Economic Note

RBNZ November OCR Review

8 November 2018

Upside, downside, in the risk basket

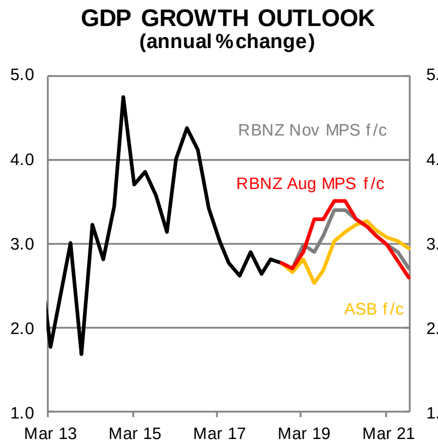
- The RBNZ kept the OCR on hold at 1.75%, and reiterated its expectation to keep the OCR at this level into 2020.
- The RBNZ noted both upside (inflation) and downside risks (growth).
- Although an OCR cut is still a risk, the risks have not increased relative to the August/September assessments.

We continue to expect the RBNZ to remain on hold into the first half of 2020, though the risk is a later start given the moderate growth outlook and still-benign wage and core inflation trends at present.

The RBNZ largely delivered what was expected, trimming its growth outlook a touch after a strong 2018Q2 outcome and boosting its near-term inflation outlook. The policy assessment's opening wording presents the directional risks to the OCR in a different way, but the message is essentially the same. The OCR could move either way, depending on developments.

The RBNZ remains **mindful of the downside risks to growth** presented by weak business confidence. **But it is also wary that inflation pressures may turn out to be stronger than it anticipates**, particularly if businesses pass on cost pressures to a greater extent than factored in.

The RBNZ's unrevised OCR forecast track suggests that the risks of a near-term OCR cut have not intensified. The strength of Q3 employment (and the low unemployment rate) highlighted this also. A cut remains a non-negligible risk, but **material weakness in 'hard' data such as GDP would be needed to seriously entertain a cut**. But we flag that our own growth outlook is more in line with the RBNZ's downside risk scenario than its central view, though we also expect a stronger inflation impact from wage growth.



Growth outlook: not thrown down the stairs

The RBNZ's growth outlook for the second half of 2018 was cut slightly, while the 2019 outlook was mostly unchanged. Given our weaker GDP growth forecasts, we had seen the risk the RBNZ cut its growth outlook by a fraction more.

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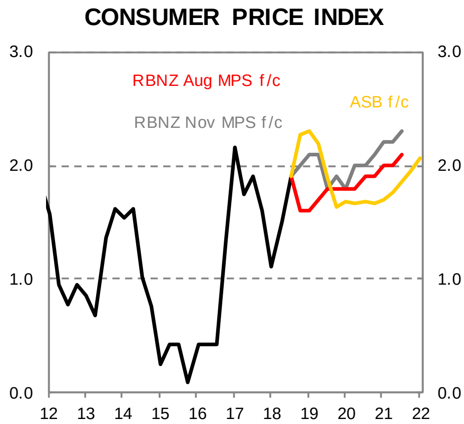
The RBNZ remains mindful of the downside risks presented by weak business confidence, **noting that if firms' investment and hiring declines due to weak business confidence or compressed profit margins, growth will be weaker** than expected. The RBNZ examines this outcome in its alternative scenario, in which annual GDP growth remains below 3% and results in the OCR being reduced by 75 basis points. ASB's current GDP forecasts do not have GDP growth reaching 3% until Q4 2019.

The RBNZ continues to expect key drivers of GDP growth to include increased fiscal stimulus, low interest rates and a supportive dollar. The RBNZ has allowed for weaker GDP growth in the near term due to the impact of high petrol prices (reducing household consumption) and evidence of weaker activity reported within the Q3 Quarterly Survey of Business Opinion. However, **there is a hint within the MPS that the RBNZ remains somewhat sceptical of the weak levels of business confidence** (as are we, given the strong fundamentals supporting the economy). The RBNZ notes *"recent business visits indicated that firms plan to invest in physical capital and automation in response to difficulty finding workers and increasing labour costs"*.

The RBNZ is not only worried about the downside risks to growth from weak business confidence, but it also concerned about the downside risks presented by the global outlook and the possibility that net export contribution to growth is weaker than expected.

Inflation: wandering up

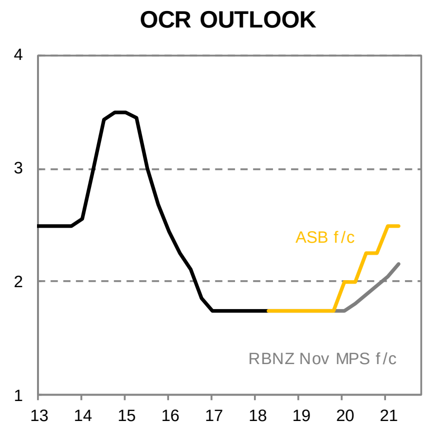


The RBNZ's inflation forecasts have firmed compared to the August MPS, across most of the forecast horizon. The near-term firming largely reflects the recent spike in fuel costs. However, as expected, the RBNZ continued to note that it will look through these movements as appropriate. On that front, the RBNZ now expects headline CPI to hit 2% in Q4 2018, but this is expected to ease again over 2019.

On the medium-term outlook, the tick up in both core and non-tradable inflation recently appears to have made the **RBNZ more confident that domestic capacity pressures will support core inflation rising back to the mid-point of the inflation target.** On top of this, the RBNZ noted the upside risk stemming from higher cost pressures. Costs are rising via a number of avenues at the moment, including: wages; higher petrol prices; and higher general import costs due to the lower NZD. In particular, **the RBNZ sees the risk that firms could pass on cost pressures sooner (or to a greater degree) than currently expected** given businesses' already-squeezed margins, and stated it will be closely watching firms' pricing behaviour in coming quarters. However, at this stage, RBNZ business visits suggest that many firms will continue to absorb higher costs, rather than pass them on to consumers (refer to Box C in the MPS).

The RBNZ's headline CPI forecast is stronger than our own, with its non-tradable forecast now more in line with our own view. All else equal, the RBNZ's latest inflation forecasts suggest an earlier start to the tightening cycle than in the August MPS – **the inflation outlook now sits *above* 2% in the medium term**.

Other ups and downs



The RBNZ sees global growth as strong, but downside risks have grown further since the September MPS. Global growth is also expected to slow over 2019. The RBNZ points out that solid overall growth masks weakness and heightened risks in specific regions. Indeed, the strong US economy is offsetting weaker outlooks in other regions such as Europe and Asia. The RBNZ also remains wary of protectionist moves weighing further on global growth. The RBNZ maintains the view was that trade tensions raise the risk that trade barriers could undermine global growth.

More positively, **the RBNZ notes that domestic financial conditions in New Zealand have eased this year**, even as the OCR remained steady. The RBNZ notes that wholesale interest rates are lower (particularly longer maturities), mortgage rates have fallen, and the exchange rate has depreciated. The New Zealand dollar TWI is around 3% lower than its January 2018 level, and around 10% below its 2017 peak.

Labour market upbeat

The RBNZ labour market projections in the MPS look somewhat dated as they do not incorporate yesterday's 'surprise' Q3 Household Labour Force Survey (HLFS) outturns (see our Labour Market Review). **The starting point for the labour market is undeniable stronger than the November MPS assessment that employment was "near its maximum sustainable level"**. In the November MPS, the RBNZ adjudged that evidence on whether employment is above its maximum sustainable level was "mixed".

Over the medium term, the labour market is projected to tighten as employment growth outpaces (the immigration-led slowing) growth in the working age population. As such, the unemployment rate is projected to ease further, troughing at 4.1% in late 2020/early 2021. We note that the lower starting point for the Q3 unemployment rate (3.9%) and the re-emergence of volatility in the HLFS survey figures will add another layer of complexity to the RBNZ forecast process and policy deliberations.

The RBNZ notes that there are limits to what monetary policy can do to facilitate full employment, noting "a structural (sustainable) improvement in employment would require non-monetary approaches to improve the alignment of labour supply and demand (for example, through education and training programmes)". We concur.

The firmer RBNZ outlook for non-tradable inflation is consistent with a firmer outlook for wage inflation. According to the November MPS forecasts, wage growth is expected to increase as the labour market tightens and the minimum wage increases and higher headline inflation lift overall wages. **Our view is that wage inflation will lift more quickly than the RBNZ forecasts. This suggests some risk of the OCR moving up sooner if higher wages flow through into medium-term inflationary pressure**.

Market reaction

There was limited immediate market reaction to the statement. The NZD initially eased against the USD and other major majors, but has subsequently firmed with the NZD TWI now back to where it was preceding the release of the statement. NZD wholesale interest rates moved fractionally higher, with the curve remaining under steepening pressure.

Key Rates	8: 55 am	9:05 am	9:30 am
NZD/USD	0.6791	0.6782	0.6786
NZD/AUD	0.9325	0.9311	0.9318
NZD/EUR	0.5929	0.5920	0.5927
NZD/JPY	76.94	76.87	76.99
NZD/GBP	0.5166	0.5158	0.5163
NZ TWI	74.10	74.00	74.05
NZ 90 day Bank Bill	1.96	1.97	1.98
NZ 1 year swap rate	2.04	2.04	2.04
NZ 2 year swap rate	2.14	2.15	2.15
NZ 5 year swap rate	2.54	2.55	2.57

Source: Bloomberg

Risk assessment

RBNZ key judgements and risks	RBNZ Risk assessment (November MPS)	RBNZ Risk assessment (August MPS)	ASB's View
Robust global growth continues:	Downside via trade	Downside	Downside: on trade tensions
Global inflation increases gradually:	Upside via trading partner inflation	Upside	Reduced upside: through recent weakness in oil & dairy prices
NZ grows above trend:	Some downside	Some downside	Some downside
NZ capacity pressures build:	Marginal downside due to more labour and goods market capacity	Some downside	Some downside: from lower 2018H2, marginally lower 2019 growth
Inflation takes its time to return to target:	Upside via wages, higher petrol prices, capacity pressures	Upside via wages and higher petrol prices	Stronger upside: Risk tilt to sooner on high fuel prices

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

November 2018 RBNZ media release

Statement by Reserve Bank Governor Adrian Orr:

Tena koutou katoa, welcome all.

The Official Cash Rate (OCR) remains at 1.75 percent. We expect to keep the OCR at this level through 2019 and into 2020.

There are both upside and downside risks to our growth and inflation projections. As always, the timing and direction of any future OCR move remains data dependent.

The pick-up in GDP growth in the June quarter was partly due to temporary factors, and business surveys continue to suggest growth will be soft in the near term. Employment is around its maximum sustainable level. However, core consumer price inflation remains below our 2 percent target mid-point, necessitating continued supportive monetary policy.

GDP growth is expected to pick up over 2019. Monetary stimulus and population growth underpin household spending and business investment. Government spending on infrastructure and housing also supports domestic demand. The level of the New Zealand dollar exchange rate will support export earnings.

As capacity pressures build, core consumer price inflation is expected to rise to around the mid-point of our target range at 2 percent.

Downside risks to the growth outlook remain. Weak business sentiment could weigh on growth for longer. Trade tensions remain in some major economies, raising the risk that trade barriers increase and undermine global growth.

Upside risks to the inflation outlook also exist. Higher fuel prices are boosting near-term headline inflation. We will look through this volatility as appropriate. Our projection assumes firms have limited pass through of higher costs into generalised consumer prices, and that longer-term inflation expectations remain anchored at our target.

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.

Meitaki, thanks.

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