ANZ Research

RBNZ August Monetary Policy Statement

7 August 2019

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Smack.

Bottom line

- The RBNZ cut the OCR 50bp to 1.00% today, surprising everyone, with no analysts expecting such a large move.
- The forecast OCR track troughed at 0.91%.
- The cut we were expecting in September has been delivered early. We continue to expect a further 25bp OCR cut in November.

Key points

The RBNZ today cut the OCR 50bp to 1.00%. The market and analysts were unanimous regarding a cut today, but no one was picking -50bp. The forward OCR track was also much lower than expected and signals clearly that the door is open to further cuts from here. We expect another cut in November, but depending on the data flow it could come as early as September. The market response was as dramatic as the RBNZ could have hoped, with both the currency and rates sharply lower.

The RBNZ noted that the outlook for both global and domestic growth had deteriorated, and has revised down its growth forecasts markedly. However, it continues to forecast a stronger lift in activity over the next year than we do, driven by investment, construction, and government spending. That said, the Committee didn't sound fully confident that this would actually eventuate: "The members discussed that if sentiment remained low, perhaps due to global economic conditions or if profitability remains squeezed, growth might not increase as anticipated over the medium term".

Although the move today was bigger than anyone expected, the door was left open to more. The OCR is forecast to trough at 0.91%, implying a better than even chance of a further cut – we forecast it to come in November.

Details of the projections

The RBNZ now expects 0.5% q/q growth in Q2 (previously 0.7%), and have revised down growth in the second half of the year a touch. However, the acceleration in growth still looks more optimistic than our own forecast. GDP growth is now seen as accelerating from a trough of 2% y/y in Q2 2019 to a peak of 3.1% y/y by Q3 2020 (previous peak of 3.3% in Q2 2020). This track looks a little more realistic than the strong cyclical uplift in annual GDP growth previously projected, but only slightly. The output gap now peaks at 0.5% of potential output (versus +0.6% in the May projections), but flirts with negative territory in the near term.

The outlook for non-tradable inflation is broadly similar in the near term to that projected in the May MPS. As before, non-tradable inflation is expected to pick up towards 3% over the medium term. The outlook for tradable inflation is slightly softer in the near term, with low import price inflation weighing. Headline inflation is expected to gradually lift to the midpoint of the target band (2%) by Q4 2021 (previously by mid-2021).

The charts below show that the RBNZ has closed half the gap between their May forecasts and our own forecasts in terms of both GDP and the OCR.

Figure 1: GDP forecasts

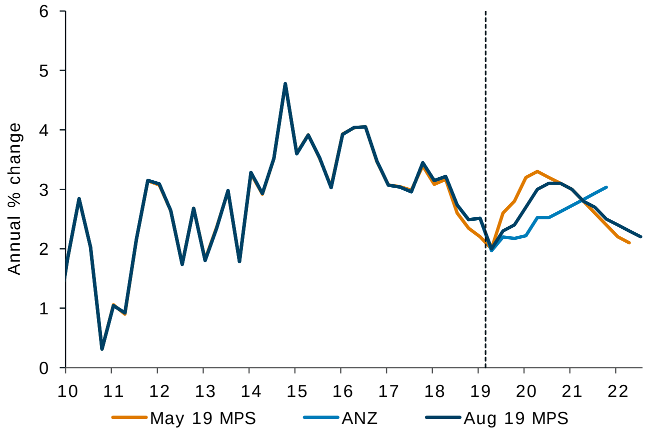
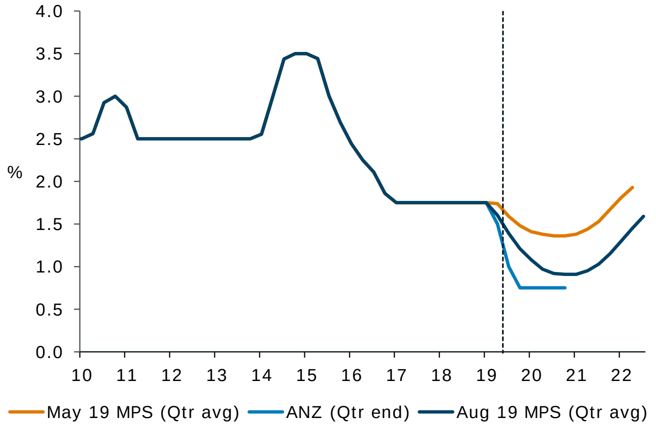


Figure 2: OCR forecasts



Source: Statistics NZ, ANZ, RBNZ

As we noted in our MPS Preview, the RBNZ's neutral interest rate assessment was due for a downgrade. The RBNZ appear to have chosen this meeting to make that assessment, with Committee members noting that estimates of the neutral level of interest rates have continued to decline. This will have fed directly into the published OCR track by going into the calculation of how much additional stimulus is needed.

Committee members also assessed that the strength of transmission from monetary policy to growth and inflation was little changed in the environment of low interest rates, pushing back on recent commentary that monetary policy has become less effective.

Risks

The Committee agreed that the balance of risks to its objectives was tilted to the downside, even with the OCR track bottoming at 0.91% over the projection.

On inflation, two offsetting domestic inflation risks were that the growth slowdown could weigh on wage inflation by more than assumed or cost pressures could see consumer prices rise more quickly. Further, weak global economic conditions could see imported inflation remain low if global growth slows further or if commodity prices decline.

On balance, the risks to growth were also to the downside. Key uncertainties were the global growth outlook, persistently low business confidence, the pass through of a weak housing market to household spending, and the impulse from fiscal policy.

Our take

A 25bp cut today was baked in by both the market and analysts, but the proactivity of the RBNZ policy committee that was evident in May was to the fore again, choosing to front-load the move and get maximum bang for their buck. Things could turn to custard before the September OCR review in seven weeks but a lot of custard looks baked in already at this point. We therefore maintain our forecast of a further cut in November, taking the OCR to 0.75%. While the starting point for the labour market in Q2 was reported as strong yesterday, this was pretty much written off as history, as we suspected it would be.

There are two schools of thought when nearly out of ammunition: hide behind a rock and preserve it, or charge. The RBNZ clearly falls in the latter camp.

Today's bold move will result in lower retail borrowing rates that should support investment and the housing market, but there will be offsetting impacts on the incomes and therefore spending of savers, and one also can't rule out a perversely negative impact on confidence of what might look to some like a crisis-type response.

The RBNZ's growth forecasts are still more optimistic than our own in terms of the speed of the bounce-back in growth over the next year. Of course, it does incorporate a slightly faster decline in the OCR than our forecasts did, but this would only have had a relatively small impact on the projections. The Committee sees downside risk to this forecast, and we agree. We expect that by November the case for another cut will be clear, but we can't rule out that it could be earlier, ie at the OCR Review in September. We – and the RBNZ – will be watching both the domestic and global dataflow closely.

On a technical note at an OCR of just 1.0% we are now entering the Twilight Zone as regards the logistics of actual monetary policy implementation via the bank settlement system. The cut would normally mean the first of the RBNZ's standing facilities (the bond lending facility, priced at OCR less 150bps) would garner a negative interest rate, but the RBNZ moved to swiftly take this off the table and have repriced this facility such that it will now attract a zero interest rate (OCR less 100bps). This means that the NZ market will avoid a negative interest rate in the RBNZ's facilities until the RBNZ cuts further. All other facility pricing remains unchanged at present.

Market reaction

The market was surprised by the RBNZ's 50bp cut, with the NZD plunging 1.85% to USD 0.6436 before the falling to a fresh low of USD 0.6378. The market was fully priced for a 25bp cut but did not see -50bp coming.

The bold cut today plus a lower OCR track bottoming out at 91bp saw the NZ rates market rally strongly, with the 2-year swap rate edging towards 1.02% (from 1.17% this morning), while the yield on the 10-year NZ Government bond fell to a fresh low of 1.128%. Similarly, the OIS market rallied strongly, with the terminal rate falling to 0.67% (from 0.90%), whilst another full cut remains priced in by February 2020. We expect the RBNZ's decision to weigh on the NZD in the short term whilst the yield curve is likely to remain supported by the RBNZ's dovish statement.

RBNZ news release key quotes

	New: 7 August 2019 (re-ordered by theme)	Previous: 26 June 2019
OCR decision	The **Official Cash Rate (OCR) is reduced to 1.0 percent**. The Monetary Policy Committee agreed that a lower OCR is necessary to continue to meet its employment and inflation objectives.	The Official Cash Rate (OCR) remains at 1.5 percent. Given the weaker global economic outlook and the risk of ongoing subdued domestic growth, a lower OCR may be needed over time to continue to meet our objectives.
Growth outlook	GDP growth has slowed over the past year and **growth headwinds are rising**. In the absence of additional monetary stimulus, employment and inflation would likely ease relative to our targets.	Domestic growth has slowed over the past year. While construction activity strengthened in the March 2019 quarter, growth in the services sector continued to slow. Softer house prices and subdued business sentiment continue to dampen domestic spending.
Global	Global economic activity **continues to weaken**, easing demand for New Zealand's goods and services. **Heightened uncertainty and declining international trade have contributed to lower trading-partner growth**. Central banks are easing monetary policy to support their economies. Global long-term interest rates have declined to historically low levels, consistent with low expected inflation and growth rates into the future.	The global economic outlook has weakened, and downside risks related to trade activity have intensified. A number of central banks are easing their monetary policy settings to support demand. The weaker global economy is affecting New Zealand through a range of trade, financial, and confidence channels.
Employment & Inflation	**Employment is around its maximum sustainable level,** while inflation remains within our target range but below the 2 percent mid-point. Recent data recording improved employment and wage growth is welcome.	We expect low interest rates and increased government spending to support a lift in economic growth and employment. Inflation is expected to rise to the 2 percent mid-point of our target range, and employment to remain near its maximum sustainable level.
OCR outlook	In New Zealand, **low interest rates and increased government spending will support a pick-up in demand over the coming year. Business investment is expected to rise given low interest rates** and some ongoing capacity constraints. Increased construction activity also contributes to the pick-up in demand. **Our actions today demonstrate our ongoing commitment to ensure inflation increases to the mid-point of the target range, and employment remains around its maximum sustainable level.**	Given the downside risks around the employment and inflation outlook, a lower OCR may be needed

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