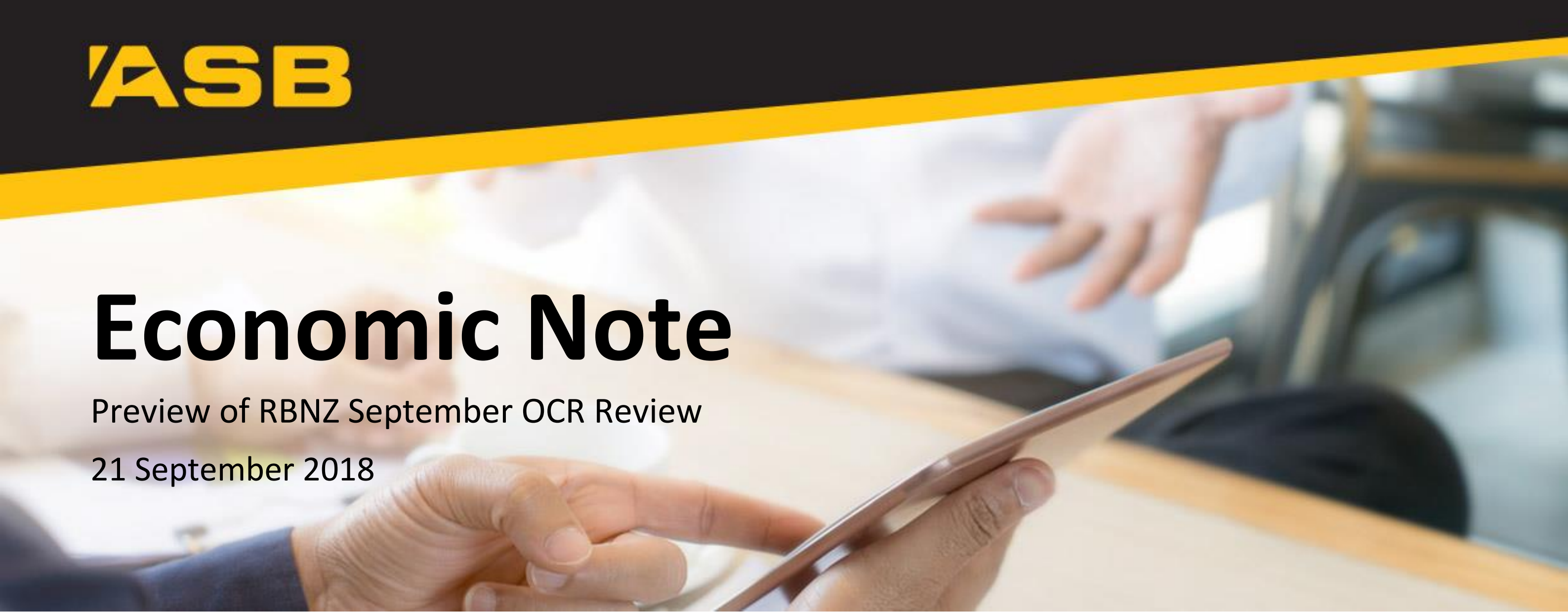

Economic Note

Preview of RBNZ September OCR Review

21 September 2018

Dangling the (rate cut) carrot

- The RBNZ is expected to stick to the script, signal the OCR is expected to remain on hold for a considerable period, but reaffirm that the next move could be either up or down.
- Despite a considerably stronger starting point for domestic economic activity, the outlook remains uncertain, with risks still skewed to the downside. The RBNZ will want to keep the market guessing over whether it will cut the OCR if H2 2018 growth disappoints.
- We still see a high hurdle to OCR moves, but respect the risk profile and would not rule out OCR cuts.

After surprising the market with a more dovish August assessment, we expect the RBNZ to stick to the script, commit to leaving the Official Cash Rate (OCR) on hold into 2020, and signal that the direction of the next OCR move could be up or down. The economy has a considerably stronger starting point for economic activity than the RBNZ had assumed. However, the downward risk profile will likely prompts a guarded policy assessment, with the RBNZ continuing to dangle the carrot of a lower OCR to keep monetary conditions accommodative. We remain constructive on the domestic outlook and expect inflationary pressures to surface more quickly than the RBNZ asserts. The hurdle to an OCR cut remains high in our view and we expect the next move to be a hike (early 2020). However, if significant downside risks did crystallise we are in little doubt that the RBNZ would follow through and cut the OCR.

RBNZ dovish in August

The August Monetary Policy Statement (MPS) was more dovish than the local market expected, with the policy assessment committing to leave the Official Cash Rate (OCR) on hold into 2020, about 12 months longer than it had signalled in May. The MPS also kept the notion of a lower OCR on the table, affirming that the next move in the OCR "could be up or down". The published OCR track had only 50bps of hikes through till late 2021. Moreover, markets were also drawn to an alternative scenario, in which weak business confidence translated into slowing growth, and the OCR would be cut by close to 100 basis points to a new record low.

Concerns about New Zealand's slowing economy appear look to have trump signs of emerging inflation. The RBNZ revised down its outlook for economic activity and while it alluded to "welcome early signs" of core inflation rising, it warned of further volatility ahead. Our takeout is that the RBNZ will likely place less emphasis on any strong inflation outcomes if they contradict the message from the activity side of the economy. **If inflation outcomes soften and activity outcomes disappoint, a lower OCR would likely result.**

Keeping the options open

Since the August assessment, developments point to more medium-term inflationary pressure. However, uncertainty remains high, and the balance of risks is still skewed to the downside.

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Please refer to the important disclosures at the end of this document.

- **Trading partner growth has continued at a solid pace and global growth prospects remain reasonable.** The direction of trade policy and contagion risks to emerging markets will likely remain a key source of uncertainty for the global economy. The global upswing could be dampened from a substantial escalation in trade protectionism.
- **Q2 NZ GDP was considerably stronger than the RBNZ had factored in** (1.0% qoq versus 0.5% qoq).
- Deteriorating business confidence continues to question whether the outlook for H2 2018 will live up to the 1.5% expansion projected in the August MPS. **We note, however, GDP growth to date has remained robust despite negative headlines and the well-publicised weakening in business confidence outcomes since the end of last year.** As we noted in our Q2 GDP review, the RBNZ should be cautious in jumping to conclusions.
- **However, achieving the close to 0.9% qoq expansion in GDP over 2019 as the RBNZ forecast, could prove challenging given that the NZ economy is at the mature stage of the expansion**, with some of the key growth drivers either at (or past) cyclical peaks.

The table below summarises the individual judgments made by the RBNZ in the August MPS and compares them with our estimates of how the RBNZ will currently being viewing the risk profile as well as ASB's core macro view.

Table 1: Balance of Risks to OCR from Individual Judgements

RBNZ key judgements and risks	Sep RBNZ Risk assessment (ASB estimates)	RBNZ Risk assessment (August MPS)	ASB's View of these risks
Robust global growth continues	Downside	Downside	Downside: on trade tensions
Global inflation increases gradually	Upside	Upside	Reduced upside: through weaker dairy auction prices
NZ grows above trend	Stronger starting point, but downside for H2 2018 and 2019.	Some downside	Some Downside: Solid 2018, but challenges ahead for 2019.
NZ capacity pressures build	Some downside	Some downside	Some Downside: slower medium-term growth outlook
Inflation takes its time to return to target	Some upside	Upside via wages and higher petrol prices	Upside: Risk tilt to sooner on high fuel prices, lower NZD

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

The shift since August is likely to reflect the stronger than expected Q2 GDP outturn as well as the likelihood the RBNZ may have scaled back its activity outlook.

There are still reasons for optimism. Many of the growth drivers - record Terms of Trade, above-trend backdrop for global growth, strong tourism inflows – remain and the RBNZ should not be unduly swayed by weaker business confidence until there are tangible signs it is weighing on overall GDP growth and inflationary pressures. Importantly, despite their post Q2 GDP lift, domestic monetary conditions are more accommodative than prior to the August MPS. Wholesale interest rates are still around 10bps lower than prior to the August MPS, with recent cuts for fixed mortgage interest rates. The NZD trade-weighted exchange rate (TWI) is still a fraction lower. **All else, equal these considerations reduce the need for an OCR cut.**

Nevertheless, we expect a cautious assessment from the RBNZ, alluding to downside risks facing the outlook. The RBNZ will be mindful that an overly optimistic assessment of the economy risks pushing up the NZD and slowing the impending economic rebalancing towards export-led growth. **Hence, the RBNZ will continue to dangle the rate cut carrot so as to keep monetary conditions accommodative and the NZD low.**

Employment target: no need for added stimulus

As this stage the RBNZ's added goal of maximising sustainable employment neither needs help from more stimulus nor is a constraint to an eventual lift in the OCR. At this point in the economic cycle, the medium-term inflation outlook will be dominating the RBNZ's monetary policy deliberations.

Keeping their powder dry

The September policy assessment is expected to reassert the intent to keep the OCR at "this level though 2019 and into 2020", with the RBNZ still well positioned to either raise or cut the OCR if need be. We remain constructive on the domestic outlook and expect inflationary pressures to surface more quickly than the RBNZ asserts. **Our core view is that the hurdle to an OCR cut remains high. However, if significant downside risks did crystallise we are in little doubt that the RBNZ would follow through and cut the OCR.**

August 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, longer than we projected in our May Statement*. The direction of our next OCR move could be up or down.*

While recent economic growth has moderated, we expect it to pick up pace over the rest of this year and be maintained through 2019.

Robust global growth and a lower New Zealand dollar exchange rate will support export earnings. At home, capacity and labour constraints promote business investment, supported by low interest rates. Government spending and investment is also set to rise, while residential construction and household spending remain solid.

The labour market has tightened over the past year and employment is roughly around its maximum sustainable level. We expect the unemployment rate to decline modestly from its current level.

There are welcome early signs of core inflation rising. Inflation will increase towards 2 percent over the projection period as capacity pressures bite. This path may be bumpy however, with one-off price changes from global oil prices, a lower exchange rate, and announced petrol excise tax rises expected. We will look through this volatility as appropriate, and only respond to any persistent movements in inflation.

Risks remain to our central forecast. The recent moderation in growth could last longer. Low business confidence can affect employment and investment decisions. Conversely, there is a chance that inflation could increase faster if cost pressures can pass through into higher prices and impact inflation expectations.

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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