Economic Weekly

07 October 2019

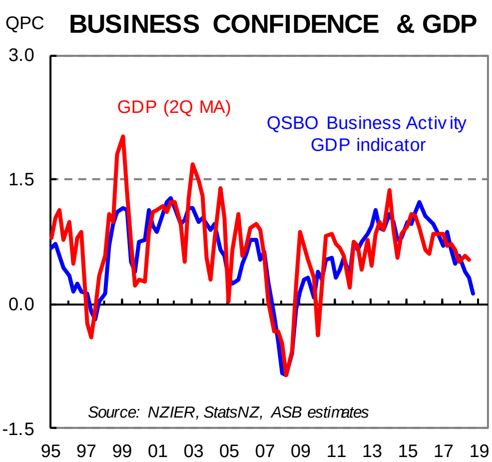
50/50 – 50bps of cuts to 0.5% floor

Last week, both of the main business confidence surveys in NZ flagged that the NZ economy risks losing even more momentum than it already has. Despite the RBNZ's double-barrelled shot at revving up the economy, the collective sum of events of the past few months has made businesses less confident in their outlook and less keen on making investment commitments. Further weakness in business confidence points to yet more easing from the RBNZ to try and prop the economy up. **We now expect the RBNZ to cut the OCR by a further 25bp in February next year, in addition to the 25bp cut we expect to see in November,** taking the OCR down to 0.5%, and coincidentally in line with where we see the Australian cash rate getting to. There will be debate over whether the November OCR decision will be another 50bp cut rather than 'just' 25bp. However**, given the August 50bp cut seems to have spooked businesses and households alike, sticking to 25bp moves may be strategically better.** How low can the OCR go, and what other options are there for the RBNZ? We lift the hood on that black box in our feature article.

Key events and views

Key Insights	We discuss unconventional policy options available to the RBNZ.
Foreign exchange	We look for consolidation inside a 0.6240-0.6400 range.
Interest rates	Lower yields and steeper curves in NZ and abroad. We retain our downward bias.
Domestic events	Card spending, manufacturing/services PMIs.
International events	US Fed meeting minutes, US CPI and Australian lending data are key this week.

Chart of the Week: Economy likely stalled in Q3



Last Wednesday's Quarterly Survey of Business Opinion from the NZ Institute of Economic Research suggests that the NZ economy ground to a halt over Q3. **Firms' reported experienced activity points to barely positive Q3 GDP growth** and has prompted ASB to forecast even more monetary easing from the RBNZ.

One feature of the survey was a sharp drop in businesses' investment intentions, worrying given NZ's poor productivity performance. Businesses and rural communities are digesting a lot of economic and environmental policy change, which is adding to the general uncertainties decision-makers face. A Government 'charm offensive' with the business and rural communities would help. The loss of confidence over the past two years cannot be sheeted home solely to global factors, particularly when the export sector has been one of the more solid parts of the economy.

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Key insights this week: Unconventional policy options and the OCR floor

- We believe the OCR floor is somewhere between -0.25% and -0.75%.
- Our preference would be for the OCR lever to be fully exercised before other measures are contemplated.
- There are a variety of other unconventional policy options available, but none are without cost. To provide the best bang for your policy buck, closer co-ordination will be needed.

This is an abridged summary of a research note we published late last week.

This year has seen a sea change in the global interest rate outlook. The catalysts appear to be the weakening global outlook and still-muted inflation, which has seen global central banks step up their provision of policy stimulus. Policy rates globally are approaching zero, including in NZ. Against this backdrop, it is prudent to think about where the floor in the Official Cash Rate (OCR) might be, and what other forms of monetary easing the RBNZ could use to support the economy.

To be clear, our view remains that the trough in the OCR will be 0.50% this cycle (or slightly below it). Having the luxury of a freely floating exchange rate and scope to loosen fiscal settings, leaves the NZ economy reasonably well placed. Nevertheless, it would be prudent to work on a plan B if everything goes to custard.

What is the OCR Floor?
This is the lower bound at which the OCR ceases to be effective in stimulating the economy. Given the reliance of the NZ banking system on deposits for funding, the floor of the OCR is likely to be the level from which it would generate deposit interest rates that would be sufficiently high to attract funding. Moreover, zero floors for some lending contracts and the limit provided for corporate borrowing rates suggests there is a limit to how low the OCR could go. Policy rates are down to as low as -0.75% in Europe and it is extremely unlikely that an economy dependent on foreign saving (NZ) would be able to attract funding from offshore by offering lower interest rates. **All up, our estimates suggest the floor on the OCR could be as low as -0.75% to -0.25%.**

Other options
In addition to cutting the OCR to its natural limit, there are a number of supplementary options available, including:

- Introducing tiered lending to mitigate the impact of the low OCR on financial institutions;
- Explicit forward guidance that policy rates will remain at a very low level until stated conditions are met;
- Lowering long-term risk-free rates by purchasing government securities (QE);
- Intervening in wholesale interest rate markets to lower long-term interest rates;
- Purchasing private sector assets, including mortgage-backed securities, and corporate bonds;
- Providing long-term funding to banks to support credit creation; and
- Foreign exchange intervention.

By all intents and purposes, the aim of such policies (and the lowering the OCR) is largely to front-load spending, by facilitating increased borrowing or via reducing the returns available to savers. They could also result in investors reassessing investment options. For small open economies (like NZ), the exchange rate is an important part of the transmission mechanism. **Most of the actions above would likely lead to a lower NZD.** Even the announcement of the intent to pursue unconventional polices would likely push the NZD lower. A lower NZD reduces the amount of heavy lifting needing to be done by domestic interest rates. There will be distributional consequences from a lower NZD, with consumers bearing much of the brunt, while the export sector would likely benefit.

These policies are not without cost
While it is always useful for policy makers to have a number of potential options in the policy toolkit, unconventional policies are not a panacea and can impose significant costs. There is is no guarantee they will prove effective in kick-starting the economy. Their adoption can also impose significant costs and distortions. These include: adding unpredictability over policy direction; significantly eroding policy credibility (particularly if ineffective); widening inequality via boosting asset prices; increasing indebtedness; imposing political risks; and placing greater risk on the RBNZ's (and Government's) balance sheet.

The need for policy co-ordination
If the RBNZ was to go down the unconventional policy route it needs to make sure that its internal policy settings

are moving in the same direction. If the proposed RBNZ capital requirements are imposed, our work suggests this will widen the margin between deposit and lending interest rates and potentially slow the supply of credit. Both would oppose the impact and effectiveness of unconventional policy. **It is also vital that the RBNZ and Treasury sing from the same song sheet,** and that fiscal policy does some of the heavy lifting. **Rather than reinvent the wheel in NZ, it is crucial that the RBNZ closely liaises with other central banks around the world to see what has worked, and what hasn't.** Moreover, some policy actions – for example, FX intervention – stand a better chance of success if co-ordinated rather than going it alone.

A final warning

Monetary policy is a powerful tool for *cyclical* stabilisation. However, its ability to counter longer-lasting influences – including persistently-weak inflation – is untested. **At best, these policies are likely to provide a temporary band aid solution to what may be longer lasting issues.** If inappropriately used, they could end up creating a larger mess down the track. **Before opting for the unconventional policy route, policymakers must be confident that propping up the economy with policy stimulus will provide better long-term outcomes for economic welfare than letting things run their natural course.** The adoption of unconventional policy represents another form of 'can kicking', but the conversation needs to turn to whether it is beneficial for economic welfare to keep the can rolling and face the risk of a larger mess to eventually clean-up and with fewer policy options available.

Table 1: Unconventional Policy options for NZ

Policy	What is it?	Benefits	Costs
Negative interest rates	OCR could go as low as -0.75% according to RBNZ. Treasury place the lower bound at -0.35%. *ASB: Lower bound is in a -0.25% to -0.75% range.*	Lower wholesale/retail interest rates. Lower NZD.	Adversely impacts bank profitability and could dampen bank lending. Will hit savers hard and may see pick-up in speculative investment/asset prices May be less effective in low saving economies (NZ).
Explicit forward guidance	RBNZ commits to holding OCR low over lengthy horizon.	Increase traction of OCR settings, holding down longer-term interest rates. Lower NZD.	Reputational/credibility loss or if circumstances change/forward guidance looks to be misleading, or if the RBNZ abandons guidance.
Quantitative Easing	RBNZ purchase NZ Govt bonds, collateralised mortgages.	Lowers long-term lending rates and frees up liquidity. Lower NZD. Could directly lower borrowing costs for mortgages.	Sizeable risks incurred by RBNZ. Could create additional volatility and overheating in asset markets. Small domestic bond market. Could reduce liquidity if purchases too many assets.
Market Intervention	Transaction to flatten domestic swaps curve and kick-start activity.	Lower long-term borrowing costs. Lower NZD.	Subjects RBNZ to considerable risk given their reduced influence on longer-term interest rates.
Term Lending facilities	New cash facility to support banking system liquidity.	Help to increase supply of credit and interest rate pass through to customers. More effective for economies reliant on bank financing. Lower NZD.	Banks may take on more credit risk than they would normally do. Could impede market efficiency.
Purchase private sector assets	RBNZ to fund asset purchases.	Supports asset values. Increases liquidity. Lower NZD.	Sizeable risks to RBNZ's balance sheet. RBNZ would have to pick winners in sectors. Could create overheating in asset markets.
Purchasing foreign currency	Outright foreign asset purchases by the RBNZ.	Holds down NZD and boosts banking system liquidity.	Large financial risks imposed on RBNZ.

Source: ASB

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6305	0.6266	0.6382	0.6464	FLAT	0.6240	0.6400	FLAT
NZD/AUD	0.9332	0.9271	0.9361	0.9151	FLAT	0.9300	0.9400	FLAT
NZD/JPY	67.26	67.64	68.25	73.62	FLAT	66.65	68.35	FLAT/UP
NZD/EUR	0.5741	0.5730	0.5781	0.5617	FLAT	0.5700	0.5805	FLAT/UP
NZD/GBP	0.5121	0.5100	0.5176	0.4968	FLAT	0.5060	0.5150	UP
TWI	70.6	70.0	71.1	70.81	FLAT	N/A	N/A	FLAT/UP

*^ Weekly support and resistance levels * Current as at 9.30am today; week ago as at Monday 5pm*

NZD Recap

The NZD briefly slipped to 10-year lows a smidge above 0.6200 last week, before recovering a little.

Globally, worries about the state of the US and global economies returned, and investors flocked back into safe-haven assets. Not only did the (increasingly global) trade war take another turn for the worst, but US economic data suggested chinks are starting to appear in the US economy's armour. Equity markets lost ground and the VIX index (a risk aversion proxy) rose.

The NZD was also buffeted by domestic headwinds last week. The ANZ and QSBO business surveys delivered a one-two punch of gloom, sending local interest rates to fresh lows and analysts (including ourselves) scrambling to factor in additional RBNZ OCR cuts. The risk the NZ economy soon slows to stall speed saw the NZD briefly belted.

We've flagged before that **speculative investors are extremely 'short' NZD, according to CFTC data.** This net short position hit another record high last week. We suspect a trimming of these positions was behind the recovery in the NZD through the latter part of last week. A reasonable read on US employment on Friday, including the US unemployment rate at 50-year lows, furthered the recovering trend.

Near-term outlook

Global markets get a chance to catch their breath this week, with a much quieter schedule of events on the slate. US CPI, the FOMC minutes, and fresh trade talks between the US and China are likely to be the most closely watched. Local data due for release are second tier at best.

For the NZD/USD, we suspect it's going to be a case of consolidation inside the familiar 0.6240-0.6400 range. If anything, the topside of the range is probably more at risk given speculative investors' extreme short positioning. Interest rate markets have moved to price a terminal OCR just below 0.5%. We share this view. The risk is probably for markets to test additional downside on this at some stage, but there are no catalysts for this to occur this week.

Medium-term outlook

Our forecasts have the NZD/USD dribbling lower for the best part of the next nine months, to a low of 0.6200 in March 2020. We'd characterise this profile as a sideways NZD/USD trend inside a low 0.6200-0.6400 range. Our lower for longer view is consistent with the trade war, and attendant negative global growth impacts, dragging on for longer than previously anticipated. The domestic slowdown also appears to be occurring at a slightly faster rate than. Our constructive view on NZ's terms of trade is the key reason we believe there is only limited NZD downside from here.

ASB foreign exchange forecasts	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>				
NZD/USD	0.67	0.63	0.63	0.62	0.67	0.68	0.68
NZD/AUD	0.96	0.93	0.94	0.94	0.94	0.94	0.94
NZD/JPY	72	68	66	64	70	71	71
NZD/EUR	0.59	0.57	0.57	0.57	0.59	0.60	0.60
NZD/GBP	0.53	0.51	0.53	0.53	0.54	0.52	0.52
NZD TWI	73.2	70.2	69.3	68.3	71.7	72.1	72.1

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	1.00	1.00	1.00	1.75	UNCH/DOWN	UP
90-day bank bill	1.05	1.15	1.17	1.89	UNCH/DOWN	UP
2-year swap	0.82	0.94	0.96	2.02	UNCH/DOWN	UP
5-year swap	0.83	0.94	1.02	2.38	UNCH/DOWN	UP
10-year swap	1.12	1.21	1.31	2.90	UNCH/DOWN	UP
10-year govt bond yield	1.00	1.09	1.15	2.61	UNCH/DOWN	UP
Curve Slope (2s10s swaps)	0.30	0.27	0.35	0.89	UNCH/DOWN	UNCH/UP

** Current as at 9.30am today; week ago as at Monday 5pm. Key UNCH = Broadly unchanged*

Market Recap

Dovish global central banks, worsening trade tensions, drama around the Trump impeachment inquiry, ongoing Brexit jitters, the softening tone of US data and weak domestic business sentiment pushed local and domestic yields lower, with larger falls for shorter-term yields. **We have changed our OCR call after the release of weak ANZ and NZIER business confidence surveys and now expect additional 50bps of OCR cuts and a 0.5% OCR floor.** Yields on the bellwether NZ 2-year swap touched record lows (0.815%), with 10-year Government bond yields approaching mid-August lulls. Australasian yields were lower after the Reserve Bank of Australia (RBA) cut the cash rate by 25bps to a record low 0.75% and left the door open to a lower cash rate. Weakening US data – the ISM manufacturing ISM at 10-year low (47.8) and the non-manufacturing ISM at 3-year lulls (52.6) – has seen US yields fall and curves steepen, with market pricing for a 25bp October Fed cut rising to 90%. We have changed our Fed call and now expect a further 100bps of Fed cuts, starting in October.

Near-term NZD interest rate outlook

Despite the sizeable falls of late, we have retained our lower for longer view of the local and global interest rate outlook, with slowing global growth and dormant inflation necessitating more policy support. The RBNZ is on the look-out for a lower OCR-induced boost, but we don't expect forthcoming domestic manufacturing/services sentiment or card spending data to show tangible signs of improvement. Moreover, there is a risk that this week's Australian business confidence data follows NZ downwards. This week's Federal Open Market Committee (FOMC) Minutes may provide insights into prospects of follow-up cuts, and we will be focusing on comments from a number of FOMC speeches this week (including FOMC Chair Powell). Brexit will likely remain an added distraction for markets. With the US set to impose higher tariffs on European aircraft and other goods next week (October 18), concerns over the global growth outlook are unlikely to recede. **Given the myriad of downside risks to the outlook, there is still scope for the curve to flatten if these risks to the outlook crystallise**.

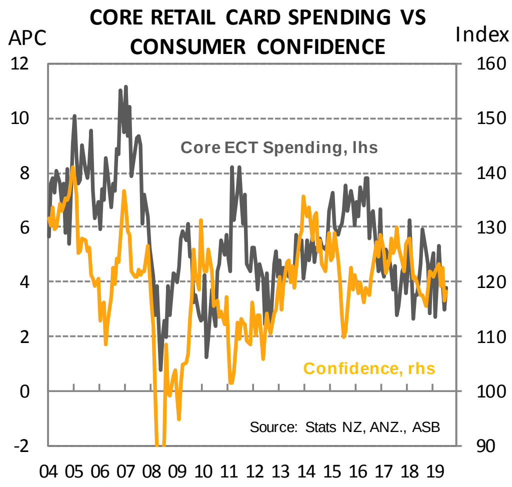
Medium-term outlook

Our forecast is for the curve to initially steepen and then to flatten as policy easing precedes mild policy tightening. We now expect 50bps of OCR cuts (-25bps Nov 19, -25bps Feb 20), with the OCR to plateau at 0.5% this cycle. We expect extremely mild and gradual OCR hikes from 2022, with an OCR endpoint of just 2%. We also expect a further 25bp cut by the RBA in February (0.5% floor). The Fed is expected to cut the 1.75%-2% Federal Funds rate by 100bps by mid-2020 (Oct, Dec, Mar 2020, June 2020), and with policy easing elsewhere. **Low inflation, low global growth and a negatively skewed risk profile should cap NZ and global long-term interest rates at historically-low levels.**

ASB interest rate forecasts	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>				
NZ OCR	1.50	1.00	0.75	0.50	0.50	0.75	1.25
NZ 90-day bank bill	1.7	1.2	1.0	0.9	0.8	1.0	1.5
NZ 2-year swap rate	1.4	0.9	0.8	0.7	0.7	1.0	1.4
NZ 5-year swap rate	1.4	0.9	0.9	0.8	0.9	1.3	1.7
NZ 10-year swap rate	1.8	1.2	1.2	1.1	1.2	1.6	2.0
NZ 10-year Bond	1.6	1.1	1.0	0.9	1.0	1.4	1.8

Domestic events

Data	Date	Time (NZT)	Market	ASB
Electronic Card Transactions, Sep, retail % mom	11/10	10:45am	0.2	0.3



Following two months of weaker-than-expected readings, August finally saw stronger-than-expected lifts for both core and total retail card spending. Core spending (ex-fuel and vehicle-related) showed considerable vigour (+1.3% mom), the strongest monthly rise since January. **Despite the urging of the RBNZ, we do not expect this brisk momentum in retail to be sustained in September with a moderate monthly increase on the cards.** There are improving signs in the housing market, but consumer sentiment has weakened in the aftermath of the August 50bp OCR cut, with the risk consumers retreat into their shells. Higher fuel prices (up roughly 2.5% in September) are also expected to weigh on discretionary spending with a likely pullback in spending on apparel, durables, and hospitality spending. Spending for the September quarter should outpace a sluggish June, keeping the expansion on consumer spending on track. We are not so upbeat for the rest of the economy.

Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
Eurozone Industrial Production, August, %mom	07/10	10:00 pm	-	-
Japan Current Account Balance, August, ¥bn	08/10	12:50 pm	2,100	1,600
Australia MI Consumer Sentiment, October	09/10	12:30 pm	-	-
US Fed Meeting Minutes	10/10	7:00 am	-	-
Australia House Lending, August, %mom	10/10	1:30 pm	2.3	4.0
UK GDP, August, %yoy	10/10	9:30 pm	0.0	-
US CPI, September, %yoy	11/10	1:30 pm	1.8	1.9
US Uni. Of Michigan Inflation Expectations, October	12/10	3:00 am	-	-

**Originally published by CBA Global Markets Research on Friday 4th October at 3.23pm*

The **Eurozone's manufacturing PMI** points to a further contraction in industrial activity in August.

The small widening of the customs trade deficit suggests **Japan's current account surplus** shrunk modestly to ¥1,600bn. Despite the narrowing, we estimate Japan's current account surplus is more than 3% of GDP.

The October reading of **Australia's consumer sentiment** will include the reaction to the Reserve Bank of Australia's (RBA) latest 25 basis point cash rate cut. Consumer sentiment dropped following the June and July rate cuts. It appears that rate cuts have raised concerns around the economic backdrop rather than alleviating them.

Market participants will be interested in the **US Federal Reserve's discussion of the risks** to the US and global economic outlook when it puts out its Meeting Minutes later this week. We also expect a discussion of options for improving the repo market.

Partial data in **Australia** suggest another **strong lift in the value of lending for housing in August**. This would make it the third consecutive solid monthly increase. Other indicators of the property market have lifted too including auction clearance rates, dwelling prices and CBA's home buying component of the Household Spending Intentions data. The RBA's latest cash rate cut will help these trends continue. This release also includes personal and business lending.

The decrease in the volume of **UK** August retail sales and the weaker composite PMI suggest **GDP** contracted in August.

US retail gasoline prices stabilised in September despite the brief spike in West Texas Intermediate (WTI) oil prices. The tight labour market and firm growth in wages will support a 1.9%yoy in the headline **CPI** and 2.4%yoy in the core CPI.

US Federal Reserve participants are concerned that long-run inflation expectations may be too low to be consistent with its 2%yoy inflation target. The **University of Michigan inflation expectations** report is due out later this week.

Key Forecasts

ASB NZ economic forecasts

	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
	<< actual	forecast >>					
GDP real - Q%	0.5	0.5	0.5				
GDP real - A%	2.1	2.2	2.1	2.1	2.4	2.4	2.4
GDP real - AA%	2.5	2.3	2.2	2.1	2.3	2.4	2.4
CPI - Q%	0.6	0.5	0.1				
CPI - A%	1.7	1.3	1.4	1.8	1.8	1.9	1.9
HLFS employment growth - Q%	0.8	0.2	0.3				
HLFS employment growth - A%	1.7	0.9	1.3	1.7	1.5	1.4	1.2
Unemployment rate - %sa	3.9	4.1	4.2	4.3	4.2	3.8	3.9
Annual current account balance as % of GDP	-3.4	-3.4	-3.3	-3.1	-3.0	-3.1	-3.1

Q% = percentage change on previous quarter

A% = percentage change since same quarter the previous year

AA% = percentage change for year ending quarter since the previous year

ASB interest rate forecasts

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NZD/JPY	72	68	66	64	70	71	71
NZD/EUR	0.59	0.57	0.57	0.57	0.59	0.60	0.60
NZD/GBP	0.53	0.51	0.53	0.53	0.54	0.52	0.52
NZD TWI	73.2	70.2	69.3	68.3	71.7	72.1	72.1

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