Economic Weekly

12 August 2019

Shock and Orr

The Reserve Bank of New Zealand (RBNZ) Monetary Policy Committee (MPC) has proved to be a decisive decision-making group, delivering a surprisingly aggressive 50 basis point Official Cash Rate cut at last week's Monetary Policy Statement, vs the 25 basis point cut that was widely expected. The RBNZ's economic projections saw the need for at least 50 basis points of stimulus, and the MPC concluded there was little to gain from delivering this stimulus in a gradual fashion. See our full review here or read more on Page 2.

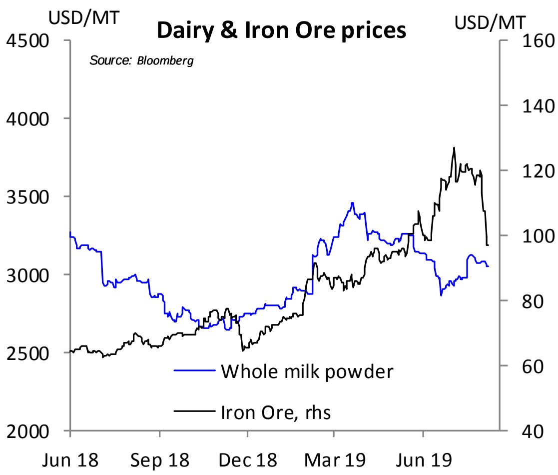
Key events and views

Key Insights	Reflections on last week's 50bp OCR cut by the RBNZ.
Foreign exchange	Last week's 'front-loading' of monetary easing also 'front-loaded' the currency reaction.
Interest rates	NZ yields fell to record lows after the RBNZ front-footed the policy easing last week.
Domestic events	No major domestic data released this week.
International events	Australia Wage Price Index, US CPI, UK and US Retail Sales.

Chart of the Week: Finding shelter in the trade storm

The past week's trade war escalation may have played a part in swaying the RBNZ into a larger OCR cut. While a full-blown trade war between the US would certainly hurt global economic growth and impact NZ economic prospects, the case is not so clear cut for NZ food exports.

In fact, **NZ food export prices may actually rise** on the back of the trade war escalation. With US food imports "unavailable", Chinese buyers will seek alternative supply, including from NZ. NZ dairy and beef commodity prices stand to gain the most from the halt on US purchases by Chinese buyers. The US is the third-leading dairy exporter to China, after the NZ and EU (in that order). See more in last week's Commodities Weekly.



One thing that could unhinge our view is a material weakening in the Chinese yuan and subsequent loss of Chinese consumers' purchasing power. **For NZ exporters, the key is the strength of the NZ dollar relative to the Chinese yuan**. On this front over recent months, the NZD/CNY has traded within a relatively tight range, so this risk has yet to materialise. But this is a risk worth keeping one eye on.

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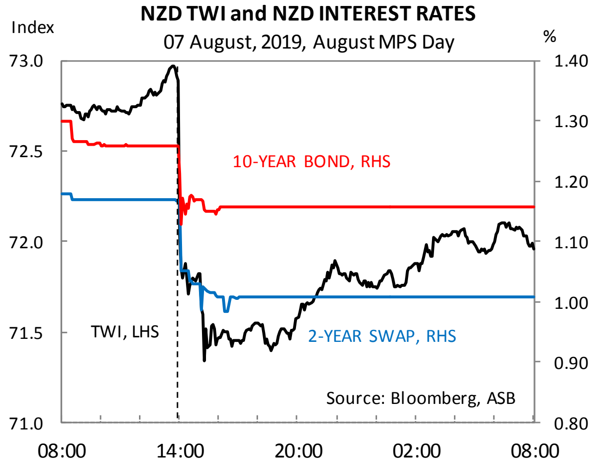
Key insights this week: Reflections on the RBNZ rate cut

- OCR cut by 50bp to record low 1% as RBNZ moves ahead of the curve. We see another (25bp) cut in November, but the risks remain tilted to an even lower outcome.
- Cutting interest rates more aggressively sooner could reduce the probability of subsequent rate cuts, but RBNZ keeps its option open and floats the possibility that unconventional policy measures could be needed.
- Monetary policy needs mates. More of the heavy lifting needs to be done by fiscal policy, with targeted government support likely to provide more timely cyclical support to the economy. More infrastructure spending will impact economy-wide capacity, but should have a medium-term focus.

A Pre-emptive monetary policy strike

The RBNZ delivered a pre-emptive strike, surprising the market with a 50bp cut to the OCR. The published OCR track signalled an easing bias remained, with the OCR bottoming at 0.91% in late 2020/early 2021. Financial markets were stunned, with NZ wholesale interest rates down sharply, led by larger falls for shorter-term rates. The NZD/USD fell by 1½ cents and was briefly below 64 US cents, before subsequently firming.



The rationale for front-loading of monetary stimulus was "simply more of a strategic discussion around regret analysis" according to Governor Orr. The Monetary Policy Committee (MPC) was willing cut the OCR aggressively now and run the risk of over-stimulating the economy rather than drip-feeding rate cuts and not providing sufficient policy support when needed. Governor Orr did not identify any specific analysis, but the MPC members were likely troubled by the swift deterioration of the global outlook and rate cuts by central banks overseas.

Such a move is not without risk. The inflation genie is firmly ensconced within the bottle, and we don't expect a marked pick-up anytime soon. However, there is the risk that the magnitude of the RBNZ cut could spook households and firms and see them (further) retreat into their shells. The RBNZ were likely cognisant of this possibility, with the record of meeting underscored the importance of additional spending from households, businesses, and the government, to meet the RBNZ's inflation and employment targets. We will be closely monitoring future readings for consumer and business sentiment for signs of an OCR impact.

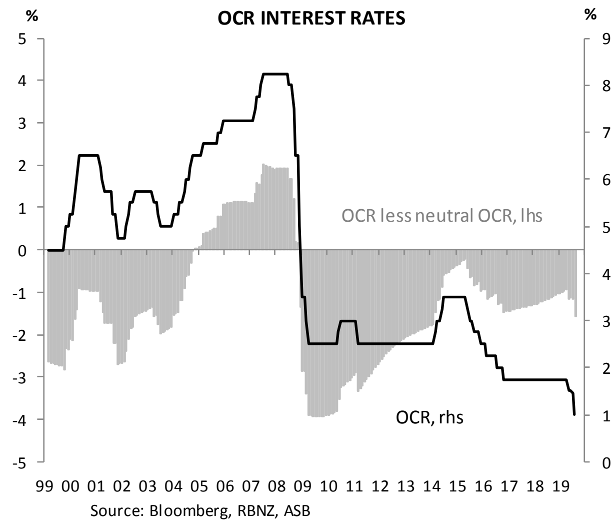
Monetary Policy is entering new territory

While Governor Orr maintained that monetary policy had not lost its mojo and was still effective, he still warned "it's easily within the realms of possibility that we might have to use negative interest rates." Governor Orr also confirmed that the RBNZ was preparing for this eventuality by looking at its broader policy toolkit and working with external experts. The OCR could potentially move below 0% (-0.75% is thought to be the effective lower bound) and there is scope for the RBNZ to adopt unconventional monetary policies, but they may be of limited impact and carry risks. The experience on Quantitative easing (QE) overseas has been mixed, with asset prices the primary beneficiary. **The RBNZ is not alone on this front and it is encouraging that it is tapping into international expertise when looking at** unconventional policy measures.

And will need mates

Monetary policy has its limits. **More of the heavy lifting needs to be done by fiscal policy**. Our public finances are in strong position. Courtesy of our historically-high Terms of Trade the Government continues to run budget surpluses and net public debt is low. The signalled relaxation of the fiscal straightjacket (adoption of a 15-25% net public debt target) after the election signals the willingness to leverage off the Government's balance sheet, which will benefit future generations provided this is used to fund productive investment. There is clear need to address New Zealand's infrastructure deficit and help address capacity bottlenecks within the economy. With circa 1.1% 10-year NZ

Government bond yields it has never been cheaper for the Government to borrow.



Timing is everything and there may be the need to front-load fiscal easing if sentiment weakens further. How should it be done – tax cuts/transfers or higher government spending and more spending on infrastructure? For more immediate impact, we believe **targeted government support to cohorts with higher spending propensities will provide a swifter bang for your buck.** An increase in benefit payments or tax cuts tilted towards lower income earners (a lift in lower tax thresholds) would likely further increase the potency of the Government's Families Package. More infrastructure spending has the potential to deliver significant benefits, by raising the productive potential of the economy. However, the lags involved are large and providing additional support to the construction sector (which already looks to be firing on all cylinders) may not be as effective as intended.

We still see downside risks to the RBNZ OCR outlook

We expect a 25bps cut to the OCR in November and for the OCR to remain at record low, until a modest tightening cycle starts from 2022.

Even at 0.75% risks to our OCR outlook remain to the downside:

- **The global scene is troubling.**
- **NZ remains exposed to global shocks.** We will be closely watching local consumer and business sentiment measures for tell-tale signs. The tourism golden goose may be cooked, with visitor arrivals to NZ from Asia having taken a dive.
- **Much will depend on what the NZD does.** A lower NZD lessens the onus on the OCR, but with other central banks also on the rate cut bandwagon, a lower NZD is not assured. **Currencies are a relative game, and NZ still looks in better shape than most.**
- **There is also a structural (enduring) element to low inflation.** We expect inflation outturns to undershoot the RBNZ's projections.
- Our work suggests that the economy is still close to its maximum sustainable level of employment (MSE). **We see the risks as being tilted towards more spare capacity emerging in the labour market, which will likely have a bearing on how low the OCR does in fact go.**
- **OCR settings are not as expansionary as the central RBNZ view.** The MPC reaffirmed our view that the neutral OCR had been on a downward trend, although the confidence intervals were wide and the RBNZ's central estimate (3.22%) was higher than our current estimates (around 2.5%-2.75%). As the chart above shows, e**ffective monetary stimulus via the OCR has been higher in past episodes (e.g. following the global financial crisis) than it is now.**
- Of note, the policy deliberations of the MPC nor the economic projections do not look to have factored in the **impact of the RBNZ's proposed higher bank capital requirements**, which is understandable given that the proposals are still at the consultation stage. If these capital requirements are imposed, our work suggests they look set to add at least 50bps to customer interest rates, with the OCR needing to be lower by a similar margin to compensate.

We note that the depth and length of the trough in the OCR remains conditional on a whole lot of factors. These include the global and domestic outlook, the extent of persistence of recent low inflation outturns, the actions of global central banks, and the NZD. **The swiftness and magnitude with which the local and global interest rate backdrop and outlook has changed are important food for thought. We are doing work on investigating how low the OCR will likely go and the efficacy of the various non-conventional policy options available. Watch this space.**

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6529	0.6628	0.6677	0.6731	FLAT/DOWN	0.6390	0.6580	UP
NZD/AUD	0.9610	0.9597	0.9503	0.9130	FLAT/DOWN	0.9500	0.9680	UP
NZD/JPY	69.58	71.96	72.02	75.17	DOWN	67.50	70.00	UP
NZD/EUR	0.5877	0.5956	0.5918	0.5806	FLAT	0.5700	0.5825	UP
NZD/GBP	0.5372	0.5359	0.5306	0.5170	FLAT	0.5280	0.5510	UP
TWI	72.5	72.9	72.9	72.72	FLAT/DOWN	N/A	N/A	UP

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

NZD Recap

The NZD underperformed last week. The RBNZ's surprise 50bps cut saw NZD/USD briefly collapse to three-year lows below 0.6400.The currency has since recovered around half its RBNZ-losses on the global trade-war cease fire and cross-related demand. But NZD/JPY remains at 7-year lows around 68.20 and, on a trade-weighted basis, the NZD sits around 72.00 – the lowest in a year. Folk can argue about whether a 50bp cut from the RBNZ was appropriate. But the element of surprise certainly provided some good bang for its buck in terms of easing financial conditions. A simple MCI confirms conditions are the easiest in around four years.

Near-term outlook

We suspect that last week's 'front-loading' of monetary easing by the RBNZ has also 'front-loaded' the currency reaction. The NZD/USD looks to have moved into a new, lower 0.6400-0.6600 trading range. The risk that the RBNZ cuts again in September, which looks under-priced by markets to us at just 25%, should limit the topside. Meanwhile, the fact that OIS markets already price a terminal cash rate of 0.65% means it will take a decent deterioration in the global outlook for the NZD/USD to make fresh lows below last week's 0.6380.

For this week, some consolidation is likely in order. This is particularly the case given the relatively quiet week in prospect in terms of local/offshore data. The risk of further escalation in US-China is probably the key event risk for the kiwi over the week. Aussie employment on Thursday and the Chinese data-dump on Friday will be the most market-moving pieces of data to watch from a NZD perspective.

Medium-term outlook

We expect the NZD to track in a broadly sideways range over the next few months. Most G10 central banks maintain easing biases. With global monetary policy relatively synchronous, relative interest rate expectations won't be a particularly strong driver of currency markets. We expect the RBNZ, RBA and US Fed to all continue cutting policy interest rates over the coming months.

Further ahead, we expect the NZD to strengthen against most currencies from late 2019 onwards. Ongoing strength in NZ's Terms of Trade will be an important source of support for the NZD. We expect NZD/AUD to remain close to 0.95 over 2019 and to subsequently firm.

ASB foreign exchange forecasts	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>				
NZD/USD	0.68	0.67	0.64	0.68	0.69	0.72	0.73
NZD/AUD	0.96	0.96	0.94	0.94	0.95	0.96	0.97
NZD/JPY	75	72	71	74	75	78	79
NZD/EUR	0.60	0.59	0.57	0.58	0.58	0.59	0.59
NZD/GBP	0.52	0.53	0.50	0.53	0.53	0.55	0.56
NZD TWI	73.9	73.2	70.2	72.7	73.1	75.1	75.8

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	1.00	1.50	1.50	1.75	UNCH/DOWN	UP
90-day bank bill	1.21	1.45	1.59	1.91	UNCH/DOWN	UP
2-year swap	1.00	1.18	1.36	1.99	UNCH/DOWN	UP
5-year swap	1.02	1.19	1.47	2.34	UNCH/DOWN	UP
10-year swap	1.28	1.49	1.85	2.87	UNCH/DOWN	UP
10-year govt bond yield	1.08	1.31	1.62	2.59	UNCH/DOWN	UP
Curve Slope (2s10s swaps)	0.28	0.31	0.50	0.88	UNCH/UP	UNCH/UP

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

Market Recap

NZ yields fell to record lows after the RBNZ surprised markets and front-footed the policy easing, by cutting the OCR by 50bps to a record low of 1.00%. The intent of the RBNZ front-loading OCR cuts was to reduce the likelihood of more aggressive cuts later. However, NZ yields fell further after Governor Orr warned that “it's easily within the realms of possibility that we might have to use negative interest rates.” **Global yields fell last week with curves flattening on elevated trade tensions.** The Chinese yuan fell to a 2008 low against the USD, with the US Treasury department officially labelling China a currency manipulator for the first time since 1994. This, and low US inflation, saw US Treasury 10-year yields fall to 3-year lows (1.70%), with European yields generally lower. The RBA held the cash rate at a record low 1%, but the tone of the Statement of Monetary Policy was dovish, with downward tweaks to the forecasts, with Governor Lowe saying the cash rate could go to the zero lower bound and that the cash rate would have to get very close to zero before the RBA would employ quantitative easing (QE).

Near-term NZD interest rate outlook

NZ interest rates are significantly lower than where they were a week or so ago and downside risk to the NZ interest rate outlook has been reduced, **but we have maintained our lower bias.** With a light local events calendar, Australian labour market data will be looked for cues on whether market pricing will shift from the 25bp RBA cut close to fully priced in by October. We remain wary of the global scene and will be closely monitoring events. Subdued Chinese inflation readings suggested it is only a matter time before the People's Bank of China conduct more monetary easing, and Wednesday's Chinese retail sales and industrial production data will be looked at for signs of weakness. **Signs of weakness in global growth and the further crystallisation in global downside risks –** including Chinese retaliation on trade, worsening news from Brexit **– could likely push global yields lower and flatten curves.**

Medium-term outlook

Our bias is for the curve to initially steepen and then to flatten as policy easing this year precedes mild policy tightening, although the risk is that longer-term yields rally further (i.e. fall) if downside global risks crystallise. **We expect a follow-up 25bp OCR cut in November and 0.75% OCR trough this cycle, with downside risks.** Gradual OCR tightening is expected from early 2022, with an OCR endpoint of just 2.25% by late 2024. We also expect 25bp of cuts by the RBA (November), a further 75bp of cuts by the Fed (September, December and March 2020), and policy easing by the ECB and People's Bank of China over the next few months. Inflation looks set to remain low and interest rate normalisation from global central banks a long way off, capping long-term interest rates at historically-low levels.

ASB interest rate forecasts	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>					
NZ OCR	1.75	1.50	1.00	0.75	0.75	0.75	1.00	1.50
NZ 90-day bank bill	1.9	1.7	1.2	1.0	1.0	1.0	1.2	1.7
NZ 2-year swap rate	1.6	1.4	1.0	0.9	0.9	0.9	1.2	1.7
NZ 5-year swap rate	1.8	1.4	1.0	1.0	1.0	1.0	1.4	1.9
NZ 10-year swap rate	2.2	1.8	1.3	1.3	1.3	1.3	1.7	2.1
NZ 10-year Bond	1.8	1.6	1.1	1.1	1.1	1.1	1.5	2.0

Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
RBA Asst. Gov. Kent speech at Sydney Conference	13/08	10:00 am	-	-
UK ILO Unemployment Rate, June, %	13/08	8:30 pm	3.8	-
US CPI, July, %yoy	14/08	12:30 am	1.7	1.7
Australia Wage Price Index, Q2, %qoq	14/08	1:30 pm	0.5	0.5
RBA Dep. Gov. Debelle speech on Sydney Panel	14/08	7:30 pm	-	-
Eurozone GDP 2nd Estimate, Q2, %qoq	14/08	9:00 pm	0.2	0.2
UK CPI, July, %yoy	14/08	8:30 pm	1.9	-
Australia Employment, July, 000s	15/08	1:30 pm	14	20
UK Retail Sales, July, %mom	15/08	8:30 pm	-0.2	-
US Retail Sales, July, %mom	16/08	12:30 am	0.3	0.2

**Originally published by CBA Global Markets Research on Friday 9th August at 2.27pm*

The Reserve Bank of Australia's (RBA) Assistant Governor Christopher Kent will deliver a speech at the Finance and Treasury Association in Sydney. He will provide an update on financial markets following the release of the central bank's quarterly Statement on Monetary Policy (SMP) last week.

UK labour market conditions remain tight. The UK unemployment rate has been stuck at more than a 43-year low of 3.8% since March 2019. The Bank of England (BoE) projects the unemployment rate to fall slightly to 3.7% in Q3, consistent with surveys of employment intentions.

We expect **US CPI** lifted 0.2%mom to 1.7% in July, supported by a modest lift in retail gasoline prices over the month. We expect core CPI to increase 0.2%mom because wage costs accelerated slightly to 3.2%yoy.

Australian wage growth is still very low, held back by spare capacity in the labour market. Offshore factors and technological change are also key reasons. We expect a 0.5% lift in wages growth for the quarter, taking the annual rate to 2.2%.

RBA Deputy Governor Debelle will give a speech titled "*Risks to the Outlook"* at a conference in Sydney. This follows the release of the quarterly SMP on 9th August. We would expect the speech to be a detailed summary of the risks, both negative and positive outlined in the SMP.

In the **Eurozone**, the second **GDP** estimate will likely confirm the economy increased at a quarterly pace of 0.2%. The unemployment rate fell to an eleven-year low of 7.5% in June, suggesting **employment** growth picked up again in Q2.

Headline **UK CPI inflation** has been close to the Monetary Policy Committee's (MPC) 2% target throughout 2019. The BoE projects headline CPI inflation to slow to below 2% over the near term, reflecting lower energy prices. The central bank also expects core inflation (excluding the effects of energy, food, alcohol and tobacco) to be close to 1.8% over much of 2019 H2.

Leading indicators suggest **a reasonable level of jobs growth in Australia should continue**. We expect a 20k lift in the number of jobs for July. We believe the unemployment rate should remain steady at 5.2%.

Weak consumer confidence and housing market conditions point to a decline in core **UK retail sales** volumes in July. Still, positive real wage growth and favourable employment growth will continue to underpin consumer spending over the medium term.

We expect headline **US retail sales** to increase 0.2%mom because retail gasoline prices rose slightly in July. We expect the control group (used for estimating consumer spending) to increase by another solid 0.4%mom. The strong labour market, rising wages and falling mortgage interest rates are underpinning retail sales.

Key Forecasts

ASB NZ economic forecasts	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
	<< actual	forecast >>					
GDP real - Q%	0.6	0.7	0.6				
GDP real - A%	2.5	2.3	2.5	2.7	2.8	2.8	2.3
GDP real - AA%	2.7	2.5	2.5	2.5	2.6	2.8	2.5
CPI - Q%	0.1	0.6	0.6	0.2			
CPI - A%	1.5	1.7	1.4	1.5	1.8	1.7	1.9
HLFS employment growth - Q%	-0.1	0.8	0.2				
HLFS employment growth - A%	1.5	1.7	0.9	1.3	1.9	1.7	1.4
Unemployment rate - %sa	4.2	3.9	4.1	4.1	4.3	4.2	4.0
Annual current account balance as % of GDP	-3.6	-3.2	-3.3	-3.5	-3.5	-3.6	-3.6

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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NZD/GBP	0.52	0.53	0.50	0.53	0.53	0.55	0.56
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