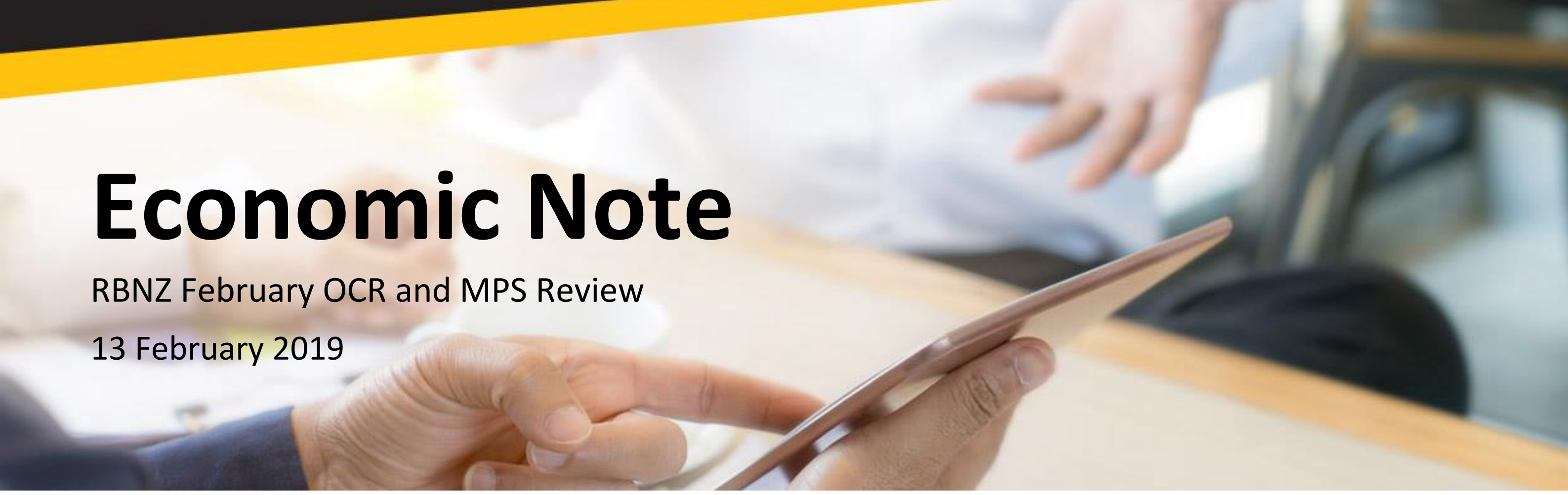


Economic Note

RBNZ February OCR and MPS Review

13 February 2019

RBNZ joins lower for longer view

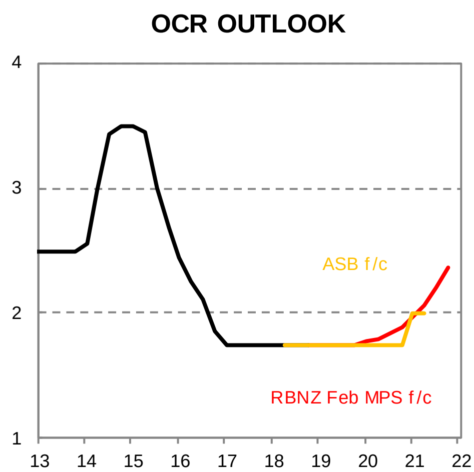
- The RBNZ Monetary Policy Statement was broadly as expected: no OCR change, but a longer on-hold period.
- A greater degree of negative global risks contributed to the RBNZ pushing its tightening out by six months.
- We expect the RBNZ to remain on hold until early 2021, but contingent on growth lifting as forecast.

The statement delivered was broadly in line with expectations, with **a note of added caution on the global environment coming through and contributing to a slight delay in when the RBNZ thinks it will eventually raise the OCR.** The RBNZ tweaked the language detailing the OCR outlook (reintroducing the "next OCR move could be up or down"), but we see the shifts as keeping consistent with the RBNZ's ongoing neutral stance. In the media conference the Governor noted the risks of a cut have *not* increased.

We recently changed our view on the OCR outlook and expect the OCR to remain on hold at 1.75% until February 2021. A key influence on our view change was the likely impact of the RBNZ bank capital proposals on banking funding costs and the broader economy. The impact of the capital changes is set to filter through roughly at a time when the RBNZ would be expected to otherwise be tightening to reduce the monetary stimulus in the economy.

Today's RBNZ Statement reinforces the 'lower for longer' view. However, both our and the RBNZ's OCR views are contingent on the economy regaining momentum over 2019. The strength (or otherwise) of the economy this year will be pivotal to whether the RBNZ remains on hold or does indeed cut the OCR (as flagged by market pricing).

The key judgements



The RBNZ's view of the outlook is that the tailwinds to growth have eased. Trading-partner growth is starting to slow, partly because of trade tensions and tighter financial conditions. Domestically, GDP growth has slowed and business confidence is low.

Viewing our version of the RBNZ's key judgements and risks shows **a subtle tweak towards highlighting more of the (predominantly downward) global risks.** Risks to the domestic growth outlook remain downwardly skewed, with the RBNZ also flagging the risks posed by weak business confidence and to the outlook for net exports. Moreover, risks on the inflation outlook were less to the upside, as the RBNZ have scaled back the risks to tradable inflation and pass-through from previous increases in petrol prices.

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Please refer to the important disclosures at the end of this document.

As the RBNZ notes, **the outlook is subject to numerous uncertainties and judgements**. To keep the assessment balanced, the MPS presented both an upside (firms pass on cost increases by more than expected) and downside scenarios (global demand does not deteriorates significantly). This was despite the more downward skew to its view of the risks.

RBNZ key judgements and risks	**RBNZ Risk assessment (February MPS)**	**RBNZ Risk assessment (November MPS)**	**ASB's View**
Robust global growth continues:	Downside via trade. Balanced NZD outlook as overseas central banks pause	Downside via trade partly offset by overseas central banks hiking rates, reducing NZD	Downside risks have increased: on trade tensions and evidence of weakening Chinese GDP growth.
Global inflation increases gradually:	Balanced	Upside via trading partner inflation	Reduced upside: through recent weakness in oil prices and higher NZD.
NZ grows above trend:	Some downside due to weak business confidence and risks to net export outlook	Some downside due to weak business confidence	Some downside due to weak business confidence and weak profitability.
NZ capacity pressures build:	Some upside, given stretched labour capacity and zero output gap starting point	Marginal downside due to more labour and goods market capacity	Some downside: from lower 2018H2 growth.
Inflation takes its time to return to target:	Less upside. Upside via wages, capacity pressures, but sideways via	Upside via wages, higher petrol prices, capacity pressures	Reduced upside: Headline CPI was lower than expected and wage growth has remained modest.

Source: ASB. Red denotes a downgrade to the RBNZ's assessed risk, green an upgrade to the risk. Black is unchanged risk.

A less rosy globe

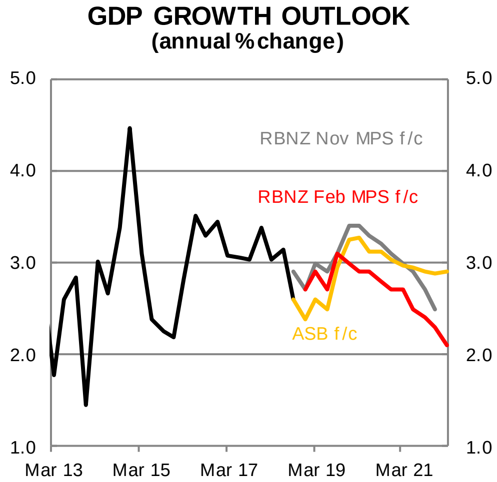
The RBNZ notes that global and trading partner growth has begun to slow and is likely to slow further over 2019. Indeed, the Bank points out that this slowing in momentum is expected to weigh on growth in New Zealand. The RBNZ adds that **tighter financial conditions and policy uncertainty are compounding the slowdown**, with concerns about the US-China trade tensions reducing financial markets' risk appetites. Commodity prices such as oil have also fallen in tandem with the weaker growth outlook.

The risks to the global outlook are also skewed to the downside. This fact is highlighted by the RBNZ including a full paragraph in its policy assessment on the global outlook (just a sentence was included in the previous Statement). In addition, the RBNZ introduces a downside scenario where the global economy slows more than in the RBNZ's central forecasts. The scenario also shows growth falling to 2.2% in 2019 and the OCR 50 basis points lower by mid-2020 than in the Bank's central scenario.

All up, we agree with this view. At this stage though, we note that NZ's export sector is holding up well, with dairy prices firming more than we had expected so far over 2019. Nonetheless, we agree that the global economy will continue to key source of risk to the monetary policy outlook over 2019.

Growth recovery a little more gradual

GDP growth is still expected to pick up over 2019 and 2020, albeit more gradually than assumed in November. A number of key growth drivers remain, including monetary stimulus, Government spending and higher net exports. A broad range of indicators suggests employment is near its maximum sustainable level and the RBNZ expect the unemployment rate to remain low over the projection period. However, household consumption growth is expected to moderate further as low house price inflation and slowing population growth weigh on consumer spending. Capacity constraints are also expected to limit residential investment growth in the near term. Modest growth is expected for business investment and the RBNZ acknowledge the risks that the recent decline



in business investment proves to be longer as global uncertainties intensify. Compared to the RBNZ, we are not as optimistic on the near-term growth outlook, but we remain constructive on the outlook for medium-term growth despite slowing population growth.

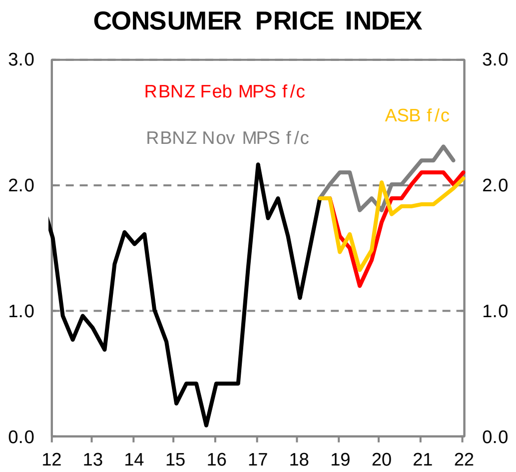
The RBNZ's projections signal an impending economic rebalancing. The composition of GDP growth is expected to become less import-intensive as growth in household consumption and business investment slows. However, there is a structural requirement to boost investment to address capacity constraints and prolong the expansion.

Inflation to dip sharply, but still heading for the mid-point

The RBNZ expects underlying inflation to pick up gradually, as capacity constraints and wage inflation lift over time. But the emphasis is on gradually, with the RBNZ noting that businesses are finding that competitive forces are preventing them from maintaining margins. The RBNZ also sees price-setting behavior as still being influenced by the past period of subdued inflation.

The two reasons above are also what the RBNZ sees as the key risks of stronger than expected domestic (non-tradable) inflation. Intensifying cost pressures could yet to force firms raise prices more swiftly than they have, sweeping aside competitive constraints and/or jolting firms to be more forward-looking. The RBNZ also observed that over the past 18 months that non-tradable inflation has been stronger than it has expected, including in the most recent CPI release.

The RBNZ's inflation forecasts now show a noticeable dip over 2019, similar to our own forecasts and consistent with the marked reversal in oil prices since last October. Annual CPI inflation is expected to approach 2% in late 2020, six months later than forecast in the November MPS forecasts. Our own forecasts have a more gradual return to the target midpoint, but are within cooee from late 2020.



Bank capital not seen as a significant influence

As noted in our Preview, we see sharp increases in bank capital as dampening the degree of future monetary tightening. These shifts were a primary reason why we tweaked our own OCR outlook. We now have a similar starting time to the RBNZ (early 2021), but a milder degree of tightening than the RBNZ's forecasts hint at.

The RBNZ's statement commented on the monetary policy implications of the proposed capital requirements (Pg 35). **The RBNZ judges that the spread of banks' lending rates to the rates at which they borrow will settle in the range of around 20 to 40 basis points higher** as a result of the proposed changes, although they acknowledge the exact effects are uncertain. Our estimates are in a slightly higher ballpark (centered around 50 basis points). However, **what was notable was the absence of any discussion of the potential for the supply of credit to be constrained**, something that would create extra drag on the economy (and reduce inflation pressures).

The RBNZ did note that "If additional support to demand is required during the potential transition to higher levels of bank capital, monetary policy would be able to respond as needed. This will be assisted by the proposed long transition period." Essentially, our view is encapsulated in that first sentence, in that the capital changes will be significant enough that they influence the future path of monetary policy.

Market reaction

While the RBNZ assessment was in line with our assessment it was not as dovish as market expectations, with the NZD and NZD interest rates up sharply following the release of the statement. The NZD rose 100pips against the USD (to 0.685), with the NZD up by a similar margin against other major TWI bilaterals. Yields on the bellwether NZ 2-year swap rose 8bps (to 1.89%), with NZD rates 8-10bps higher across the curve.

February 2019 RBNZ media release

Statement by Reserve Bank Governor Adrian Orr:

Tena koutou katoa, welcome all.

The Official Cash Rate (OCR) remains at 1.75 percent. We expect to keep the OCR at this level through 2019 and 2020. The direction of our next OCR move could be up or down.

Employment is near its maximum sustainable level. However, core consumer price inflation remains below our 2 percent target mid-point, necessitating continued supportive monetary policy.

Trading-partner growth is expected to further moderate in 2019 and global commodity prices have already softened, reducing the tailwind that New Zealand economic activity has benefited from. The risk of a sharper downturn in trading-partner growth has also heightened over recent months.

Despite the weaker global impetus, we expect low interest rates and government spending to support a pick-up in New Zealand's GDP growth over 2019. Low interest rates, and continued employment growth, should support household spending and business investment. Government spending on infrastructure and housing also supports domestic demand.

As capacity pressures build, consumer price inflation is expected to rise to around the mid-point of our target range at 2 percent.

There are upside and downside risks to this outlook. A more pronounced global downturn could weigh on domestic demand, but inflation could rise faster if firms pass on cost increases to prices to a greater extent.

We will keep the OCR at an expansionary level for a considerable period to contribute to maximising sustainable employment, and maintaining low and stable inflation.

Meitaki, thanks.

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