ASB

Economic Note

RBNZ September 2019 Official Cash Rate Review

25 September 2019

Waiting on the wing

- The RBNZ kept the OCR steady at 1%, in line with expectations.
- Growth risks remain, but the RBNZ appears more confident that recent policy stimulus will boost the economy.
- We continue to expect a further 25bp cut in November, with the risk of more action next year.

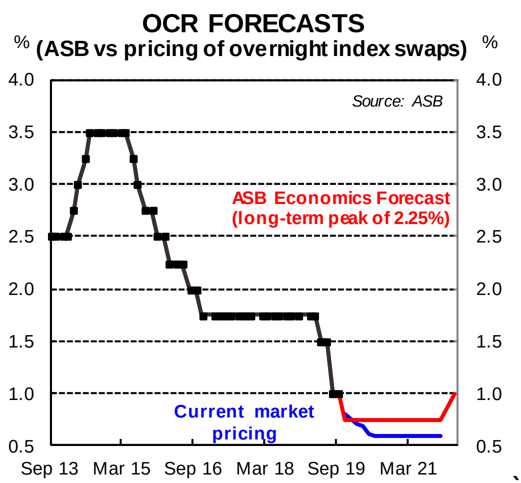
The on-hold decision was widely expected, though a rate cut wouldn't have been a big surprise after the bold action last month. But, in line with our view, events since the August cut weren't large enough to prompt getting further on the front foot. The murky global environment and weak business confidence remain as growth risks. Against that, the RBNZ is heartened by the impact its monetary easing has had and expects household and business spending to pick up in response – and has put greater emphasis on fiscal policy.

Even though the OCR remained steady at this meeting, a lower OCR remains very much on the cards. We continue to expect a 25bp cut in November, which today's statement and meeting summary leave the door open for. But by itself the statement suggests that a November cut isn't a dead certainty, with a lingering possibility that an improved environment could see the RBNZ hold fire.

We still see a November OCR cut as the highly likely outcome, and have a list of several catalysts that could trigger follow-up action next year. Importantly, we expect growth will fall short of the RBNZ's August forecast, which should prompt the RBNZ to eventually break across the advantage line again.

Some caution already banked

Back in August the RBNZ really front-footed weak economic news and the growing array of growth risks with its 50bp OCR cut. Even though its forecasts back then suggested some risk of the OCR moving even lower, not enough has changed in the intervening weeks to step out again at this point. The RBNZ also expects the easing to date to take hold. And, interestingly, the RBNZ explicitly mentioned that there is scope for more fiscal stimulus (as well as monetary), a hint that monetary policy would like a mate.



Inflation: hopefully to rise

The summary of record of the meeting of the Monetary Policy Committee showed the expectation that inflation would lift gradually to 2%, supported by rising capacity pressures, increasing import costs, higher wages, and pressure on margins. Moreover, the meeting highlighted both upside and downside risks to the inflation outlook. On the upside, rising labour and import costs could provide a boost to (currently low) inflation over the medium term. The record, however, did note the (downside) risk to

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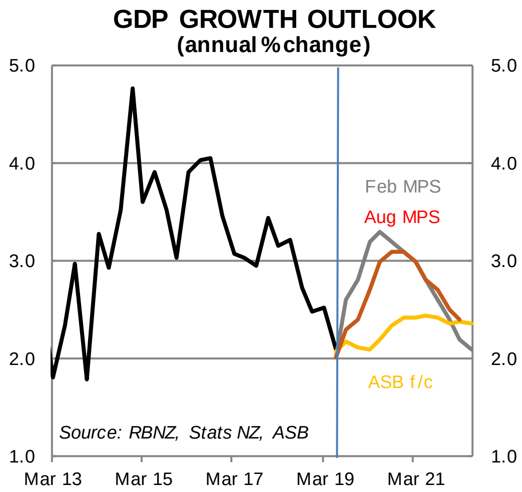
inflation expectations posed by ongoing low inflation. In our view, recent falls in the NZD could act to push up consumer prices in the short term. However, we do not fully buy into the RBNZ's optimism over the domestic growth outlook and believe inflation pressures will take longer to resurface.

Risks still skewed to a lower OCR

Even beyond our forecast November cut we see the risks as being stacked towards the RBNZ deciding even more stimulus is needed to meet its inflation and employment mandates. The potential triggers include:

- Continued weak business confidence;
- Softening of consumer confidence;
- Further weakness in global growth;
- Incorporation of increased bank capital requirements into the RBNZ's economic forecasts (which it hasn't done yet);
- Any reassessment by the RBNZ that the neutral interest rate is lower;
- Downward revision in the RBNZ's estimate of how low unemployment can sustainably sit without generating added inflation.



In a nutshell, these risks centre around the RBNZ revising down its growth outlook, assessing that inflation pressures remain too muted, and taking a view that monetary policy isn't as stimulatory as it has been assuming.

Market reaction

The market reaction was small. Wholesale interest rates lifted 1-2bps across the curve, consistent with the idea that the Statement was a little less dovish than market expectations. The NZD/USD rose 20-30 points. The market is pricing in an 80% probability of a 25bp cut in November, which seems fair.

Monetary Policy Committee: High level policy considerations

Sep OCR Record	August MPS Record	Risks to OCR (ASB view)
OCR settings and bias Developments had not significantly changed the outlook for monetary policy since August. Consensus to keep the OCR at 1.0%. Scope for more fiscal and monetary stimulus if necessary.	*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.	Downside. We still expect 25bp OCR cut by end of the year.
Global prospects Global trade and other geopolitical tensions remain elevated, dampening the global growth outlook and demand for NZ exports.	*Global prospects* Heightened global uncertainty was reducing investment and suppressing trading partner growth. 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.	Modest downside to RBNZ outlook for trading partner growth.
NZD and overseas central banks MPC pleased to see the exchange rate	*NZD and overseas central banks* Additional stimulus from central banks had underpinned growth and reduced the	Some upside. TWI at 70.7 is 4% below

decline since the August OCR cut.	likelihood of a more-pronounced slowdown.	August MPS assumption.
Domestic outlook Slower GDP growth over H1 2019. Demand pressures and low interest rates, supportive fiscal policy to boost domestic demand. Weak business confidence is impacting investment.	*Domestic outlook* Slowing global demand impacting New Zealand through the trade, financial and confidence channels. Low business confidence had dampened business investment. Both upside and downside risks to household spending and from the impact of fiscal policy.	Downside. RBNZ August growth projections look too optimistic given weak sentiment.
Labour market Employment remains close to its maximum sustainable level. Scope for more fiscal and monetary stimulus to support RBNZ employment objectives.	*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 given risks to growth outlook
Inflation Rising capacity pressures and increasing import costs, higher wages, and pressure on margins expected to lift inflation gradually to 2%. Both upside and downside risks to inflation outlook.	*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.	Downside. Low NZ inflation looks be structural.

Source: ASB, RBNZ

RBNZ Policy assessment

25 September 2019

The Official Cash Rate (OCR) remains at 1.0 percent. The Monetary Policy Committee agreed that new information since the August Monetary Policy Statement did not warrant a significant change to the monetary policy outlook.

Employment is around its maximum sustainable level, and inflation remains within our target range but below the 2 percent mid-point.

Global trade and other political tensions remain elevated and continue to subdue the global growth outlook, dampening demand for New Zealand's goods and services. Business confidence remains low in New Zealand, partly reflecting policy uncertainty and low profitability in some sectors, and is impacting investment decisions.

Global long-term interest rates remain near historically low levels, consistent with low expected inflation and growth rates into the future. Consequently, New Zealand interest rates can be expected to be low for longer.

The reduction in the OCR this year has reduced retail lending rates for households and businesses, and eased the New Zealand dollar exchange rate.

Low interest rates and increased government spending are expected to support a pick-up in domestic demand over the coming year. Household spending and construction activity are supported by low interest rates, while the incentive for businesses to invest will grow in response to demand pressures.

Keeping the OCR at low levels is needed to ensure inflation increases to the mid-point of the target range, and employment remains around its maximum sustainable level. There remains scope for more fiscal and monetary stimulus, if necessary, to support the economy and maintain our inflation and employment objectives.

Meitaki, thanks.

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