ANZ Research

RBNZ OCR Call Change

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Contact

Sharon Zollner
Chief Economist
Telephone: +64 9 357 4094
Sharon.Zollner@anz.com

Pedal to the metal

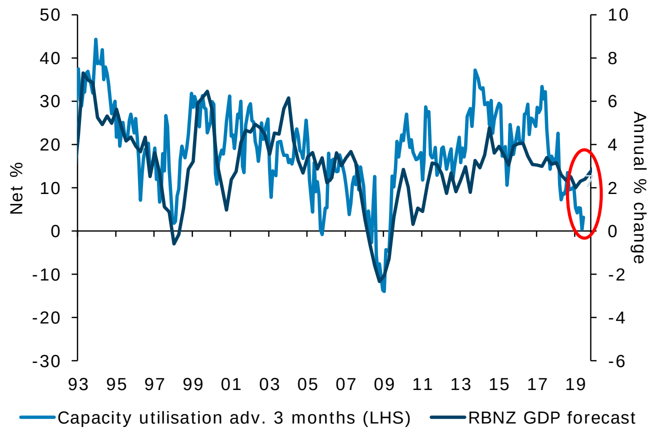
- The growth and inflation outlook continues to deteriorate. We now expect 25bp OCR cuts in November, February and May, taking the OCR to 0.25%.
- We would not rule out another cut as soon as September, but it is not our central view.
- The forecast 25bp May cut is a placeholder for the impact of the RBNZ's bank capital proposals, the details of which are as yet unknown.

Global and domestic economic signals continue to deteriorate. There are seven reasons why we think the RBNZ will conclude that it's pedal to the metal time.

1. Near-term domestic growth indicators are deteriorating

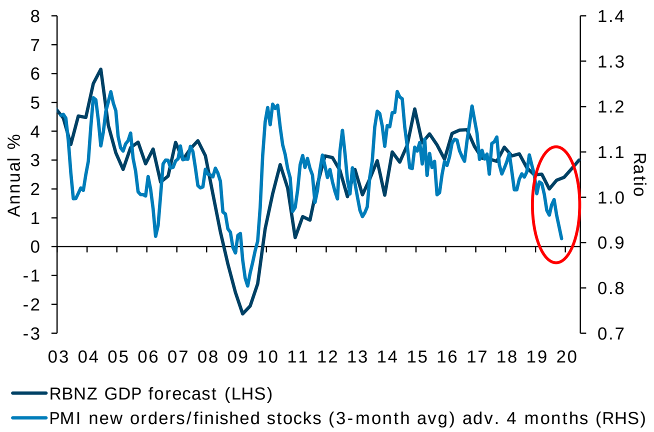
Near-term activity indicators out of both our own Business Outlook survey (figure 1) and the BNZ-Business NZ PMI (near-term observable data on firms' orders and inventories, figure 2) tell a story of very weak growth momentum in the second half of this year, inconsistent with the Reserve Bank's August MPS forecasts.

Figure 1. ANZBO capacity utilisation and RBNZ GDP forecast



Source: Statistics NZ, ANZ Research

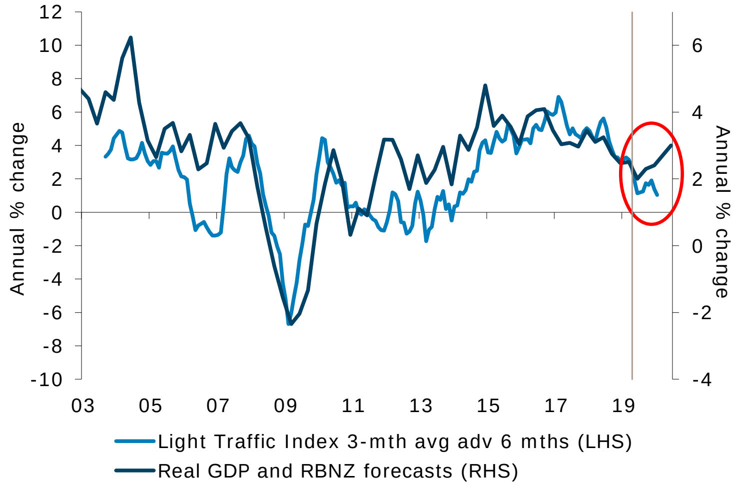
Figure 2. PMI: new orders/finished stocks and RBNZ GDP forecast



Source: BNZ-Business NZ, Statistics NZ, ANZ Research

There is not much reason for optimism about the outlook in the hard data either. The ANZ Truckometer Light Traffic Index is the most leading hard data we have, and it is still trending downward. At best it has found a ledge in recent months; it's certainly too soon to call it a floor. It's not in the RBNZ's camp either (figure 3). We'll get another read on this next week.

Figure 3. ANZ Light Traffic Index and GDP



Source: Statistics NZ, ANZ Research

One can certainly argue – and indeed we have – that while downside risks are accumulating, the growth fundamentals remain solid (robust commodity prices, easier monetary conditions, population growth, and a tight labour market). But the fact is, a continued slowdown over coming months, contrary to the RBNZ's projections, is hiding in plain sight.

If the world keeps it together – and that is an increasingly optimistic "if", given the relentlessly negative tone of most the global dataflow – the recent substantial easing of both interest rates and the exchange rate should support a decent pick-up in activity as we head into next year. But the RBNZ requires the economy to run hot – above trend – to get inflation up towards the midpoint of the target. Fat chance of that happening any time soon. Our GDP forecasts are under review.

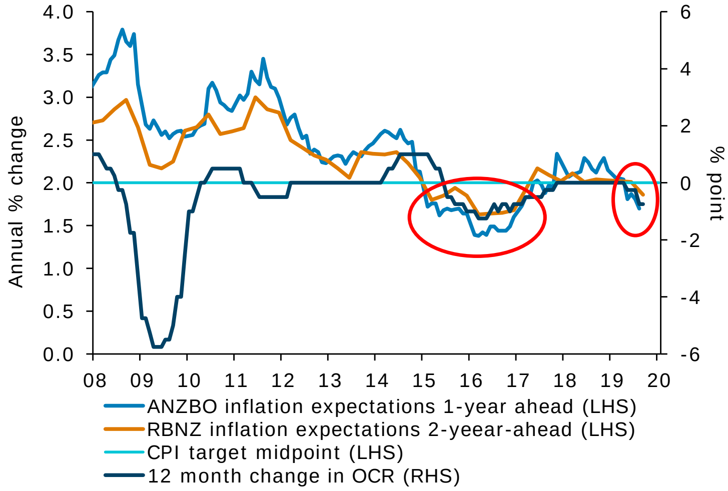
2. Inflation expectations are slipping

Sliding inflation expectations were a key reason the RBNZ cut the OCR in 2015-16, and the RBNZ Governor has stated in interviews that they are of particular concern at present as well. The RBNZ's preferred 2-year-ahead measure from its own Survey of Expectations is only available quarterly, but the monthly ANZ Business Outlook 1-year ahead expectations measure broadly tracks it, and it is slipping from the 2% target midpoint (figure 4, over).

Typically, changes in the OCR follow inflation expectations quite closely. The RBNZ quite rightly takes note of these expectations, as there is a self-fulfilling element to what firms expect inflation to be. If expectations become entrenched away from target, inflation targeting gets a whole lot harder.

The chart shows that the proactive OCR cuts delivered so far this year mean recent developments in inflation expectations are not a call for immediate action, but we suspect expectations are not likely to turn around any time soon.

Figure 4. Inflation expectations and the OCR

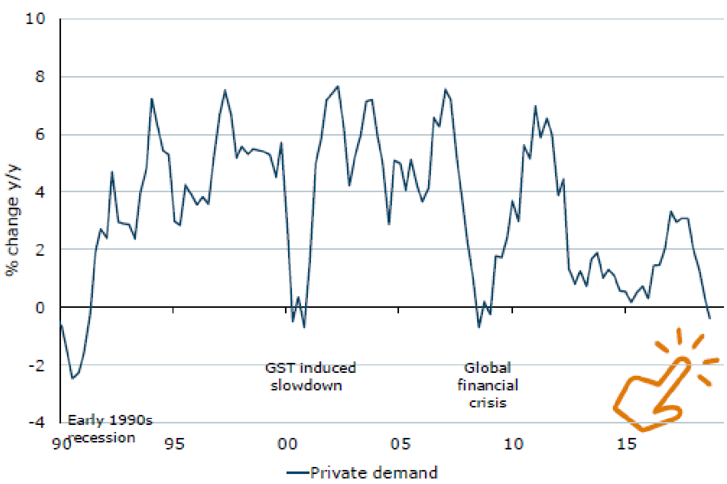


Source: RBNZ, ANZ Research

3. Our Australian colleagues now expect the RBA to cut the cash rate in October, February and May, taking it to 0.25%

The RBA is in a tougher spot than the RBNZ, it's fair to say. Construction (an important employer) is dropping, GDP growth in Q2 was the lowest since 2009, and most of the growth there was in the past year came from the public sector. The unemployment rate and household debt are both higher than in New Zealand, the housing market has taken a much harder hit (though is showing definite signs of life), and CPI inflation is further from the target midpoint.

Figure 5. Australian private sector demand



Source: ABS, ANZ Research

But while the urgency for cuts may be less in New Zealand, RBA cash rate cuts do put pressure on the RBNZ to keep pace in order to avoid the NZD/AUD appreciating and unhelpfully tightening New Zealand financial conditions.

An Australian slowdown will also make life tougher for New Zealand exporters. Australia accounts for 16% of our goods exports and is a very important tourism market as well.

4. The global environment continues to deteriorate

Good news is in short supply these days. We could go through it piece by piece but a tweet this week from @linzcom sums up the global data-flow outside of the US pretty accurately:

(insert here) is at its lowest levels since (insert either "2007", "2008" or "2009")

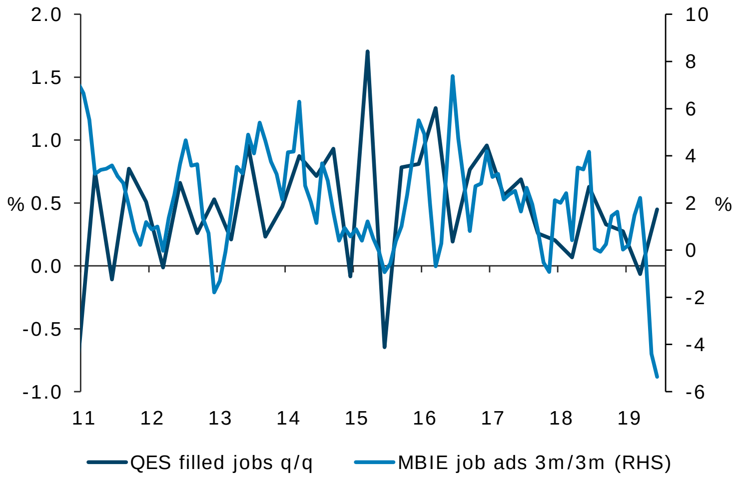
New Zealand is a small, open economy at the end of the day; a cork on an increasingly turbulent ocean. Supply-side factors are largely shielding our commodity prices from gravitational forces currently, and that's immensely valuable. Indeed, our recent Weekly discussed how the impact of the global slowdown on the New Zealand economy has been surprisingly benign so far.

But we have to be realistic about in which direction the risks lie, and also, unfortunately, the fact that this time, China is part of the global growth slowdown problem, not the white knight coming to our exporters' rescue with an enormous stimulus package, as they did following the GFC.

5. The labour market outlook is deteriorating

The RBNZ has a full employment target too these days, and while the labour market is certainly tight at the moment, employment indicators aren't looking great. Job ads are now backing up the story that employment intentions out of the ANZ Business Outlook survey have been saying for some time.

Figure 6. MBIE job ads and QES filled jobs



Source: MBIE, Statistics NZ, ANZ Research

6. The RBNZ proposes to lift bank capital requirements significantly

Our published economic forecasts do not yet incorporate the impacts of the RBNZ's proposed sharp increase in banks' capital requirements, which we believe will have more significant impacts on both the price and availability of credit than the Reserve Bank anticipates. That's because the details are not yet known.

However, it does seem clear from public statements by Reserve Bank officials that a fairly hefty increase is coming, whatever the details may be. Our central estimate is that the changes as proposed would be worth 80bp off the OCR – and a decent chunk off growth despite this offset.

For now, we are putting in a 25bp cut in May as a placeholder. But based on our new OCR forecasts, if the policy were to be implemented as proposed, there probably won't actually be sufficient headroom left in the OCR for monetary policy to offset the impacts as we modelled that it would. When it comes to our forecasts, much of the impact of the policy is therefore likely to show up in a lower GDP track than otherwise. But we'll wait to see the details.

7. The outlook for the dairy sector is troubling

The New Zealand dairy sector is not having a happy time. It is true that global dairy prices are holding up quite well and the NZD has helpfully depreciated. But everything else is turning a bit pear-shaped. We estimate that Fonterra is likely to be forced to shave the milk payout this year by 20-45c as a result of further asset write-downs on its balance sheet.

This is cash-flow that dairy farmers can ill afford to lose as they battle higher on-farm costs, tougher environmental regulation, tightening credit, and a very uncertain land market. So while our forecast of the Calculated Milk Price is $7/kgMS, the actual payout is likely to have a 6 in front of it. That was true of the last three seasons, of course, but the break-even milk price continues to inch higher as costs rise.

Summary

It's not an exaggeration to say that it is pretty much one-way traffic out there. The only easily identifiable upward risk at present is that the housing market could take off again in response to the record-low mortgage (and term deposit) rates. However, the RBNZ is responsible for financial stability as well, and what the low OCR giveth, the LVR restrictions taketh away. And any housing flurry might also get rudely interrupted if the labour market tightness dissipates as rapidly as the indicators are suggesting it might.

New Zealand is experiencing a growth stall. It is important to note that as things stand here and now, there is no fundamental reason for the economy to go into recession, and the Reserve Bank is doing everything it can to make sure it doesn't.

But given the deteriorating global environment, and the context of the current downward trajectory in the domestic data, the prospect of the economy accelerating to *above-trend* growth – which is what the RBNZ needs to be able to credibly forecast in order to forecast delivering on its inflation target over the medium term – looks a long way off. Too far off.

The RBNZ will conclude it can't afford to wait and see. Each successive cut from here is likely to be less stimulatory than the last, but they'll throw what they've got at it. Our new forecast endpoint for the OCR is right at the limit of where we estimate conventional monetary policy effectiveness ends. Down the track, there's scope to get creative with unconventional policy, though we stress that the pros and cons would have to be very carefully weighed, with the global track record hardly a ringing endorsement. But conventional OCR cuts are a logical start.

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