Economic Note

RBNZ September 2019 Official Cash Rate Preview

20 September 2019

Never Say Never Again

- In August the RBNZ surprised by delivering a 50bp OCR cut. We expect no move in September.
- But….for the time being we wouldn't rule anything out! It's a crazy world out there.
- We expect a 25bp OCR cut in November, and have a long list of reasons why the OCR could fall further in 2020.

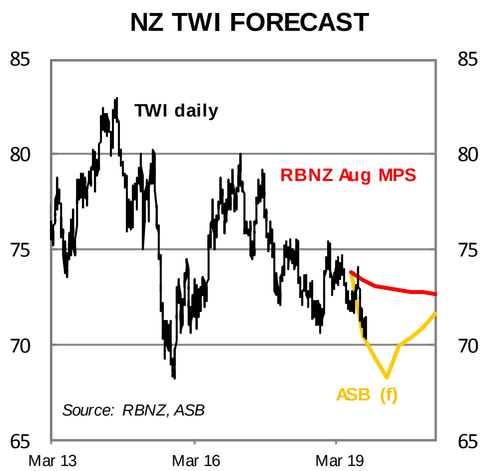
After the August 50bp OCR cut, which universally surprised with its size, a lot of people have said "well, you got that one wrong". To which I have replied "no, we got it half right", which (mathematically) is correct. The case for easing to 1% was clear, but most of the market community had expected it would be done gradually rather than in one hit.

Has the urgency to cut further remained? We think not, but the lesson is: Never Say Never Again. The Monetary Policy Committee is making Sean Connery look like a thumb twiddler as it takes on its Largo equivalent in the form of elusive inflation pressures. But recent developments have been fairly much in line with the RBNZ's outlook and assumptions, suggesting **there is time to monitor the impact of the Shock and Orr 50bp cut and wait for greater clarity[1] around US-China trade tensions and Brexit paths.** And the RBNZ will be pleased at the Skyfall that lending rates and the NZ dollar have experienced: **the easing of monetary conditions to date this year has been substantial.**

But the risks to interest rates are all one way, with further OCR cuts next year very possible. NZ growth could remain bogged down given weak sentiment and the worsening global growth outlook. Furthermore, the RBNZ has yet to factor any economic drag from its proposed increases in bank capital requirements. Q is working away on some unconventional tools for the MPC, such as Quantitative Easing.

What has changed since the August Shock and Orr cut?

One important and positive development since the August 50bp OCR cut has been the substantial easing of monetary conditions it engineered, much like having Felix Leiter dramatically save the day with a big wad of cash:



- The NZ dollar has eased slightly on a Trade Weighted Index basis since the August Monetary Policy Statement (MPS), and is tracking slightly weaker than RBNZ assumptions;
- Despite having climbed off their lows, NZ wholesale interest rates are up to 20bp lower for 1-5 year tenors. A terminal OCR of about 0.60% is now priced in (versus 0.9% prior to the August Statement);
- Fixed-term mortgage rates have fallen up to 30bp for key 1- and 2-year rates;

[1] In this context 'clarity' is a highly utopian state of understanding where you think you can guess enough about what might happen that you feel you could make a rough stab at making a key decision that might even turn out to be right.

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- Floating mortgage rates are 50bp lower;
- But term deposit rates have fallen 20-30bp, a drain on savers' disposable income.

We believe the RBNZ has been pleased with the traction it has had in pushing stimulus out into the economy. And there are signs the housing market is starting to respond to the OCR cuts, with sales turnover recovering and house prices picking up.

But most other developments are in the category that will give M(PC) cause for concern:

- NZ's trading partner growth outlook continues to soften, with (mostly downside) global risks mounting;
- The US-China trade war remains hot and with uncertain outcomes;
- And then there is UK Brexit. Boris Johnston's headlong charge towards a 'no-deal' Brexit is a masterclass in sabotage for SPECTRE to learn a thing or two from. And the Labour Opposition's position requires heavy-duty deciphering: there is some mild confusion out there – this video won't help.
- Domestically, business confidence fell further in a survey straddling the 50bp OCR cut, and anecdotally the response to the large cut has been more "what do they know that we don't" rather than feeling reassured. Consumers look to be hunkering down given growing unease over the economic outlook.
- Inflation expectations have edged down, a potential headwind for pushing inflation back to around 2% on a sustained basis.

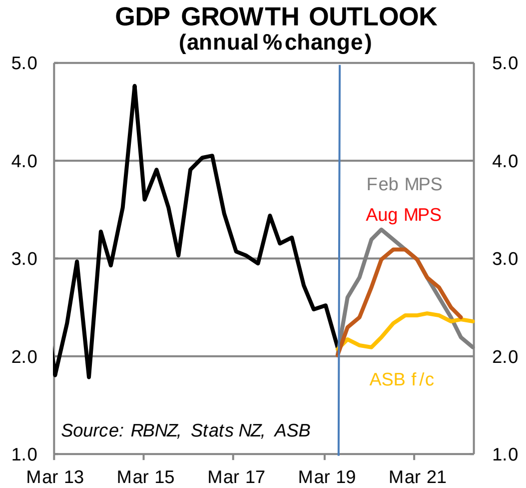
All up, there aren't likely to be material changes to the unpublished forecasts that underpin the September OCR decision, with the global situation likely to remain front of centre to the MPC's policy deliberations. But we flag that the domestic growth outlook is increasingly likely to come under the microscope.

Growth trajectory: no Moonraker

Although the RBNZ may be happy with the financial market reaction to its 50bp cut, it will be less happy with the "hearts and minds" response. Both business confidence (in a survey that straddled the cut) and consumer confidence have subsequently weakened. There remains a significant risk of weak sentiment translating into softer business investment, employment and consumer spending.

Our growth outlook now has nowhere near the bounce that the RBNZ's had in its August forecast. The RBNZ's growth outlook is at risk of being revised down, potentially for the November MPS and supporting the case for a 25bp cut then.

Our new Recession Probability Model flags a 30% chance of the economy currently dipping into recession. That is still a 70% chance of no recession, but does point to an economy that is growing at a subdued pace and more vulnerable to any knocks.



More need to fire the Golden Gun?

In the current environment of getting your revenge in first on your nemesis (i.e. pre-empting risks of weak inflation and sub-par employment), we have a comprehensive list of issues that stand a good chance of spurring the RBNZ to take action beyond merely dropping the OCR to 0.75%:

- If business confidence fails to start recovering soon. Weak business sentiment, if sustained, would point to ongoing sub-trend growth and weak inflation;
- Even weaker global growth, further dampening tourism arrivals and taking the edge off still-good export commodity returns. A lower NZD is likely to partially offset this;
- The RBNZ's proposed capital requirements, which the RBNZ has yet to factor into its economic outlook. Our research suggests the capital increases look set to add at least 50bps to customer interest rates, and

monetary policy will need to offset this growing headwind for the cost and supply of credit;

- Reassessment of the Neutral OCR – the RBNZ's estimate (circa 3.2%) remains too high in our view (2.5%). If the capital requirements are implanted, the neutral OCR will likely move lower still, with an OCR of 1% progressively providing less stimulus;
- A reassessment (lower) of the Non Accelerating Inflation Rate of Unemployment (NAIRU). A higher threshold for Maximum Sustainable Employment (MSE) could mean more policy stimulus is needed to meet it, all else equal.

The key message is: be on the lookout for further decisive action from 002 The Terrace. Any one of the above could prompt M(PC) to terminate the risks with extreme prejudice.

Monetary Policy Committee: High level policy considerations

August MPS Record	**Risks to OCR (ASB estimates)**
Global prospects Heightened global uncertainty was reducing investment and suppressing trading partner growth. This highlighted the risk of a larger or more prolonged slowdown in global economic growth. Considerable economic and policy uncertainty could see global growth continue to decline despite policy stimulus.	Further slight downward revisions to RBNZ outlook for trading partner growth. Brexit risks higher; US-China trade tensions still high
NZD and overseas central banks Additional stimulus from central banks had underpinned growth and reduced the likelihood of a more-pronounced slowdown.	Upside risk given lower NZD. Risk of lower OCR in longer term via further global stimulus boosting attractiveness of NZ interest rates.
Domestic outlook Slowing global demand impacting New Zealand through the trade, financial and confidence channels. Low business confidence had dampened business investment and if it remains weak, growth might not increase as anticipated over the medium term. Both upside and downside risks to household spending and from the impact of fiscal policy. Importance of additional spending from households, businesses, and the government, to meet the RBNZ's inflation and employment targets.	Downside remaining if business confidence remains weak. Some upside if low interest rates boost housing by more than RBNZ assumes.
Labour market Employment was around the targeted maximum sustainable level. Committee pleased to see that the labour market data hold up relative to expectations in 2019Q2. However, outlook for employment and (inflation) was softer given GDP outlook.	Downside. Still-high underutilisation. Some slack (higher unemployment) likely to emerge.
Inflation Softer outlook for inflation given weaker global and domestic conditions. Survey measures of short-term inflation expectations slightly lower, longer-term close to 2%. Both upside and downside risks to wages.	Modest downside from low inflation expectations.
OCR settings and bias The Committee agreed that the balance of risks to achieving its consumer price inflation and maximum sustainable employment objectives was tilted to the downside. Consensus cut by 50bps (rather than 25bps) would best meet policy objectives. No policy bias provided. Neutral OCR likely to have continued to decline but little change in transmission mechanism.	Downside. We expect OCR trough of 0.75% by late 2019, with risk the OCR moves lower over 2020.

Source: ASB

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