Economic Weekly

09 December 2019

Spend-ups and elections

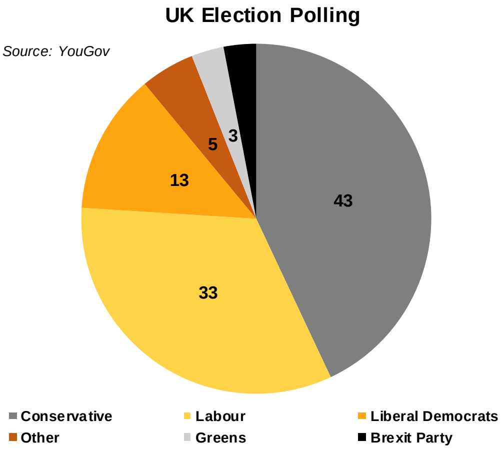
Things are heating up as we head into the second-to-last full workweek before Christmas. The big NZ event is the Half Year Economic and Fiscal Update on Wednesday, which is likely to set the scene for less fiscal restraint given recent announcements of adding spending and the effective shedding of the 20% of GDP net debt target. Already the Government has announced some added spending as well as an intention to borrow more to fund infrastructure projects. **Overseas the US Federal Reserve is likely to keep interest rates on hold** this Thursday morning, which last Friday's strong employment figures reinforced. The UK General Election (and next key step in determining the path of Brexit) is Friday morning our time, with results out in our Friday afternoon.

And the last thing to note is that the RBNZ's bank capital requirements were made public last Thursday. There was some relaxation of the type of eligible capital and the length of time for the transition. But there is a sting in the tail for the large banks that front-loads some key changes. We cover these key aspects in our feature article.

Key events and views

Key Insights	Minimum Bank Capital Requirements – the good, the bad and the unknown
Foreign exchange	The NZD was the strongest performing G10 currency last week.
Interest rates	NZ interest rates also higher on week-ago levels.
Domestic events	Half-year Economic and Fiscal Update from Treasury.
International events	US Federal Reserve rate announcement, US and China CPI, UK Elections.

Chart of the Week: The Boris and Jeremy show



Friday afternoon our time will deliver the results of the UK General Election, which is to some extent a quasi-referendum on Brexit (or at least on the divergent and, in some cases, confusing approaches the various political parties have to Brexit). The recent YouGov poll has both the Conservatives (on 43%) and Labour (on 33%) gaining ground since the election was called. In contrast, the Liberal Democrats and very minor parties have lost ground. In the First Past the Post system, the Conservatives are likely to increase their majority, making passing of the deal already agreed with the EU more likely. Still, it all appears a case of who will make the least mess, given that 78% of poll respondents think the Government has handled Brexit badly yet 62% say Labour is not ready to govern. At least, maybe, there will soon be a cure for Brexit fatigue.

Key insights this week: Capital – the good, the bad and the unknown

For banking, the biggest announcement of the year is now behind it: the RBNZ's new bank capital requirements have been decided and made public. There was some easing from the initial proposal, but the timing of some changes for the large banks means the ramp-up of capital kicks in quite quickly for them.

First the good

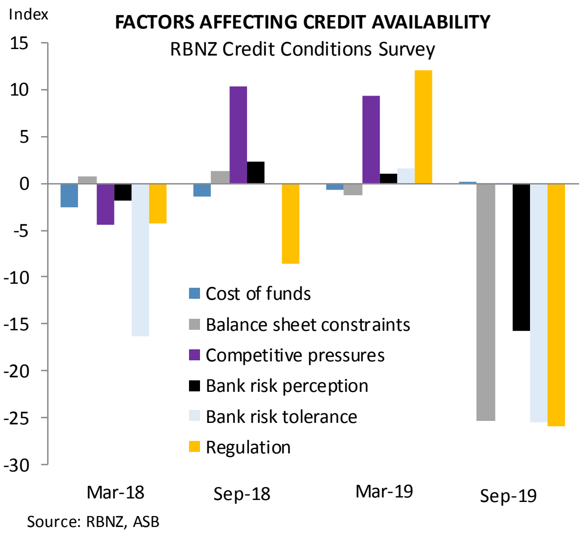
The RBNZ has taken on board some of the feedback received about the short implementation timeframe and narrowness of the type of capital. The initially-proposed transition period of 5 years has been lengthened slightly to 7 years. Small banks will now only need a total capital ratio of 16%, down from the 17% in the original proposal and more noticeably lower than the 18% requirement for the big-4 Domestic Systemically Important Banks (who will therefore hold a 2% "buffer" above the small banks). This change reduces the stringency of the capital impost on small banks, who face various challenges in raising capital through their small scale, low returns, and (in some cases) ownership structure constraints.

The allowed form of Tier 1 capital (i.e. higher quality capital) has been relaxed slightly to allow redeemable preference shares (in addition to common equity), and up to 2.5% of Tier 1 requirements can be met through these securities rather than (more expensive) common equity. On paper at least, these changes give banks an additional source of capital and a cheaper one at that. And, for the small banks with limited options for raising capital through retained earnings or common equity injections (the latter a challenge for some ownership structures), this change could be a lifeline.

However, from a practical point of view, institutional investor appetites for this additional form of capital may be weak, leaving heavy reliance on (more expensive) common equity capital. The appeal of redeemable preference shares may be largely confined to domestic retail investors seeking higher returns than term deposits. Appetite from issuers to issue these securities is another consideration. There is the risk of retail investors not fully understanding what they are buying, which issuers will be wary of in a regulatory backdrop focusing on providing 'good outcomes for customers'. The RBNZ ruled out some pre-existing forms of more 'exotic' bank capital for, in part, this reason.

Now the bad

There are some technical changes 'under the hood' for the 4 large banks that use internal models to calculate their risk-weighted assets, the denominator for calculating capital ratios. These changes are as originally proposed by the RBNZ. But the kicker is they need to be in place within the first year of the 7-year transition. The amount of capital these changes are equivalent to is effectively like raising the RBNZ capital ratios by a further 1% over and above the headline ratio. And the 2% buffer between the 4 large banks and the small banks needs to be in place by July 2021, the start of the second year of the transition.



For large banks, therefore, there are some relatively steep changes coming in short order. A concern we expressed with the RBNZ's original 5-year implementation frame was that a relatively swift lift in capital requirements risks creating a tightening of credit conditions. The front-loading of changes means that risk is very high, despite the new 7-year timeframe. And it is the banks that provide the vast majority of lending for commercial purposes that will be impacted.

As we pointed out in our Financial Stability Review note as well as Friday's capital requirements note, the RBNZ's Credit Conditions Survey is already showing a tightening of credit availability for loan types that will be most affected by the RBNZ's capital changes. The RBNZ's assumption that credit growth over the 7-year transition period will only reduce by 0.02 percentage points (5.08%, from 5.10%) looks a shade optimistic.

That leaves the uncertain

Any work trying to estimate costs and benefits of regulatory changes like this have error bands around them – economics does not have the precision of physics. Here is a list of unknowns, which will never be precisely known – though our understanding of some may improve over time:

- How big is the economic cost of a financial crisis? The RBNZ estimates the net present value of a crisis at 63% of GDP. Some of the external experts the RBNZ employed suggested it could be higher. Other academics, comparing outcomes for financial crisis-affected countries vs. non-crisis countries note the difference in outcomes is very small – so the direct cost of a crisis may not be large. For example, NZ's GDP fell by a similar amount to US GDP during the Global Financial Crisis, yet NZ had no banking sector meltdown (finance companies accounted for only a small part of NZ lending).

- How much will the added capital holdings reduce the probability of a crisis occurring? There is inherent imprecision in the RBNZ's estimate of the chance of a crisis under the current capital holdings. And the future chance of a crisis assumes the RBNZ is correct in estimating its new capital levels reduce the chance of a crisis to 0.5% (i.e. 1 in 200).

- How big is the interest rate impact on customers? The RBNZ assumes 20.5 basis points. Our estimates suggest 30 to 80 basis points, but with 50-80bp the more conceivable range. The RBNZ assumes capital will in effect be readily available at a lower cost than it is currently. Yet, with NZ's capital regime being stricter than Australia's (and others), NZ will still need to offer a decent return relative to the other alternative uses to ensure NZ attracts enough capital going forward to support credit growth.

The RBNZ estimates the net long-term benefits from its new regulations are a 0.43% benefit of annual GDP. Our adjustments to the RBNZ's estimate, varying only the interest rate impact, show a range from a net benefit of 0.25% of GDP through to a net cost of 0.75% of annual GDP. Even just the one assumption around the interest rate impact can swing the impact of the added insurance NZ will have from a net benefit to a net cost.

This last point on net benefits is effectively moot now. But over the next 200 years we'll figure out some more refined answers!

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6557	0.6446	0.6365	0.6886	UP	0.6445	0.6720	UP
NZD/AUD	0.9598	0.9509	0.9245	0.9514	UP	0.9500	0.9715	FLAT
NZD/JPY	71.22	70.71	69.51	77.67	FLAT	70.00	72.95	FLAT
NZD/EUR	0.5930	0.5850	0.5758	0.6051	FLAT/UP	0.5830	0.6050	UP
NZD/GBP	0.4991	0.4992	0.4966	0.5390	DOWN	0.4870	0.5060	UP
TWI	72.7	71.5	70.1	75.01	FLAT/UP	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 was the strongest performing G10 currency last week, by some margin. NZD/USD soared over 2%.

We've been cautioning against the upside risks facing the NZD for some time. Last week the stars aligned. Broad-based USD weakness, the (admittedly vague) promise of large NZ infrastructure projects, and the RBNZ's slight watering down of its bank capital proposals all combined to propel NZD/USD through 0.6450 resistance to finish the week around 0.6570. NZD/AUD touched 0.9600.

Near-term outlook

Having firmly broken near-term resistance, **we think further gains are in store for the NZD**. First, NZ economic data have taken a turn for the better, reflected in less negative NZ-US interest rate differentials. NZ-US 2-year swap spreads have lifted from -75bps in October to -38bps currently.

Second, the Terms of Trade are conferring fundamental support. NZ commodity export prices are on a tear, and we expect a fresh record high for the Terms of Trade in coming quarters. Finally, the global backdrop has stabilised and investors are rediscovering their risk appetite – a positive development for 'risk-sensitive' currencies like the NZD.

According to our short-term valuation model, fundamental 'fair-value' is seen in a 0.6750-0.7150 range.

In terms of event risk this week, we have the US Federal Reserve meeting (interest rates likely on hold), ECB policy meeting (maintain open-ended easing stance), NZ fiscal update (here comes the spending) and UK General Election (Conservatives primed to win a majority) to watch for this week, set against the usual daily ups and downs of US-China trade war sentiment.

Medium-term outlook

Our Group medium-term forecasts have the NZD/USD drifting lower for the next few months, to a low of 0.6200 in March 2020. This slow and low forecast profile reflects the drag from the NZ growth slowdown and associated RBNZ interest rate cuts, and the subdued global backdrop. From late 2020, we expect the currency to begin trending higher again as fiscal and monetary stimulus eventually drives a recovery in the NZ economy.

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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	0.71	0.72
NZD/AUD	0.96	0.93	0.94	0.94	0.94	0.94	0.94
NZD/JPY	72	68	66	64	70	72	72
NZD/EUR	0.59	0.57	0.57	0.57	0.59	0.61	0.62
NZD/GBP	0.53	0.51	0.49	0.46	0.51	0.53	0.54
NZD TWI	73.2	70.2	69.1	67.9	71.5	74.3	75.0

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	1.20	1.22	1.15	1.99	UNCH/DOWN	UP
2-year swap	1.25	1.18	1.06	2.06	UNCH/DOWN	UP
5-year swap	1.37	1.26	1.19	2.36	UNCH	UP
10-year swap	1.66	1.55	1.54	2.79	UNCH	UP
10-year govt bond yield	1.53	1.36	1.38	1.92	UNCH	UP
Curve Slope (2s10s swaps)	0.42	0.37	0.48	0.73	UP	UNCH/UP

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

Market Recap

NZ swap yields start the week 5-15bps higher than a week ago, with modest changes in US and Australian counterparts. The catalyst for higher NZ yields was the December 5 RBNZ announcement on final bank capital requirements**.** Tier 1 capital requirements for the systemically-important NZ banks will still be raised to 16%, but markets viewed the RBNZ decision to lengthen the transition period to 7 years (from 5) and to allow a more relaxed definition of Tier 1 capital as a signal the new criteria will be less stringent than earlier proposed. The view of Governor Orr is that the RBNZ was in an "on-hold phase on monetary policy", with RBNZ Deputy Governor Bascand viewing the economy to be near a turning point. Australian yields firmed after the RBA held the cash rate at 0.75% and maintained a modest easing bias. We view the Australasian outlook as requiring more interest rate support and now expect 50bps (rather than 25bps) of RBA rate cuts over 2020. US Treasury yields ended the week a touch higher (10Y 1.84%) following the strong US payrolls report (266k versus 180k expected).

Near-term NZD interest rate outlook

NZ swap yields across the curve are currently 30-55bps above October lows, and odds of 2020 OCR cuts have been pared back significantly, with just 10bps of OCR cuts priced in over the next 12 months. **We have retained a modest downward bias for NZ yields given our OCR view of one more 25bp cut in 2020 (May), but note the risk that NZ yields further along the curve may already have bottomed.** The major local event this week is Wednesday's Half Year Fiscal Update, which should show a healthy set of Government accounts and likely provide some hints around the Government's spending and investment plans for Budget 2020. Tomorrow's speech by Governor Lowe may provide more clarity on the RBA's view on the economy and whether the 35bp on cuts priced in for 2020 is justified. **The direction of longer-term yields will largely depend on global trade headlines and actions of global central banks**. The US Federal Open Market Committee (FOMC) is widely expected to hold the 1.50-1.75% Federal Funds rate, and yields may tick up if FOMC Chair Powell delivers a positive economic assessment. The ECB is expected to make no policy changes and maintain its open-ended accommodative easing stance. The UK General Election (viewed as referendum on Brexit) on December 12 is unlikely to significantly influence NZ yields, but a clear result could be positive for global yields by alleviating a source of global uncertainty.

Medium-term outlook

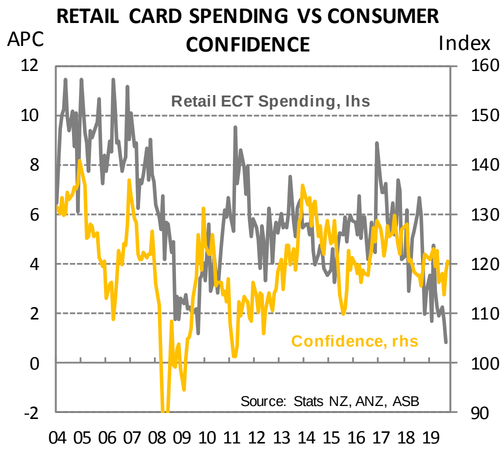
We expect a further 25bp cut in May 2020, with the OCR on hold at 0.75% until a series of mild and gradual hikes from 2022 (OCR endpoint of 2.25%). The RBA is expected to cut the 0.75% cash rate by 50bps in 2020 (Feb, Aug), with the RBA cash rate at the 0.25% effective lower bound. The 1.50%-1.75% Federal Funds rate is expected to be cut by 75bps in 2020 (Mar 20, Jun 20, Sep 20). **Low inflation, low global growth and a negatively skewed risk profile should cap NZ and global long-term interest rates at historically-low levels.** mark.smith4@asb.co.nz

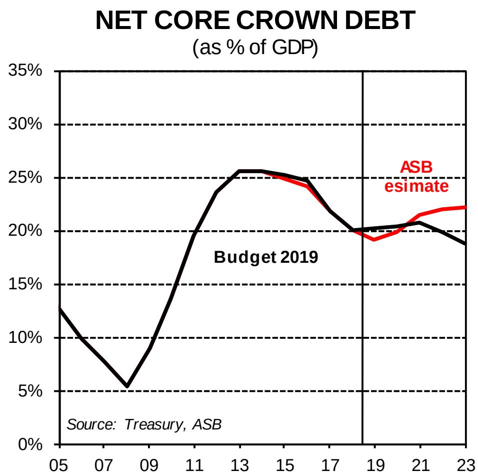
ASB interest rate forecasts	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>				
NZ OCR	1.50	1.00	1.00	1.00	0.75	1.00	1.50
NZ 90-day bank bill	1.7	1.2	1.2	1.2	1.0	1.3	1.8
NZ 2-year swap rate	1.4	0.9	1.2	1.1	1.0	1.3	1.7
NZ 5-year swap rate	1.4	0.9	1.2	1.2	1.2	1.5	1.9
NZ 10-year swap rate	1.8	1.2	1.5	1.4	1.4	1.6	2.0
NZ 10-year Bond	1.6	1.1	1.3	1.2	1.2	1.4	1.8

Domestic events

Data	Date	Time (NZT)	Market	ASB
Electronic Card Transactions, Retail, Nov, %mom	11/12	10:45am	-	1.0
Half-year Eco & Fiscal Update, OBEGAL 2019/20, % of GDP	11/12	3:00pm	-	0.3

Electronic card spending fell back in October following a number of solid months. **We expect the October dip to be temporary, with a rebound in durable, apparel and consumable retail to drive a circa 1.0% monthly increase in retail card spending**. The strengthening housing market and rebounding consumer confidence are two key underlying supports. While currently low annual growth in retail card spending should pick up over the next few months, we do not expect the very strong Q3 increases in retail sector volumes to be repeated in Q4.





We expect the Half-Year Economic and Fiscal Update to show a healthy set of Government accounts, but at the same time to give some hints around the Government's spending and investment plans for Budget 2020. The 2018/19 end of year accounts produced a pleasant surprise for the Government, with the operating surplus (OBEGAL) rising to $7.5bn and net debt dipping further to 19.2% of GDP. This surprise has given the Government a sizeable fiscal war chest heading into an election year. In addition to the fiscal war chest, recall that the Government announced earlier in the year that it will no longer target net debt below 20% of GDP and will operate a net debt range of between 15% to 25% of GDP. With this in mind, the Government has already announced that it will bring forward major investments in New Zealand's infrastructure, which will be detailed in the Budget Policy Statement (included as part of the Half-Year Update). Translating this into numbers, we expect to see more modest operating balances, along with a higher debt profile. In particular, we anticipate that the Government will signal that net debt will run above 20% over the forecast period. In turn, these forecasts also mean that the Government's bond programme is likely to be higher than Budget 2019 levels, and some of this extra debt may be front-loaded into the DMO borrowing programme. For our part, we broadly agree with the Government's move to boost fiscal spending. However, we see risks that the Treasury's economic growth forecasts may be on the optimistic side and thus overstate the size of the fiscal war chest available for spending and/or investment.

Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
China CPI, %yoy	10/12	2.30 pm	4.4	4.0
UK GDP, October, %mom	10/12	10:30 pm	0.1	-
RBA Governor Lowe speech	10/12	11:05 am	-	-
Australia Consumer Sentiment	11/12	12:30 pm	-	-
US CPI, November, %yoy	12/12	2:30 am	2.0	1.8
US Fed Interest Rate Announcement, %	12/12	8:00 am	No change	No change
ECB Interest Rate Announcement, %	13/12	1:45 am	No change	No change

**Originally published by CBA Global Markets Research on Friday 6th December at 2.14pm*

We expect **China's consumer inflation** to accelerate to 4% yoy in November on base effects and elevated pork prices. PPI deflation should stay around at 1.5% yoy because the producer price PMI was in contractionary territory over November.

An improvement in the **UK's** composite PMI to 50 suggests GDP expanded slightly in October. But the decrease in the volume of UK October retail sales points to a downside risk to the **GDP** print.

Reserve Bank of Australia Governor Philip Lowe is due to speak at the AusPayNet Summit, Sydney. Given the audience, the speech may focus on the payments system. Asst. Governor Bullock is part of a panel at the same event.

Australian consumer sentiment was soft over H2 2019. This month's survey was taken over the first week of December. The release of a weak GDP reading and discussion of unconventional monetary policy options may have dampened sentiment. However a lift in the Australian dollar (which is viewed by some households as a barometer of economic strength) may provide some offset.

US headline CPI inflation was likely unchanged at 1.8% yoy in November, following a slight fall in retail petrol prices. We expect core CPI inflation to remain higher at 2.3% yoy, reflecting the strong US labour market.

We expect the US Federal Reserve to leave the Fed Funds rate unchanged. The central bank is confident that current policy settings are at an appropriate level to lift US inflation back towards target. We doubt there has been any material reassessment of this view since the October meeting. Downside economic risks have eased somewhat and the labour market remains strong. However, inflation remains subdued.

The European Central Bank (ECB) is widely expected to make no monetary policy changes and maintain its open-ended accommodative easing stance. The ECB could announce the launch of a comprehensive review of its monetary policy strategy at this meeting. The ECB review is expected to be wide-ranging – from the definition of price stability to the tools used to achieve the price stability objective.

ASB

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	0.7	0.3				
GDP real - A%	2.1	2.5	2.2	2.0	2.6	2.5	2.5
GDP real - AA%	2.4	2.4	2.3	2.2	2.2	2.6	2.5
CPI - Q%	0.6	0.7	0.4	0.5			
CPI - A%	1.7	1.5	1.7	2.2	1.7	1.7	1.7
HLFS employment growth - Q%	0.7	0.2	0.3	0.3			
HLFS employment growth - A%	1.4	0.8	1.2	1.5	1.5	1.5	1.6
Unemployment rate - %sa	3.9	4.2	4.1	4.2	4.3	4.1	3.9
Annual current account balance as % of GDP	-3.4	-3.4	-3.3	-3.1	-2.7	-2.8	-2.7

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

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(end of quarter)		<< actual	forecast >>				
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NZD/USD	0.67	0.63	0.63	0.62	0.67	0.71	0.72
NZD/AUD	0.96	0.93	0.94	0.94	0.94	0.94	0.94
NZD/JPY	72	68	66	64	70	72	72
NZD/EUR	0.59	0.57	0.57	0.57	0.59	0.61	0.62
NZD/GBP	0.53	0.51	0.49	0.46	0.51	0.53	0.54
NZD TWI	73.2	70.2	69.1	67.9	71.5	74.3	75.0

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