RBNZ November Monetary Policy Statement

13 November 2019

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Hold up

Bottom line

- Contrary to analyst and market expectations, the RBNZ left the OCR unchanged at 1.0% today, despite significantly lowering the near-term growth outlook.
- The forecast OCR track was all but unchanged, with a low of 0.90% hinting at further action if required.
- We expect the RBNZ will continue to be disappointed on the growth front, but they have made a meaningful downward revision to their estimate of the economy's speed limit. This makes future aggressive action less likely.
- We are now forecasting two further cuts in May and August next year, taking the OCR to 0.5%. The risks around this forecast are tilted towards earlier and/or more cuts, depending partly on the outcome of the RBNZ's capital proposals.

Key points

The RBNZ today left the OCR unchanged at 1.0%, while leaving the door ajar to further action if required. The market had been ascribing around 80% odds to a 25bp cut, which saw a ferocious reaction by both rates and FX.

As expected, the RBNZ revised down its near-term growth projections but remains relatively optimistic on the medium-term outlook. The OCR track was all but unchanged versus August, with the Policy Assessment noting the Committee "will add further monetary stimulus if needed."

In our view, the RBNZ's growth forecasts remain too optimistic, particularly regarding business investment. On our own forecasts the worst is indeed behind us, but that isn't a sufficient condition to hit the inflation target in the medium term. The RBNZ is not taking in consideration declines in the availability of credit to the productive sector, which we think will have a meaningful impact on investment, though the magnitude of the impact is uncertain.

On the other hand, the Bank has also revised down its estimate of the speed limit of the economy, as its capacity suite has not deteriorated as quickly as GDP growth. This means that they don't "need" forecast growth to be as high in order to be able to forecast hitting their inflation target over the medium term. Essentially it cancelled out the downward revision to growth that we thought would dominate their thinking. Whether that is right or wrong will take some time to become evident, but the assumption matters.

Not least, it buys the RBNZ time. We have therefore taken one cut out of our own forecasts, and pushed out the profile. We continue to expect two further 25bp rate cuts, but now see them occurring in May and August. This would take the OCR to 0.5%. We see downside risk to this endpoint.

The big two data points between now and the February *Monetary Policy Statement* are the RBNZ's bank capital decision, to be released on 5 December, and Q3 GDP, due on 19 December. The RBNZ's forecast for GDP is 0.3% q/q, similar to our own, and they presumably already know their capital decision. That leaves only global factors to provide a meaningful surprise.

Details of the projections

The RBNZ now expects only 0.3% q/q GDP growth in Q3 (previously 0.6%), and 0.6% in Q4 (previously 0.7%). Annual GDP growth accelerates from a trough of 2.0% y/y in Q4 2019 to a peak of 2.8% y/y by Q4 2020. This forecast remains more optimistic than our own (see charts page), primarily due to differing views on the likely responsiveness of business investment to the monetary stimulus. In our view, uncertainty and reduced availability of credit will curtail the investment response to lower rates.

The outlook for annual non-tradable inflation is a little stronger in the near term, reflecting the stronger starting point. Over the medium term, the non-tradable inflation forecast is broadly similar to the August MPS, reflecting a downgrade to the RBNZ's potential GDP assumption. The Bank now judges there to be less labour supply than previously, despite recent upward revisions to SNZ's estimate of net migration. That's because despite employment growth slowing, indicators of labour market capacity remain fairly tight. That's true, but wage growth due to market factors remains fairly subdued.

The outlook for tradable inflation is slightly higher due to a weaker NZD-TWI than the RBNZ had expected back in August. This helps headline inflation lift to the midpoint of the target band (2%) by Q1 2020 (previously by end-2021) and range between 1.7% and 2.1% thereafter. Importantly, headline inflation is forecast to average 2% in 2022.

Risks

On balance, the RBNZ appears to still consider the growth and inflation outlook as skewed to the downside. The Committee noted near-term downside risks to the economy, most notably coming from the sharp slowdown in firms' trading activity in business surveys. In contrast to the August MPS, the RBNZ seemed to downplay the risks coming from the global economic slowdown, instead choosing to focus on the strength in New Zealand export prices. Regarding fiscal policy, the Committee noted two-way risks; fiscal stimulus could be greater than assumed, but there could also be delays in implementing spending and investment programmes.

On inflation, the RBNZ note that lower inflation in recent quarters and weaker economic growth has dampened inflation expectations, and this is a key downside risk to their inflation outlook. The RBNZ expect recent strength in domestic inflation to be transitory, as recent regulated price increases drop out, but they expect underlying inflation to pick up over time.

In addition to these risks, we believe there's significant downside to the RBNZ's expectation that trading-partner growth appears to have reached a trough, and is forecast to increase gradually over the projection.

Our take

The Reserve Bank has cut the Official Cash Rate by a full percentage point in the past six months, and early signs are indeed that it is having an impact. The Committee is no doubt hoping they have now done enough. They may have done – business sentiment appears to be bottoming out, wage pressure is lifting, the housing market is showing signs of life, and commodity prices are lifting while the NZD is nonetheless falling, a heady combination for the primary sector.

The worst is indeed likely behind us. But the RBNZ needs to do more than arrest the economy's slide. To be confident of hitting their inflation target over the medium term they require growth to accelerate, which is a much tougher ask. However, how *much* the economy needs to accelerate is the question. The RBNZ has changed its assumption on this score, which – together with the lower exchange rate and some helpful regulated prices – means that despite the downward revision to their growth forecast, they now forecast achieving their inflation goal more quickly than before.

With bank credit availability tightening and firms still wary about what the future may bring, we are sceptical that business investment is going to respond as enthusiastically to lower interest rates as the Reserve Bank's models predict, even if 'the vibe' is improving. And while we fully expect interest rates to impact the housing market positively, in two weeks' time the Governor is going to put on his financial stability hat and talk about high household debt and unaffordable houses. The RBNZ can't let housing off its leash, helpful as that might be for generating inflation pressures. Whether they'll ease the LVR restrictions is a tricky call. Holding the OCR steady today makes it more likely that they will.

We expect that in time, the OCR is heading further down. But the RBNZ has now switched to a more patient approach. This has been enabled by a lower exchange rate, a higher inflation starting point, and importantly, the new assumption that inflation will lift more for any given growth rate.

We expect that the RBNZ will be disappointed by the economy's growth performance, but that is now more of a medium-term story, as the RBNZ has built just 0.3% q/q Q3 growth into their forecasts (ANZ 0.4%). The current positive global vibe may or may not last as long as February, but if it does, the RBNZ is likely to be able to continue its new, more patient stance.

We are therefore forecasting two further rate cuts in May and August next year, taking the OCR to 0.5%, with the balance of risks tilted to earlier and/or more. One of these cuts is, as before, a placeholder for the need to offset the impact of the RBNZ's bank capital proposals. We will revise our forecasts once the details of this important policy are known in early December.

That's not to say a February cut can be ruled out, by any means. In terms of what could prompt it:

- Global markets lost the plot last Christmas. There is no shortage of pressure points out there that could cause the positive vibe to crack.
- New Zealand's commodity prices are holding up remarkably well in the face of slowing growth, but are prone to shocks.
- The hurdle to a downside Q3 GDP surprise is high. But historical GDP revisions associated with the September quarter release could show a sharper slowdown, causing another rethink of capacity pressures.
- Inflation expectations might refuse to play ball and keep falling.

Market reaction

The market was caught off-guard by the RBNZ's November Statement, which saw the NZD rally 1.4% as the decision broke, before paring back the move slightly. This is not entirely surprising given the market was pricing in a 80% chance of a cut this morning. At present there is little chance of a 25bp cut priced into the curve for 2020, with the market's implied terminal cash rate now at 0.90%, in line with the RBNZ's largely unchanged OCR track.

The domestic interest rate market sold off markedly, with the yield on the NZD 2-year swap rising by 18-20bp. Meanwhile, the yield on the 10-year NZGB didn't fare much better, rising by 15bp after the decision with neither the end of the curve looking back after the sell-off. We expect the NZD to remain buoyed by the decision as the markets digest the recent Statement, while yields are likely to rise further in the meantime.

Figure 1. GDP Production

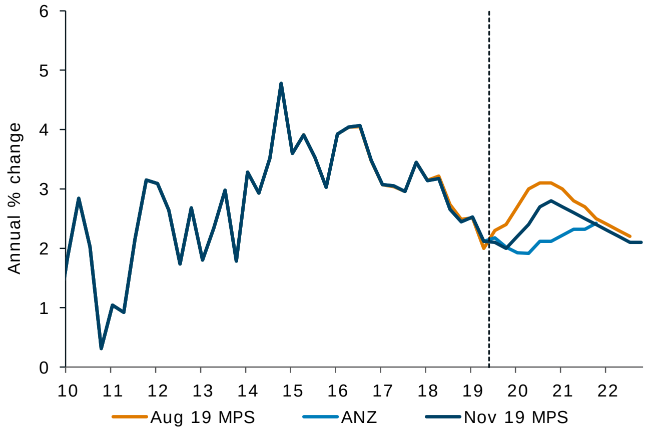


Figure 2. OCR

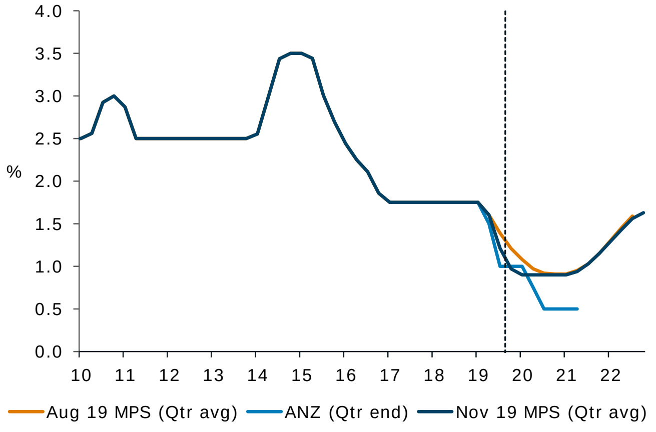


Figure 3. Headline CPI

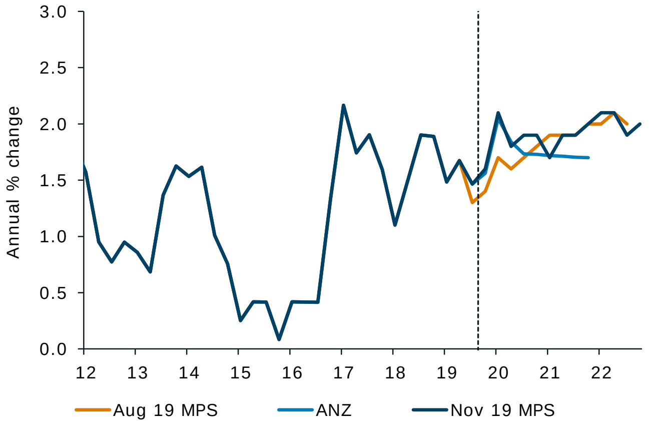


Figure 4. Non-tradable inflation

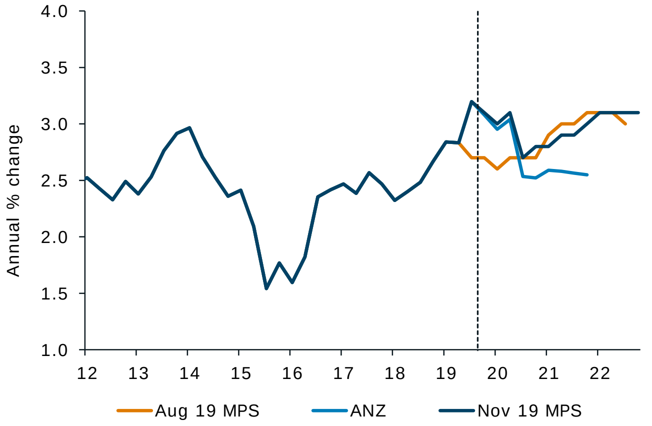


Figure 5. Tradable inflation

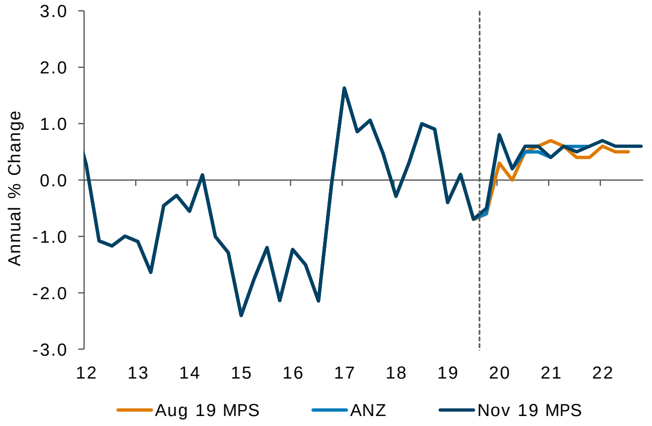
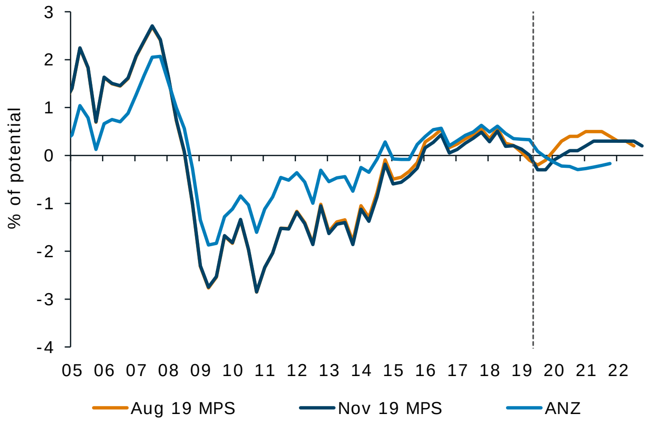


Figure 6. Output gap



Source: Statistics NZ, ANZ, RBNZ

RBNZ news release key quotes (re-ordered by theme)

	New: 13 November 2019	**Previous**: 25 September 2019
OCR decision	The Monetary Policy Committee has decided to keep the Official Cash Rate (OCR) at 1.0 percent. Employment remains around its maximum sustainable level while inflation remains below the 2 percent target mid-point but within our target range. Economic developments since the August Statement do not warrant a change to the already stimulatory monetary setting at this time.	The Official Cash Rate (OCR) remains at 1.0 percent. The Monetary Policy Committee agreed that new information since the August *Monetary Policy Statement* did not warrant a significant change to the monetary policy outlook. Employment is around its maximum sustainable level, and inflation remains within our target range but below the 2 percent mid-point.
Growth outlook	Economic growth continued to slow in mid-2019 reflecting weak business investment and soft household spending. We expect economic growth to remain subdued over the remainder of the calendar year. We will continue to monitor economic developments and remain prepared to act as required. Domestic economic activity is expected to increase during 2020 supported by low interest rates, higher wage growth, and increased government spending and investment. The low level of the OCR has flowed through to lower lending rates more generally, which support spending and investment. Rising capacity pressures are projected to promote a pick-up in business investment.	The reduction in the OCR this year has reduced retail lending rates for households and businesses, and eased the New Zealand dollar exchange rate. Business confidence remains low in New Zealand, partly reflecting policy uncertainty and low profitability in some sectors, and is impacting investment decisions.
Global	Trading-partner growth has also slowed. Growth in global trade and manufacturing is weak and uncertainty remains high, dampening global business investment. However, New Zealand's export commodity prices have been robust, underpinning a positive terms of trade. The lower New Zealand dollar exchange rate this year is also providing a useful additional offset to the weaker global economic environment.	Global trade and other political tensions remain elevated and continue to subdue the global growth outlook, dampening demand for New Zealand's goods and services. Global long-term interest rates remain near historically low levels, consistent with low expected inflation and growth rates into the future. Consequently, New Zealand interest rates can be expected to be low for longer.
OCR outlook	Interest rates will need to remain at low levels for a prolonged period to ensure inflation reaches the mid-point of our target range and employment remains around its maximum sustainable level. We are committed to achieving our inflation and employment objectives. We will add further monetary stimulus if needed.	Low interest rates and increased government spending are expected to support a pick-up in domestic demand over the coming year. Household spending and construction activity are supported by low interest rates, while the incentive for businesses to invest will grow in response to demand pressures. Keeping the OCR at low levels is needed to ensure inflation increases to the mid-point of the target range, and employment remains around its maximum sustainable level. There remains scope for more fiscal and monetary stimulus, if necessary, to support the economy and maintain our inflation and employment objectives.

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