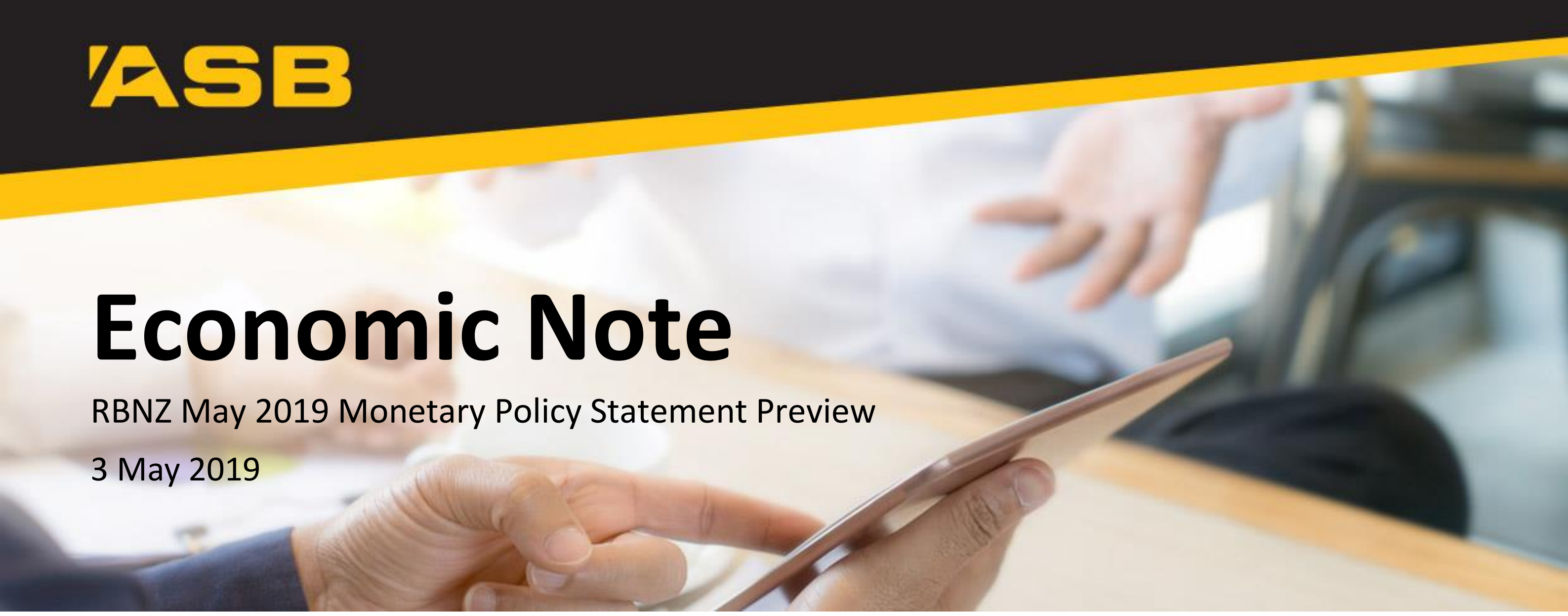

Economic Note

RBNZ May 2019 Monetary Policy Statement Preview

3 May 2019

Making a statement

- Next Wednesday at 2pm is the first Monetary Policy Statement of the RBNZ's newly-minted Monetary Policy Committee, which is faced with a finely balanced decision over whether to cut the OCR or leave it on hold.
- The policy outlook appears to have softened since the RBNZ formally moved to an easing bias in March, and conditions for cutting the OCR now look to have been met.
- We expect the RBNZ to cut the OCR 25 bps to 1.50% and to maintain an easing bias. We expect the published OCR track to flag future cuts and culminate in a low OCR endpoint, which is consistent with our OCR outlook.

It's been just over a month since the RBNZ surprised markets by shifting to an explicit easing bias in its March OCR review, openly stating that the most likely next move in the cash rate was down. This month's OCR decision is likely to be a close call and market reaction is a given, irrespective of the policy decision. **On balance, we think the new Monetary Policy Committee will have seen enough evidence to justify acting and will deliver a 25bp OCR cut in May, followed by a further 25bp cut in August.** Pushing the RBNZ over the rate cut hurdle will be the increasing conviction that the domestic growth outlook is not consistent with meeting the RBNZ's inflation and labour market objectives under the *Remit for the Monetary Policy Committee* (the 'remit'). Even if the OCR is not cut next week, the weaker medium-term inflation and labour market outlook is likely to prompt RBNZ cuts in the coming months.

Cutting to the chase – "just do it"

The May MPS is the first monetary policy decision by the newly minted Monetary Policy Committee. We expect the decision to be finely balanced, with valid arguments on either side of the cut/hold OCR fence. **However, when push comes to shove, we expect the RBNZ to cut the OCR by 25bps to 1.50%, maintain an easing bias, and to flag a further cut in the next few months.**

For a while now, we have been sceptical whether the medium-term inflation outlook is consistent with an OCR at 1.75%, with our expectation being that CPI inflation will settle below 2%. One reason why we think that the RBNZ will cut the OCR in May is that we do not believe the economy will have the necessary momentum to ensure medium-term inflation will settle in the midpoint of the 1-3% inflation target band. The cooling growth outlook points to a sizeable risk that core inflation will retreat further below the inflation target midpoint. We are also becoming more concerned that cooling growth momentum is likely to translate into increasing labour market slack within the economy.

The table summarises our view of how the RBNZ key judgments and risks have evolved since the February MPS. It highlights some more optimism over the global outlook, but suggests there have been major changes since February pertaining to the domestic inflation and activity outlook.

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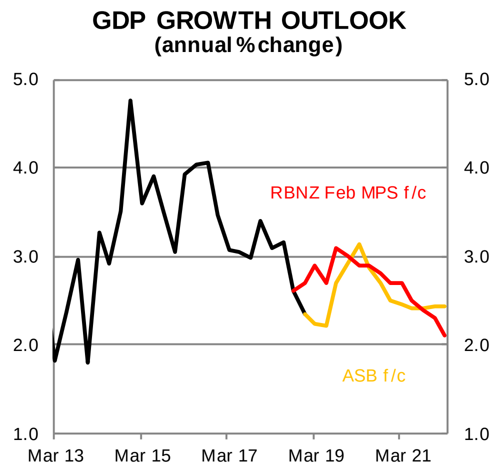
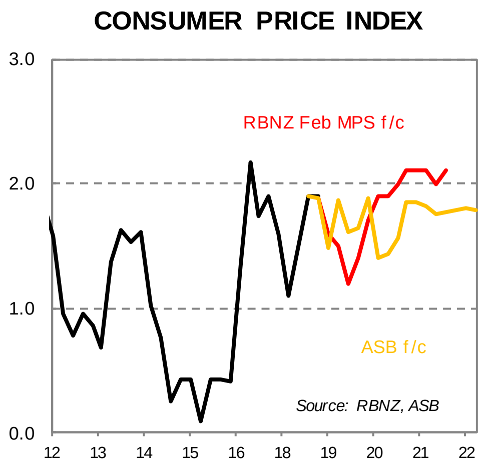
Table 1: Key judgements and risk assessment

RBNZ key judgements and risks	RBNZ Risk assessment (February MPS)	ASB's View of RBNZ May Risk assessment
Robust global growth continues:	Downside via trade. Balanced NZD outlook as overseas central banks pause	Solid Q1 GDP prints for the US, Eurozone and China, rebounding global equity markets, but mixed forward indicators. The Chinese recovery is dependent on policy stimulus and Australian activity data soft. Trade, Brexit risks are unresolved.
Global inflation increases gradually:	Balanced.	Some downside risk: Australian/US inflation prints have been weak despite "transitory' Fed view.
NZ grows above trend:	Some downside from weak business confidence and net exports	Softer starting point for GDP growth. 2019H1 outlook still weak given subdued business confidence.
NZ capacity pressures build:	Some upside, given stretched labour capacity and likely mild increases in output gap by 2020.	Slower GDP growth and lower starting point for some labour market capacity metrics.
Inflation takes its time to return to target:	Less upside. Upside via wages, capacity pressures, but sideways via tradable prices	Further downside risk: Q1 CPI prints were below expectations. Q1 wage inflation was subdued, undershooting RBNZ expectations.

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



The domestic activity outlook has deteriorated in recent months. Domestic growth tailwinds are not blowing as strong as they were, and 2018's 'soft patch' risks extending into 2019, as flagged by weak business sentiment surveys. Over a considerable period of time, the RBNZ ended up substantially overestimating 2018 growth (relative to its February forecasts) and risks doing the same for early 2019. The economic expansion is in the mature phase of the cycle and, with construction sector activity close to peaking, it is difficult to find a new growth driver. The housing market backdrop is also not as supportive for consumer spending. While export returns looks very good, there is a limited flow through to the wider economy, with debt repayment a priority for parts of the rural sector. Business sentiment has remained stubbornly low and will need to significantly lift to be consistent with the expected strengthening in growth later this year. Increasingly, there is the prospect that GDP growth follows the RBNZ's 'downside scenario' projections from February's Monetary Policy Statement, which included 50bps of OCR cuts over 2020.



A weaker domestic growth outlook will likely result in capacity pressures remaining less acute, dampening upward pressures on core inflation. Importantly, considering the dual mandate, the slower pace of growth momentum also looks to be feeding through into the demand for labour, with the level of employment from the Household Labour Force Survey (HLFS) being little changed since mid-2018 and with sluggish growth in hours worked and paid hours from the Quarterly Employment Survey (QES). **The low unemployment rate is being increasingly being driven by people exiting the labour force rather than strong jobs growth.** Weaker growth momentum within the economy is likely to translate into increasing labour market slack within the economy, which is likely to jeopardise *Objective 2aii* of the MPC Remit which is to "support maximum sustainable employment".

Moreover, pricing metrics have remained benign and suggest that future annual inflation outcomes are likely to settle below the midpoint of the 1-3% inflation target. Headline CPI and wage inflation undershot the RBNZ's

February projections and look set to remain low. The RBNZ's estimates of core inflation appear to be stuck below 2%. Wage inflation is failing to fire despite the historically-low underemployment rate and minimum wages increases. We note that persistently-low wage inflation is not consistent with firming core inflation. The global inflation environment is benign and will likely keep tradable inflation below the lower part of the inflation target, notwithstanding volatility caused by firming petrol prices.

Events since the March OCR statement have provided the RBNZ with a little more optimism on the global outlook, although risks remain downwardly skewed. The starting point for global growth looks to have held up reasonably well, with solid Q1 GDP prints for the US, China and Eurozone. Global equity markets have also rebounded. However, forward-looking indicators – including manufacturing PMIs – suggest that global growth is unlikely to accelerate from here, and what growth we have seen has been heavily dependent on policy stimulus. Recent data have confirmed the Australian economy is slowing, despite the still-tight labour market. Underlying inflation readings for our major trading partners have been benign, and we don't see any catalysts on the horizon that will push those readings higher.

Notwithstanding recent falls in wholesale interest rates, some fixed mortgage interest rates and the lower NZD, tighter monetary conditions are in the pipeline. 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. We estimate that the new requirements will add 50bps to customer lending rates by 2023, with risks of a higher impact for some sectors**. This will necessitate a lower OCR and a longer period of monetary policy support, all else equal, and we have revised down our estimate of the neutral OCR (to 2 ¼%).**

Various reasons have been cited for not cutting the OCR and instead waiting until more details emerge. 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. The global growth outlook still looks reasonable despite the downward risk profile. Budget 2019 is coming up and may announce more policy stimulus or additional measures that may help alleviate business concerns. Domestic business confidence may well rise now that the prospect of a capital gains tax has been shelved. In recent months, monetary conditions have relaxed. Cutting the OCR now may risk inflaming the housing market in parts of the country. There is also the view that the RBNZ should save policy ammunition for when cuts are really, really needed.

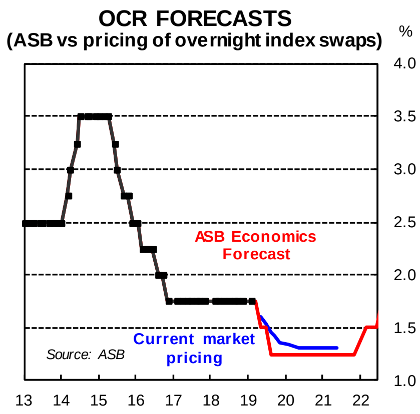
We can push back on that view. If there is the case for cutting the OCR, why delay given monetary settings will take time to work? Much of the reason for the weaker NZD of late has been due to expectations of OCR cuts and by not validating this, the RBNZ risks putting a rocket under the NZD. Moreover, the 1-3% CPI inflation target has a medium-term focus and is symmetrical; it is highly unlikely wage and price settings would significantly ratchet up if the OCR was cut. From a risk management point of view, it is probably better to run the risk of pushing CPI inflation higher than not cutting the OCR and persistently dampening inflation and inflation expectations. Why worry about preserving policy ammunition given there is considerable scope for more fiscal policy support in NZ by virtue of our sound fiscal position – a luxury few others have. The RBNZ would already have been briefed by the Treasury on the forthcoming Budget, which is likely to remain prudent in our view. Moreover, the NZD remains the safety valve for the NZ economy, and will adjust (lower) if an adverse shock eventuates, cushioning the wider economy. The RBNZ also has other tools at its disposal to directly impact the housing market (such as LVR restrictions) if need be.

MPS Projections to flag a lower OCR

The May MPS will include detailed economic projections. We expect the RBNZ's economic projections to depict a solid economic outlook, with GDP growth expected to pick-up over the course of 2019. However, we still expect a weaker growth outlook than in the February MPS. The unemployment rate is likely to remain low over the projection period. Volatility in tradable prices will probably result in some volatility for annual headline CPI readings over 2019, with annual CPI inflation expected to settle around the midpoint of the 1-3% inflation target at the end of the projection period. Some volatility over 2019 CPI outturns is likely given volatility in tradable prices. **The published OCR track is expected to flag the likelihood of at least one further OCR cut over 2019, with the OCR edging up towards the end of the projection period.**

Market reaction is a given

Market reaction is a given considering current market pricing and positioning. We expect 50bps of OCR cuts over 2019 (May and August), with the OCR to remain at 1.25% before gradually moving higher by 2022. We expect a historically-low OCR endpoint of 2.25% this cycle. This is slightly more dovish relative to current market pricing, with odds of a May cut currently at around 55% and with close to 40bps of OCR cuts priced in over 2019.



Next Tuesday's RBA decision at 4.30pm will significantly impact local market positioning and pricing. With the Australian General Election on May 18, our Australian colleagues do not expect the RBA to cut the cash rate, but to adopt an easing bias. If, however, the RBA did cut the cash rate, then it would be game on for NZ market pricing.

If, as we expect, the RBNZ cuts the OCR and flags the prospect of further cuts, local interest rates and the NZD are likely to initially head lower. If the OCR is not cut, and the published OCR track does not validate current pricing by at least flagging the strong likelihood of OCR cuts, local interest rates and the NZD will likely spike higher. However, we expect this to be a temporary respite, with the RBNZ still expected to cut the OCR over 2019.

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