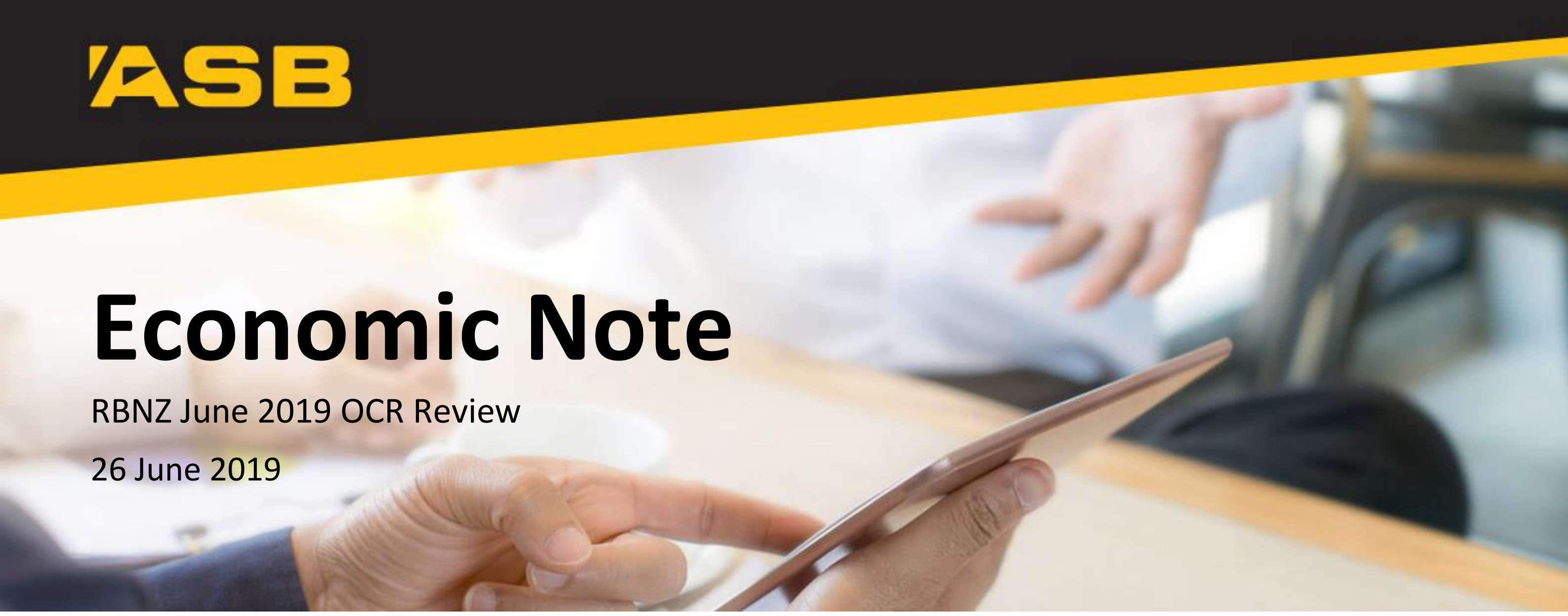

Economic Note

RBNZ June 2019 OCR Review

26 June 2019

Dovish pause

- The RBNZ kept the OCR on hold at 1.5% and flagged greater risk of weaker inflation, as expected.
- We continue to expect one further cut to 1.25%, in August.
- Further global weakness and any lift in assessed labour market slack could spur an even lower OCR.

Summary and Implications

The RBNZ kept the Official Cash Rate (OCR) on hold at 1.5% in a finely-balanced decision that firmly points to an imminent rate cut. The RBNZ's assessments of the various risks (both up and down for interest rates) and discussion of whether to cut the OCR today all point to one further cut in August, in line with our expectations. A 25bp OCR cut is close to fully priced for August, with a total of around 50bps of OCR cuts priced by November.

The question is whether a 1.25% OCR will prove to be the floor. There appear to be two main factors that would drive an even lower OCR. One is further deterioration of the global environment, particularly through the growth risks from drawn-out trade tensions. The other would be if the RBNZ materially reassesses its view of how much slack is in the labour market and concludes there is a lot more than thought – which is the big change in view driving the Reserve Bank of Australia to cut interest rates decisively. For now, the RBNZ still assesses that employment is "broadly at its maximum sustainable level", implying no view change to date. But watch this space.

Market reaction was for slight lifts in the NZD and wholesale rates, but only in keeping with unwinding the small probability of a cut that was priced in for this rate announcement.

RBNZ hold the OCR at 1.50%

As was widely expected the RBNZ held the OCR at 1.50%. However, the policy assessment confirmed that an easing bias was in place noting a "lower OCR may be needed over time to continue to meet our objectives." The Record of the meeting noted that the Monetary Policy Committee (MPC) agreed that the risks to achieving its consumer price inflation and maximum sustainable employment objectives were tilted to the downside. Members agreed that more support from monetary policy was likely to be necessary. The decision on whether to cut the OCR in June looks to have been finely balanced, with the Record noting "the Committee discussed the merits of lowering the OCR at this meeting".

Global outlook of concern

The RBNZ remained concerned over the global economy, highlighting the weakened outlook, highlighting slowing global growth and the ongoing weakening in global trade, which has coincided with recent falls in dairy and oil prices and the prospect of more policy support from overseas central banks.

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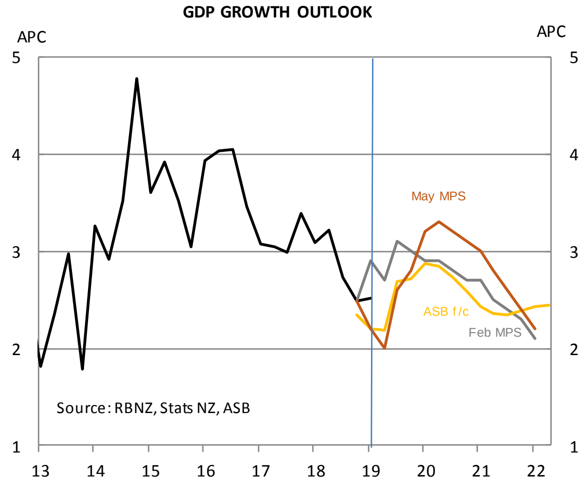
The Record of the meeting discussed the various channels through which slowing global growth and trade tensions affect New Zealand, importantly highlighting the impact of slowing global growth and trade tensions on business investment, which has remained sluggish for this stage of the cycle given widespread capacity constraints. By and large, we agree with the RBNZ's summary of the global backdrop and the balance of risks. However, we note that NZ's export sector is holding up well, with NZ's Terms of Trade outlook strong. A lower NZD is an important release valve.

Domestic tug-o-war: Fiscal stimulus vs soft housing & business sentiment

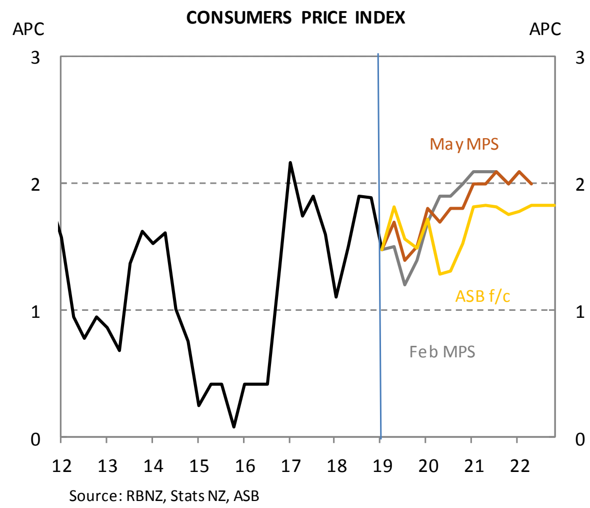
While the RBNZ acknowledged that global economic conditions had deteriorated, the domestic outlook was more balanced, although uneven as the domestic economy faced offsetting shocks. March quarter GDP had held up better than the May MPS projections, although there were disparities between strong construction and weak services activity. Supporting domestic activity will be fiscal stimulus, with Budget 2019 incorporated a stronger outlook for government spending than assumed in the May MPS. However, the RBNZ were concerned over the impact of "softer house prices" and "subdued business sentiment" in dampening domestic spending. We remain sceptical that conditions are in place to trigger a pick-up in growth momentum. Still-sluggish business sentiment continues to point to sub-trend growth continuing.



The Record highlighted the concerns of the MPC on the household spending outlook if "recent softer house prices" are sustained. This looks to be a comment more directed at the weak Auckland housing market, and we note that other regional areas are looking more upbeat. Furthermore, **we expect that solid population growth, still-present dwelling shortages and very low mortgage interest rates to trigger a pick-up in house price inflation by the end of the year.**

Little mention of inflation

The inflation outlook was only covered briefly in today's Statement, with the assertion that CPI Inflation was expected to rise to the 2 percent mid-point of the RBNZ's 1-3% target range. The RBNZ seem to have tied the CPI inflation outlook to its assessment of capacity pressures despite acknowledging the apparent disconnect between capacity and inflation in the labour market. **We view much of the recent lull in inflation as having a more enduring impact, likely necessitating more monetary policy support. This may have implications for future OCR settings**.



Labour market disconnect

Importantly, MPC members discussed the apparent disconnect between measures of labour market capacity and still subdued wage growth. Whether this disconnect continues will be critical in the Bank achieving its objective of 'maximum sustainable employment' and hence how much further the Bank will need to lower the OCR. There is a risk here that the RBNZ follow's the RBA's lead and lowers its estimate of the NAIRU (non-accelerating rate of unemployment – essentially the 'neutral' level of unemployment). The implications of such would be that there is a greater amount of slack in the NZ labour market than previously thought and hence more work for the RBNZ to do in lowering interest rates to boost labour demand. The next set of labour market figures due 6 August (one day before the RBNZ next meets) will be key to watch in this regard, particularly the wage growth measures. **Our view is that NZ's NAIRU is likely to be below 4.5%.**

Market reaction and policy implications

Market reaction was very subdued given the tone of the Statement was broadly in line with consensus. The NZD lifted around 20 points to 0.6650 and wholesale interest rates rose 1-3bps across the curve. OIS pricing remains consistent with just under 50bps worth of rate cuts by November.

An August OCR cut is about 80% priced in, in line with our central view that the RBNZ will cut the OCR by 25bps in August. Current market pricing has a terminal OCR or around 1% as opposed to our expectation that the OCR will trough at 1.25%. **We note, however, that the future direction of the OCR will be data dependent and contingent on global events, the actions of overseas central banks, and the NZD.**

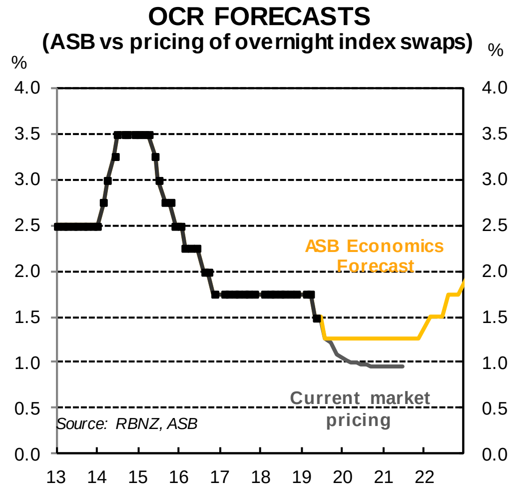


Table 1: OCR Side by side comparison.

June 2019 OCR	**May 2019 MPS**
OCR Decision, balance of risks and outlook	*OCR Decision, balance of risks and outlook*
The Official Cash Rate (OCR) remains at 1.5 percent. *Given the weaker global economic outlook* and the risk of ongoing subdued domestic growth, a lower OCR may be needed over time to continue to meet our objectives. The Committee discussed the merits of lowering the OCR at this meeting. However, the Committee reached a consensus to hold the OCR at 1.5 percent. *They noted a lower OCR may be needed over time*.	The Official Cash Rate (OCR) has been reduced to 1.5 percent. The Monetary Policy Committee decided a lower OCR is necessary to support the outlook for employment and inflation consistent with its policy remit. Given this employment and inflation outlook, a lower OCR now is most consistent with achieving our objectives and provides a more balanced outlook for interest rates.
Global Outlook	*Global Outlook*
The global economic outlook has weakened, and *downside risks related to trade activity have intensified*. A number of central banks are easing their monetary policy settings to support demand. The weaker global economy is affecting New Zealand through a range of trade, financial, and confidence channels.	Global economic growth has slowed since mid-2018, easing demand for New Zealand's goods and services. This lower global growth has prompted foreign central banks to ease their monetary policy stances, supporting growth prospects. However, there is uncertainty about the global economic outlook. Trade concerns remain, while some other indicators suggest trading-partner growth is stabilising.
Exchange rate	*Exchange rate*
Economic Activity	*Economic Activity*
Domestic growth has slowed over the past year. While construction activity strengthened in the March 2019 quarter, growth in the services sector continued to slow. Softer house prices and subdued business sentiment continue to dampen domestic spending.	Domestic growth slowed from the second half of 2018. Reduced population growth through lower net immigration, and continuing house price softness in some areas, has tempered the growth in household spending. Ongoing low business sentiment, tighter profit margins, and competition for resources has restrained investment.
Labour market	*Labour market*
We expect…employment to remain near its maximum sustainable level. *Given the downside risks around the employment (and inflation) outlook*, a lower OCR may be needed	Employment is near its maximum sustainable level. However, the outlook for employment growth is more subdued and capacity pressure is expected to ease slightly in 2019.
Inflation	*Inflation*
Inflation is expected to rise to the 2 percent mid-point of our target range.	Consequently, inflationary pressure is projected to rise only slowly.

Source: RBNZ, ASB

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