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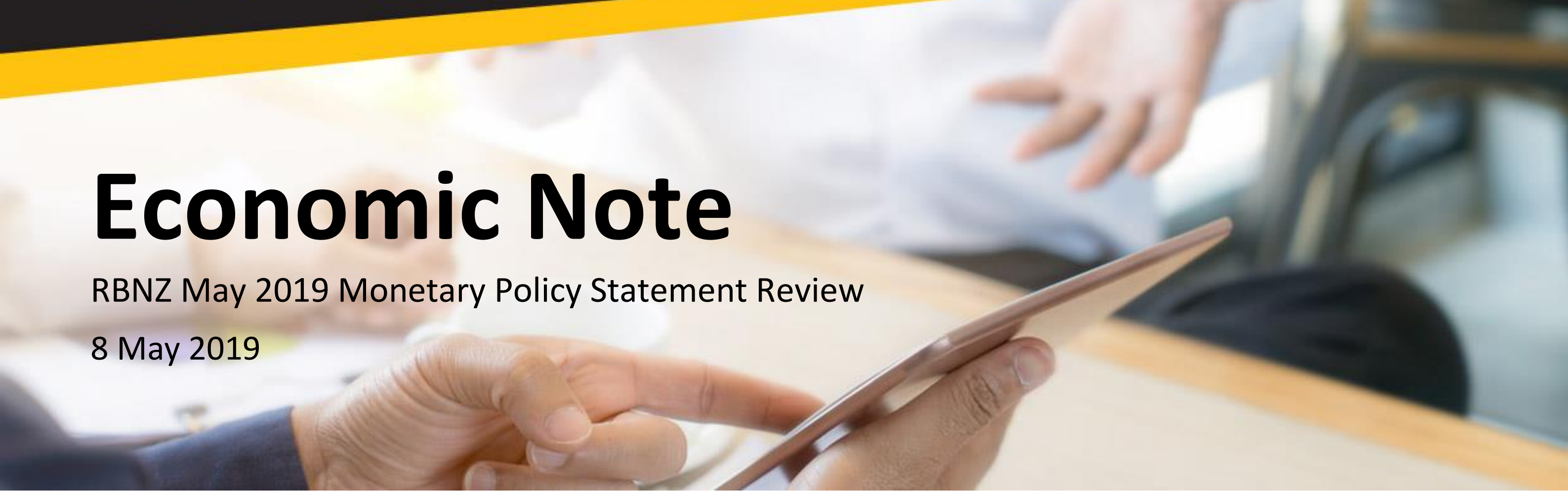

Economic Note

RBNZ May 2019 Monetary Policy Statement Review

8 May 2019

Taking the easing easy

- The RBNZ has cut the OCR 25bp to 1.5%, against a backdrop of divided market opinion on whether there would be a cut or not. The new Monetary Policy Committee (MPC) reached a consensus.
- A slight easing bias remains, with the RBNZ's OCR outlook flagging the possibility of a follow-up OCR cut.
- Future moves look to be data dependent. We have pencilled in an August cut, with risks tilted to a later cut.

We did expect an OCR cut to be delivered, although it did appear like a 60:40 call and broader opinion was finely divided. But the RBNZ has – appropriately – put increasing weight on broad challenges that businesses are facing as well as the slower and more uncertain global growth outlook.

We continue to expect a follow-up OCR cut in August, to 1.25%, but feel the risks are skewed to a later move. The RBNZ's current OCR outlook suggests a measured assessment and heavily data-dependent outlook rather than a sense of urgency. The RBNZ's latest OCR forecasts, prepared before the OCR cut decision, show only a 50% chance of a further cut.

The OCR outlook is now "more balanced". The RBNZ's growth forecasts for the first half of 2019 look realistic and less vulnerable to over-optimism. Around our August cut call we see the risks as tilted to a slightly later move, rather than earlier.

But we do have firm conviction that a further cut will come. We do not see inflation sustaining around the 2% target mid-point without getting further stimulus. Moreover, employment growth has slowed, creating a growing risk that the RBNZ may not achieve its maximum sustainable employment objective. The impact of higher bank capital requirements will also require an offsetting move downwards in the OCR at some point.

RBNZ cuts to the chase

In a decision that was widely seen as a close call, t**he newly-formed RBNZ Monetary Policy Committee reached a consensus decision** that an OCR cut was necessary. The committee deliberations seem to be centred on cutting the OCR now vs continuing to wait while signalling a rate cut. **The RBNZ decided to get on the front foot and "establish a more balanced outlook for interest rates".** And rightly so, we believed the RBNZ had all the evidence it needed to make today's decision. Global and domestic growth has slowed, profitability is under pressure, the labour market appears to have softened and the balance of risks to the outlook remains skewed to the downside. The question now shifts to if/when there is a follow-up cut. **We have firm conviction that another cut is needed.** But the tone of the statement suggested the RBNZ Monetary Policy Committee is not in any rush to cut again (and may not even believe a second one is needed at this stage). We have pencilled in a second rate cut for August, **but with the RBNZ low-balling near-term economic forecasts the risk is it takes a little longer before the RBNZ cuts again.**

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Global outlook stablised but committee more concerned about downside risks

The RBNZ remained guarded on the global outlook, noting that global and trading partner growth has slowed since mid-2018 and that the global economic outlook remained uncertain. Indeed, the Bank noted that Australian consumption growth eased over 2018, Chinese growth fell 0.4 percentage points to 6.4% in 2018, and that growth in Europe has slowed significantly. That said, recent developments have been more positive. In particular, the Bank notes that some global growth indicators "may be stabilising". In China, stimulatory government policies appear to be strengthening the Chinese economy. Meanwhile, uncertainty around Brexit has eased at least for the time being. However, the re-escalation in US-China trade tensions highlights uncertainty around the outlook. 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. Notably, we expect dairy prices to firm over 2019, in contrast to the RBNZ's expectation that they fall.

NZ growth momenutum slows, business confidence remains key

To us, the key catalyst to the change in the RBNZ's policy outlook has been weaker than expected NZ GDP growth which materialised over H2 2018, combined with indications that growth is likely to remain soft over the first half of 2019. The RBNZ highlights the three key drivers of weaker growth being slower population growth, lower Terms of Trade and weaker business confidence. In its view, weak business sentiment is likely impacting business investment but it is hard to ascertain the underlying reasons behind this. The RBNZ notes the role of policy uncertainty as one factor, but the RBNZ also places emphasis on declining profitability and slowing economic growth as playing a key role in weak confidence. **The latter two factors are likely to continue to weigh on business confidence to some extent over 2019 (in our view) and will continue to pose a downside risk to business investment and the GDP growth outlook.**

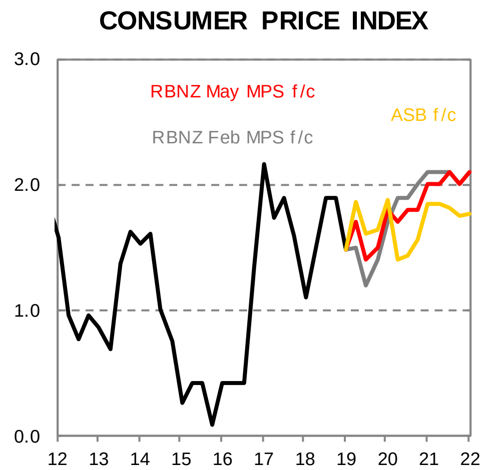
However, the RBNZ appear to have partly allowed for this. The RBNZ's near-term GDP forecasts are reasonably conservative, taking account of the weak Q1 business confidence survey. Indeed, over H1 2019 the RBNZ's forecasts in total are slightly more conservative than our own, **which provides a high hurdle for the RBNZ to be surprised on the downside around GDP growth figures, and, hence to moving the OCR lower.**

Conservative net migration assumption

We note that the RBNZ does not appear to have incorporated the recently reported strengthening in net permanent and long-term (PLT) immigration into its projections, instead sticking to the February MPS view of slowing net immigration**. If the recent strength in net immigration is genuine and persistent, the upshot will likely be a stronger pace of population growth, domestic demand and labour supply growth than what the RBNZ asserts.** As a result, the RBNZ's forecasts for household consumption appear cautious.

Inflation takes longer to return to target

The RBNZ depicted a more modest inflation outlook, with headline inflation expected to return to the 2% target mid-point in mid-2021, slightly later than projected in the February Statement. Low inflation outturns over recent years are expected to continue to weigh on firms' pricing behaviour. And, although increasing capacity pressure has led to increasing costs for firms, pricing behaviour has remained subdued. The outlook for domestic inflationary pressure has softened as a result of the slowdown in GDP growth, with non-tradable inflation expected to ease slightly in the near term, before gradually rising as capacity pressure builds and wage inflation firms. The RBNZ admitted that tradable inflation has been lower than anticipated, and while a weaker NZD may lift prices, the moderate domestic and global inflation backdrop is expected to restrain inflation. The RBNZ also acknowledged the possibility that the slowdown in world demand growth leads to



persistently-lower imported inflation. If the global slowdown dampens CPI inflation by more than projected, additional monetary stimulus may be needed to lift inflation back to the target mid-point over the medium term. **We view much of the recent lull in inflation as having a more enduring impact, likely necessitating more monetary policy support.**

Labour market softer

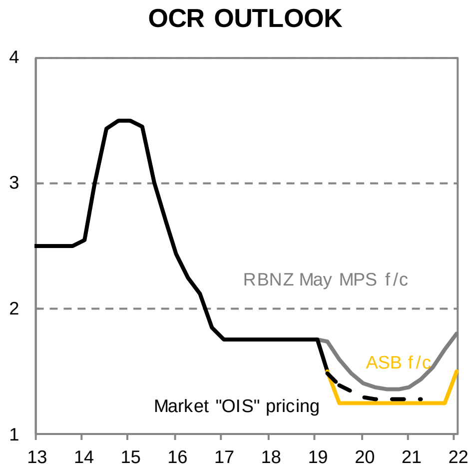
The RBNZ assessment is that employment is currently near its maximum sustainable level, with the economy currently operating near full capacity, despite the slowdown in economic growth. The recent slowdown in GDP growth is expected to result in a "slight" softening in the labour market over 2019. Employment is then expected to recover as GDP growth picks up from the 2019H2, with employment expected to remain close to its maximum sustainable level through until at least mid-2022. The unemployment rate is expected to gradually ease towards 4% over the latter part of the projection, with the employment rate to peak just below 68% of the working age population by late 2021. **We see the risks as being tilted towards more spare capacity remaining in the labour market, likely restraining wage inflation and weighing on medium-term inflation.**

Impact of likely increase in bank capital requirements not yet incorporated

Importantly, the MPS made little mention of the impact of the proposed increase in bank capital requirements, which is understandable given the proposals are still at the consultation stage. Our view is that the higher capital requirements will add at least 50bps to customer interest rates by late 2023. If we start to see customer borrowing rates move higher as a result of the capital requirements, this will likely necessitate a lower OCR, all else equal.

Market reaction and policy implications

With analysts and markets being divided leading up to the RBNZ announcement, the NZD and NZD interest rates fell immediately after the 25bp cut was announced. The NZD initially fell over 1% against the USD, but has settled around 0.6590 at the time of writing, around 0.2% below this morning's level. Swap rates have settled 1-6 bps lower, with the largest decline in the 1-year swap rate, which has fallen to 1.63% at the time of writing. Market pricing implies the risk of further easing from the RBNZ. However, the overall reaction has been quite muted, a reflection of the RBNZ's "more balanced" outlook following today's cut.



Despite the RBNZ retaining a neutral policy outlook, we expect a further cut over 2019 (pencilled in for August), reflecting our conviction that the medium-term inflation outlook will require more policy support. The exact timing of OCR cuts is fluid, and will crucially depend on the tone of forthcoming domestic data, the NZD and developments in the global economy.

Table 1: Key judgements and risk assessment

The table (overleaf) below 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.

RBNZ key judgements and risks	**RBNZ Risk assessment** **(May 2019 MPS)**	**RBNZ Risk assessment** **(February 2019 MPS)**
Global growth eases towards historical averages:	Trading partner growth averages 3.3%, but the outlook is uncertain, TWI remains around 73 over the projection period.	Downside via trade. Balanced NZD outlook as overseas central banks pause
Global inflation increases gradually:	Balanced.	Balanced.
Soft NZ growth in near-term but rises above trend:	Soft H1 2019 GDP. Supportive monetary & fiscal settings to support demand, amid slowing population growth. Growth driven by net exports, with sluggish growth in domestic demand.	Some downside from weak business confidence and net exports
NZ capacity pressures build:	Balanced.	Some upside, given stretched labour capacity and likely mild increases in output gap by 2020.
Inflation trends up to 2%:	Weaker starting point, with modest pass-through from higher wages and rising fuel prices.	Less upside. Upside via wages, capacity pressures, but sideways via tradable prices

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

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