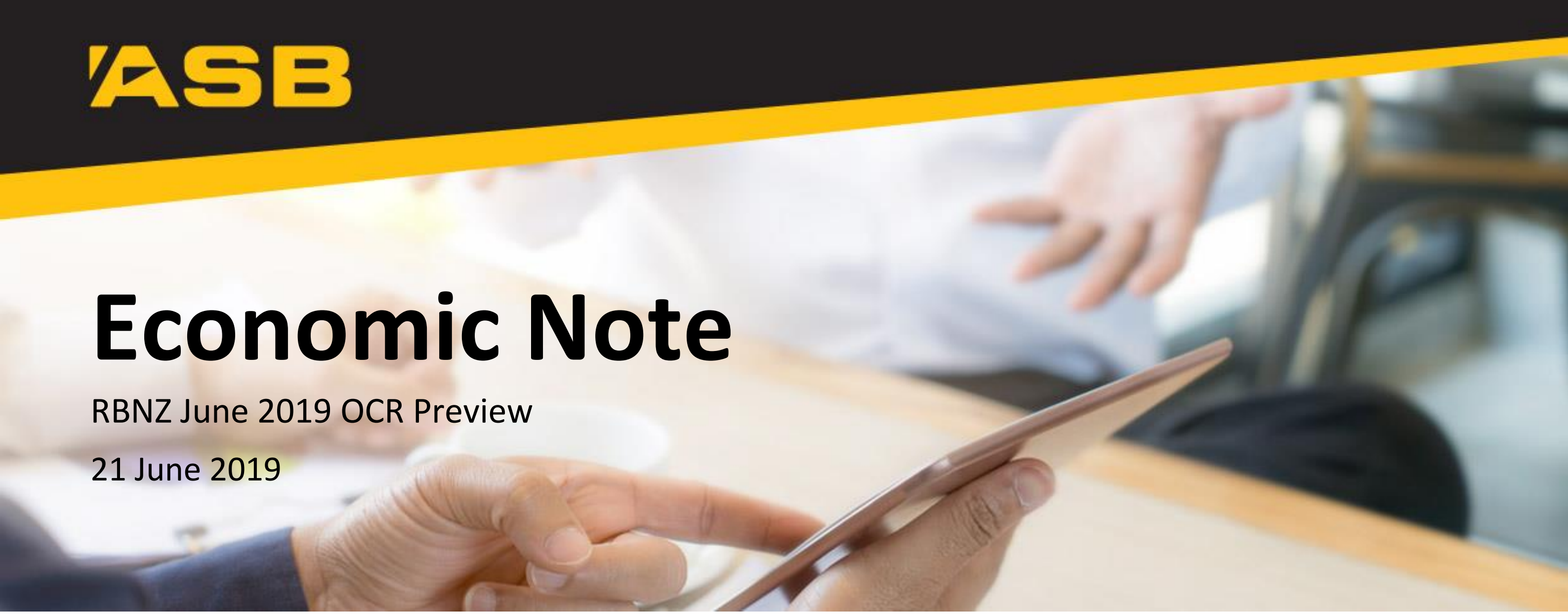

# Economic Note

RBNZ June 2019 OCR Preview

21 June 2019

## Easing bias in evidence

- We expect the Monetary Policy Committee to hold the Official Cash rate at 1.50%, and to retain an easing bias.
- This is only expected to be a temporary respite, with the OCR set to hit another record low of 1.25% in August.
- Absent a marked deterioration in global prospects, we do not expect the NZ economy will require significantly more interest rate support. Talk of the OCR falling towards (and below) 0% and unconventional policy support being necessary looks a little premature at present, although the RBNZ should be prepared to act if needed.

It's been just over a month since the RBNZ cut the Official Cash Rate (OCR) to a new record low of 1.50%, deeming it was necessary to support a "more balanced' outlook for NZ interest rates. We expect the RBNZ to hold the OCR at 1.50% in June, but to acknowledge the risk profile and signal that the future direction of the OCR is likely downwards. This is only expected to be a temporary respite, with the OCR set to hit another record low of 1.25% in August so as to meet the RBNZ's inflation and labour market objectives under the *Remit for the Monetary Policy Committee* (the 'remit'). Nothing can be ruled out in the current juncture, but there remain a number of supports to the economic outlook that should generate sufficient inflationary pressure and keep employment sufficiently elevated as to prevent the OCR moving lower still. Absent a marked deterioration in global prospects, talk of the OCR heading towards zero (and potentially below it) and quantitative easing (QE) being required in NZ still appears a little premature.

### RBNZ off the fence

In the May Monetary Policy Statement (MPS), the RBNZ finally got off the fence and cut the OCR by 25bps to a new record low of 1.50%. The motivation was that the RBNZ had come around to the view that a 1.50% OCR would be "most consistent" with the bank meeting its policy objectives. The RBNZ deemed the outlook for interest rates as being "more balanced", but the tone of the statement was consistent with a lower OCR, with the published rate projections signaling a further 15bps of OCR cuts by mid-2020.

Developments since then suggest the May OCR cut is unlikely to be the last over 2019. This reflects as combination of domestic and global catalysts:

- **NZ growth momentum has cooled.** GDP growth of 0.6% in Q1 (2.5% yoy) was a touch firmer than the May MPS projections (+0.4% qoq). Underlying details were softer, with services GDP advancing a sluggish 0.2% qoq. More recent activity data prints and forward indicators point to sluggish sub-trend growth continuing and business sentiment has remained stubbornly low. We are not as upbeat as the RBNZ, with clear downside risk to the May MPS projections of GDP growth averaging 0.8% per quarter through till late 2020.
- **We are also becoming more concerned moderate growth momentum is likely to translate into increasing labour market slack within the economy.** This is of key importance given the RBNZ's objective to support maximum sustainable employment under the new *Remit for the Monetary Policy Committee* (the 'remit').
- **Related to both these considerations is the growing realisation that the trade-off between capacity pressures and inflation has changed.** The penny looks to have dropped across the ditch after the Reserve

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Bank of Australia cut its cash rate to a record low of 1.25% in early June, with the RBA revising down its estimates of the non-accelerating inflation rate of unemployment (NAIRU) from around 5% to roughly 4½% and signalling that further RBA easing is more "likely than not".

- **The inflation backdrop remains benign.** Despite the May OCR cut, we remain sceptical that the medium-term inflation outlook is consistent with an OCR at 1.50%, with our expectation that CPI inflation will settle below 2%. The moderate growth outlook points to a sizeable risk that core inflation will retreat further below the inflation target midpoint. The sharp fall in global oil prices since the May MPS (Dubai oil prices have fallen by close to 15% in USD terms) point to weaker headline inflation and lower inflation expectations.
- **Global developments have soured**. Concerns over global growth have intensified, with trade growth slowing, notwithstanding the more soothing recent messages on trade coming from the US and China. Risks to the global outlook remain skewed to the downside. Trade frictions and Brexit remain unresolved key downside risks. Global inflation has remained subdued.
- **Overseas central banks have responded.** The RBA and ECB have signaled further policy easing is in the wings, while the US Federal Reserve has dropped the pledge to remain "patient", but instead "act as appropriate". The People's Bank of China has signalled that policy stimulus will be increased to counter slower growth. Interest rate expectations for the RBA and Fed are tilted to rate cuts. We expect a 25bp July Fed cut and a total of 100bps of cuts over the next 12 months, with 25bp cuts in July and likely November by the RBA.
- **Exchange rate in focus.** The NZD TWI is slightly below the 73 Q3 assumption in the May MPS. Not cutting the OCR risks sending the NZD higher, particularly if overseas central banks act on their easing biases.

## The OCR looks set to move lower, but not till August

**We expect the RBNZ to hold the OCR at 1.50%, but to signal the more likely direction of the next OCR move will be down**. **From a risk management point of view, it is probably better to run the risk of pushing CPI inflation higher than not cut the OCR and persistently dampening inflation and inflation expectations. As such, we would not rule out a June cut and believe the decision is likely to be finely balanced.** Additional OCR support is likely needed, but we have stuck with our August view for the next 25bp cut (to 1.25%), which will provide the RBNZ with time to more thoroughly examine the policy outlook, take in NZ Q2 labour market and CPI inflation data and observe the actions of other central banks (particularly the Fed and RBA).

**Our core view is that the OCR will plateau at 1.25% in August, although we note the risk of a lower trough in the NZ interest rate cycle.** There are still supports to the domestic outlook, including historically-low interest rates and our historically-high Terms of Trade, still-strong (but uncertain) net immigration, and high inbound tourism. Financial conditions have relaxed considerably since May, with wholesale interest rates touching record lows and with yields on the 2-year swap down close to 100bps since the start of the year. The global outlook, while softer, still looks reasonable. Moreover, Budget 2019 has flagged increased government spending. We also note that the recent teachers' settlement could generate a bow-wave of public sector wage increases that could filter through the broader labour market. Cutting the OCR further could significantly boost property prices and endanger financial stability, although the effectiveness of the loan-to-value restrictions mean this is only a secondary concern. Moreover, the RBNZ should save policy ammunition for when cuts are really, really needed.

**There is also the small matter that the RBNZ's proposed higher capital requirements** will likely result in higher customer lending interest rate and could adversely impact the supply of credit to sectors with high capital requirements if the requirements are adopted in their currently proposed form. Our research suggests the proposed requirements will add 50bps to customer lending rates by 2023, with risks of a higher impact for some sectors**. We will have to wait until November to see exactly what the RBNZ is likely to run with, but our view is that the imposition of the higher capital requirements from 2020 will necessitate a longer period of monetary policy support, all else equal.** As such, we do not expect the OCR to move above 2% till late 2023.

## It's too premature to talk extreme monetary policy measures, but more work is needed

**What about the OCR heading below 1.00% and (potentially) below 0%?** After all, it has been a race to the bottom for global interest rates despite a still reasonable global backdrop. The OCR could potentially move below 0% (-0.75% is the likely lower bound according to the RBNZ), but around 200bps of OCR cuts from here is still chicken-feed considering the OCR fell by close to 600bps during the Global Financial Crisis. There is scope for the RBNZ to adopt unconventional monetary policies, including for example, adopting negative policy interest rates, conducting large scape asset purchases and imposing targeted term lending schemes to ease credit conditions. However, these measures they can be of limited effectiveness and carry risks. Nevertheless, we believe it would be prudent for the RBNZ to more thoroughly investigate these various options, so they are more prepared to consider using them if needed.

## Market reaction

Current market pricing has about 25% odds for a June OCR cut, with a 25bp cut in August almost fully priced and with close to 50bps of OCR cuts priced in by next February, with the OCR expected to trough just below 1.00% by mid-2020. Market reaction to next Wednesday's OCR Review is likely to be modest if, as we expect, the RBNZ holds the OCR at 1.50% and flags the prospect of a lower OCR. A RBNZ cut next week will trigger NZD falls and will likely see market expectations for the OCR shift lower still. If the OCR is not cut and the RBNZ depicts a neutral assessment, both the NZD and NZ yields will likely spike higher. Looking ahead, we will be closely monitoring the actions of global central banks (most notably the RBA), the NZD, as well as developments pertaining to the domestic and global outlook.


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