Economic Note

RBNZ March OCR Review

27 March 2019

Watching, worrying, but probably waiting no more

- The RBNZ left the OCR at 1.75% but has moved to an easing bias with a cut seen as more likely than a hike.
- Global and domestic growth concerns, as well as a stronger NZD, contributed to the RBNZ's softer stance.
- We have now moved to forecast OCR cuts from August, with the risk of an earlier move.

The RBNZ has made a clear shift, dropping its neutral bias and intent to keep the OCR on hold until 2021, and instead flagging the more likely direction for the next OCR move to be down. **We have moved over the line and now expect 25bp OCR cuts in August and November of this year.** In the near term the risk of an OCR cut will remain high. Every OCR announcement is now potentially 'live'. A key uncertainty is whether 2019 growth will pick up after a patchy 2018. The global economy is showing more signs of deceleration, and the RBNZ has been surprised at times over the last year over how weak NZ growth has been.

There are still a number of supports for the economy. However, we have mounting concern that NZ growth will not pick up sufficiently quickly to drive inflation pressures up, particularly as business confidence started the year on a softer tone. We do think the RBNZ has some time to wait and assess data, but we expect that the patience of Governor Orr is wearing thin and the threshold for tolerating weaker-than-expected data is likely to be low. **If the economy doesn't start showing signs of re-accelerating soon, then the RBNZ could conceivably cut as early as May as it heralds in the new Monetary Policy Committee.**

Upcoming business confidence surveys will be very important between now and the May Monetary Policy Statement in shaping views of how robust or otherwise the domestic economy is. And further deterioration in the global outlook is another potential trigger. Core inflation gauges (due April) will matter a lot, given the softness in domestic demand last year. The May Monetary Policy Statement deliberations will likely make an exciting start for the new Monetary Policy Committee members.

The OCR isn't going up for a considerable time. The risk is clear and present - and down.

Domestic caution

The RBNZ continues to expect ongoing low interest rates, and increased government spending and investment, to support economic growth over 2019. **However, the RBNZ was notably more cautious on the outlook for domestic economic activity.** It cited the weaker 'starting point' for economic activity, revealed by the worse-than-expected 2018 Q4 GDP figure, which the RBNZ attributed to softness in the housing market and weak business investment.

We still believe low interest rates and higher government spending will provide support to domestic demand and that the outlook for the Terms of Trade remains positive, given the recent strengthening in dairy commodity prices. **However, we remain concerned about the domestic outlook and can see some downside risks around the RBNZ's**

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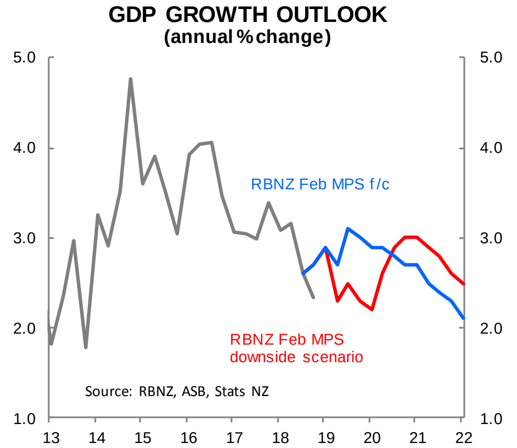
0.8% qoq and 0.7% qoq picks for H1 2019 GDP. Some of the tailwinds supporting the economy are turning into headwinds, with the RBNZ citing slowing trading partner demand for our two largest partners, Australia and China. **The impact of persistent weak business sentiment was also acknowledged, with the RBNZ increasingly concerned that this will filter through into broader economic activity.** We note that various readings for domestic confidence have remained weak and signal further cooling in momentum. The NZ economy is inching towards the downside scenario in the February Monetary Policy Statement (MPS), in which the OCR was cut 50bps by mid-2020. Next week's Quarterly Survey of Business Opinion (QSBO) will be closely watched, and weak readings here will lift the odds of a May OCR cut.



Global a tad more gloomy

The RBNZ specifically called out the weaker global economic outlook and accompanying risks as factors driving its changed stance. According to the RBNZ, "the risk of a more pronounced global slowdown has increased" since the last announcement.

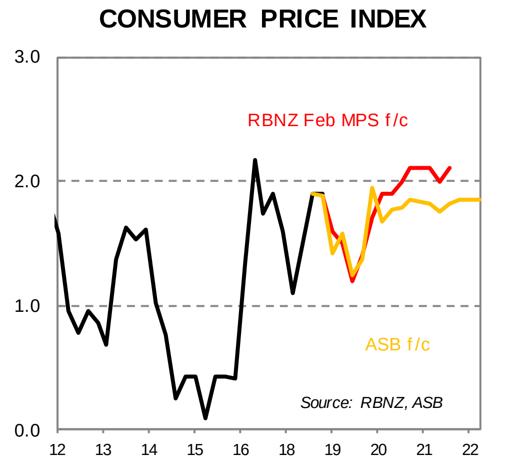
At present we don't see the urgency for a cut when looking purely at our core commodity exports. We are more optimistic than the RBNZ on the strength of export prices and export sector incomes, which are moving counter-cyclically to the global economic cycle. Dairy is one recent example, as supply growth has been increasingly crimped by NZ's dry conditions. Nevertheless, the global situation could shift on a dime. Trade tensions between the US and China have yet to be resolved. The Brexit outcome is anyone's guess, and a 'no-deal exit could be the last straw on the camel's back, given the potential for disruption to NZ exports.

NZD on the radar

The RBNZ also highlighted concerns over the NZ dollar (NZD), which had been pushed up by the dovish turn of global central banks. Historically the NZD has tended to act as a shock absorber, with the NZD easing as global prospects wane. **While we have seen sharp falls in the NZD in the wake of today's decision, the NZD remains reasonably well supported** at around 74 on a Trade-Weighted Index (TWI) basis. Resilience in the NZD has occurred despite NZD interest rates falling to fresh record lows, with the Terms of Trade a major NZD support. The longer the NZD holds up, the weaker the outlook for medium-term inflation, and the greater the possibility of an OCR cut.

RBNZ still expects 2% inflation

RBNZ commentary on the inflation outlook and the labour market was little changed, with the RBNZ continuing to assert that strengthening pressures on capacity would be sufficient to push CPI inflation up to around 2%. **Downside risks around this are clear, given the risks to the activity outlook and our low CPI inflation view.** We will be closely watching pricing side indicators. Signs that point to a cooling in core inflationary pressures will also reinforce the risk of an OCR cut.



Market reaction

The RBNZ announcement was considerably more dovish than market expectations. There was a significant rally in NZD interest rates (yields lower). Markets have swung more aggressively to OCR cuts, with 10bps of cuts priced in by May, a full OCR cut by November, and close to 40bps of cuts by mid-2020. Yields on the bellwether 2-year swap initially fell 20 points, but have settled about 15 basis points lower than prior to the OCR announcement. Yields across the curve fell to record lows, with the 10-year NZ bond yield down 11bps to 1.87%. The NZD fell against most key bilaterals, with the NZD TWI down 1.3% to 73.9. The NZD fell by more than 1 US cent to around 68 US cents and was down 1 Australian cent to 0.957 AUD.

Table 1: Side-by-side Statement comparison

March 2019 OCR	February 2019 MPS
OCR Decision, outlook and balance of risks	*OCR Decision, outlook and balance of risks*
The Official Cash Rate (OCR) remains at 1.75 percent. Given the weaker global economic outlook and reduced momentum in domestic spending, the more likely direction of our next OCR move is down. The balance of risks to this outlook has shifted to the downside. The risk of a more pronounced global downturn has increased and low business sentiment continues to weigh on domestic spending. On the upside, 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.	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. 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.
Global Outlook	*Global Outlook*
The global economic outlook has continued to weaken, in particular amongst some of our key trading partners including Australia, Europe, and China.	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. A more pronounced global downturn could weigh on domestic demand.
Exchange rate	*Exchange rate*
This weaker outlook has prompted central banks to ease their expected monetary policy stances, placing upward pressure on the New Zealand dollar.	No comment
Economic Activity	*Economic Activity*
Domestic growth slowed in 2018, with softness in the housing market and weak business investment contributing. We expect ongoing low interest rates, and increased government spending and investment, to support economic growth over 2019. Low interest rates, and continued employment growth, should support household spending and business investment. Government spending on infrastructure, housing, and transfer payments also supports domestic demand.	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.
Labour market	*Labour market*
Employment is near its maximum sustainable level.	Employment is near its maximum sustainable level.
Inflation	*Inflation*
However, core consumer price inflation remains below our 2 percent target mid-point, necessitating continued supportive monetary policy. As capacity pressures build, core consumer price inflation is expected to rise to around the mid-point of our target range at 2 percent.	However, core consumer price inflation remains below our 2 percent target mid-point, necessitating continued supportive monetary policy. As capacity pressures build, core consumer price inflation is expected to rise to around the mid-point of our target range at 2 percent.

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