ANZ Research

RBNZ February Monetary Policy Statement

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Watch this space

Bottom line

- As universally expected RBNZ left the OCR unchanged at 1.0% today, noting that "monetary policy has time to adjust if needed" to negative impacts of the devastating COVID-19 outbreak in China.
- The forecast OCR track was revised higher, with no cuts in the near term projections and a higher end point. The COVID-19 outbreak is considered "an emerging downside risk" but the RBNZ "assume the overall economic impact... in New Zealand will be of a short duration." We're assuming something a little larger, though also short-lived, but we are increasingly nervous.
- We are not currently forecasting any further OCR cuts, but all economic forecasts have a short shelf life at present. It's a fast-moving situation and the RBNZ will respond as they see appropriate.

Key points

The RBNZ today left the OCR unchanged at 1.0%, while leaving the door open to further action if required. The market had not expected a move today, but the RBNZ did strike a more sanguine tone than expected, seeing the NZD and short-term yields spike higher. The tone at the Q&A at 3pm may well also engender a market response. The RBNZ will be taking questions via twitter.

As expected, the RBNZ revised down its near-term growth forecast on coronavirus disruptions but remains optimistic on the medium-term outlook, anticipating a pick-up in growth in the second half of the year. The OCR track was revised 10-18pts higher, with the current upward momentum in the economy taken to mean that monetary policy has the luxury of "time to adjust if needed as more information becomes available."

The RBNZ's take on the near-term impact of the COVID-19 outbreak is milder than our own, with Q1 growth a little lower than was forecast in the November MPS but Q2 growth a touch stronger, reflecting the assumption that the impacts will be very short-lived. We suspect the impact will last well into Q2 at least, but it's fair to say that all estimates are highly uncertain and will be under constant review.

Beyond the estimated virus impact, our core macro view is similar to that of the RBNZ, though we see greater downside risks from emerging bank balance sheet pressures caused by declining deposit growth and soaring mortgage demand. This could squeeze credit availability, particularly to the productive sector. We remain less optimistic about the outlook for business investment, particularly now this new, significant uncertainty has presented itself.

Emerging drought conditions also present a medium-term growth risk. Normally, stock offloading in response to drought provides a near-term boost to GDP (at the cost of less output later), but with China port disruptions there are currently significant bottlenecks in the processing chain. The dynamics may therefore play out somewhat differently this time. We will be watching developments closely.

In terms of the data to watch from here, commodity prices are key, as are monthly trade statistics. We already know that tourist arrivals will be well down, with China accounting for 11% of arrivals, but we'll be watching arrivals from other countries to gauge any broader impact on appetite for long-haul travel. And of course, we'll be watching statistics about the outbreak itself as well as anecdotes of disruptions to New Zealand producers who have China as a part of their supply chains.

Details of the projections

The RBNZ expects 0.4% q/q GDP growth in Q4 (previously 0.6%), and have also trimmed their Q1 growth forecast to 0.4% (previously 0.7%). The latter reflects the initial impacts of COVID-19 (assuming there is no substantial outbreak in New Zealand and that the outbreak overseas is beginning to be contained by the end of the month). However, Q2 has been revised higher to 0.9% q/q (previously 0.7%) reflecting a rapid bounce back.

Annual growth is forecast to trough at 1.6% y/y in Q1 2020 and lift to 3.1% by Q4 2020. This forecast is more optimistic than our own (see charts page), due in part to differing views on the likely responsiveness of business investment to the current monetary stimulus. In our view, uncertainty and reduced availability of credit will curtail the investment response to lower rates. But COVID-19 threatens to swamp such forecast nuances.

The outlook for annual non-tradable inflation is a touch stronger over the latter forecast years, despite the RBNZ revising their estimate for potential GDP growth a little higher. Weaker tradable inflation provides a partial offset, meaning the headline inflation forecast is little changed from November. Headline inflation is expected lift to 2.2% in Q1 2020, but moderate to 1.7% by Q1 2021. Inflation is forecast to average 2% over the forecast horizon.

Risks

Naturally, COVID-19 was a key part of the risk discussion. It is expected to dampen Q1 GDP by 0.3% – a smaller and more short-lived impact than we are assuming (0.5%pts over H1) – with export prices expected to be 0.5% lower. The channels the RBNZ identifies are the same ones most forecasters are discussing: tourism and education exports, disrupted demand for exports (eg due to disruption at China's ports), a hit to confidence impeding spending and investment, and financial market impacts. They did not mention implications if the supply of intermediate goods from China were to be significantly disrupted. They note that a lower NZD would be an important offset to the economic impacts and that impacts would be broader if there were to be a substantial outbreak in New Zealand.

The RBNZ notes that estimating the economic impact of the outbreak is "extremely difficult" and that the impact will depend on how long the outbreak lasts, how widely it spreads, and how people respond. They said that the current implications for monetary policy are small because the impacts are assumed to be short-lived, and monetary policy acts over longer horizons. However, if the impacts looked likely to be more significant or persistent than assumed, then monetary policy implications could be larger.

They also noted some upside risks – greater government spending, a faster pace of wage growth and stronger consumption – along with both upside and downside risks to business investment. They also noted some of the challenges facing the rural sector: environmental policy, tighter credit conditions, and drought conditions. They did say that imports of services could be affected if fewer New Zealanders were to travel overseas, which would be a positive for GDP. They said the recent bank capital changes would dampen the outlook for the OCR, but that this was swamped by other positive developments since the

November MPS. They did not mention the emerging risks we see to credit availability in light of the slow pace of deposit growth, which could be an emerging headwind to growth.

Our take

After significant cuts to the OCR last year the Reserve Bank would have been feeling increasingly confident they had done enough, until the COVID-19 outbreak in China came along. Last year's cuts have been working: business sentiment found a floor, wage pressure is lifting, the housing market is booming, and consumers think it's a good time to spend. But there's suddenly a big black cloud on the horizon, and no one can tell what economic weather it will bring.

The RBNZ has no more information than anyone else on how things will pan out from here. They could have chosen to cut the OCR today as an insurance move, similar to what they did in response to September 11, the SARS outbreak, and the Christchurch earthquake. The economic impacts were highly uncertain then too. But what's different this time is that the RBNZ has very little conventional ammunition left. Every bullet must be used judiciously.

By 25 March, a very long six weeks away, we will all have a much better idea of both the near-term immediate impact, and the potential timeline and geographic spread of the epidemic. If it's warranted, the RBNZ will cut the OCR. The OCR path they forecast today should not be seen as any kind of commitment in such a rapidly moving situation.

But it's actually the exchange rate, rather than interest rates, that is the most important adjustment mechanism for this kind of global shock that hits exporters hardest. There's no reason to think the NZD won't do its job, and move broadly together with our commodity prices, wherever they may head. We tend to take the NZD for granted, and it can never please all the people all the time, but it's an absolutely crucial adjustment mechanism, particularly when the OCR is nearing rock bottom.

Market reaction

The no-cut decision, removal of cuts from the OCR projections, higher end-point (the projection for Dec 2021 was lifted by +18bps) and stoic view of the potential impacts of COVID-19 have seen the NZD regain its composure, and will likely buoy sentiment near term. NZD rates have also moved higher and will remain under pressure over coming days. That said, while there is now a big gap between market expectations and the RBNZ's new projections (around 15bps of cuts priced in by August vs the RBNZ's no-change track), implying further upside risk, we doubt cuts will be fully priced out just yet given the developing nature of near-term virus-related risks.

Figure 1. GDP Production

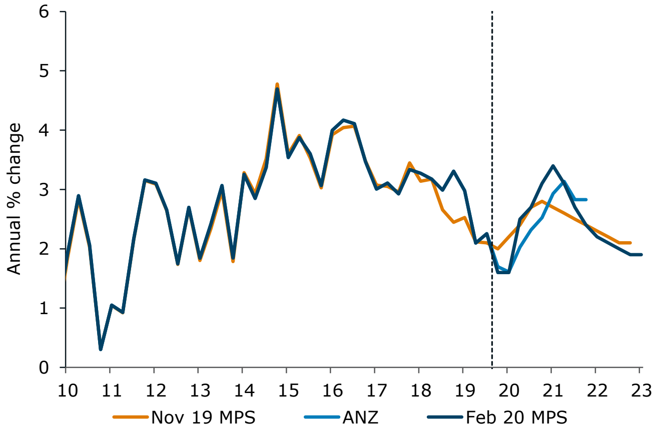


Figure 2. OCR

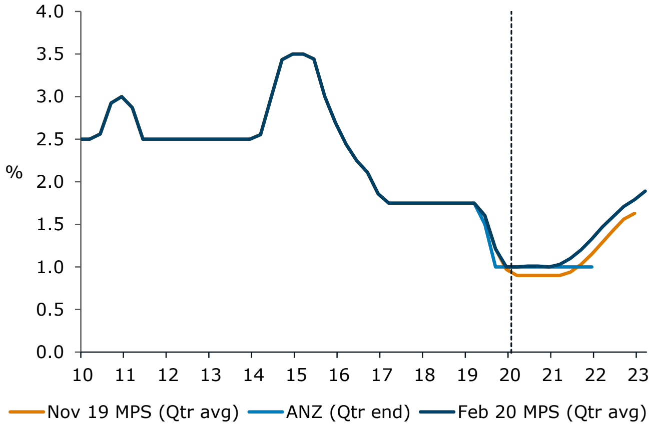


Figure 3. Headline CPI

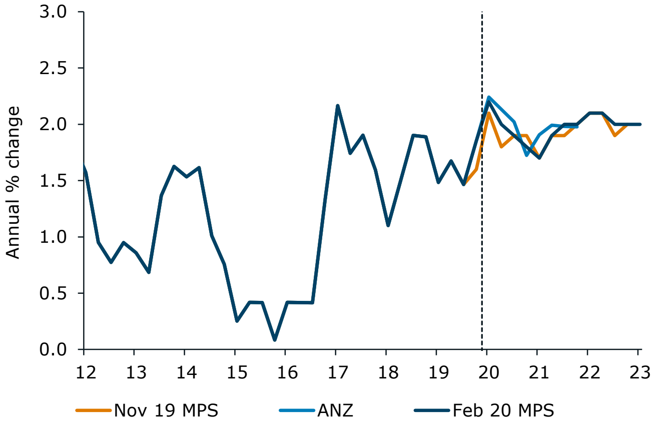


Figure 4. Non-tradable inflation

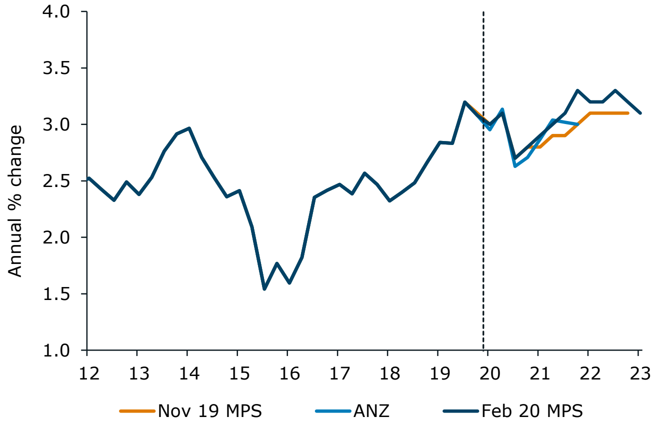


Figure 5. Tradable inflation

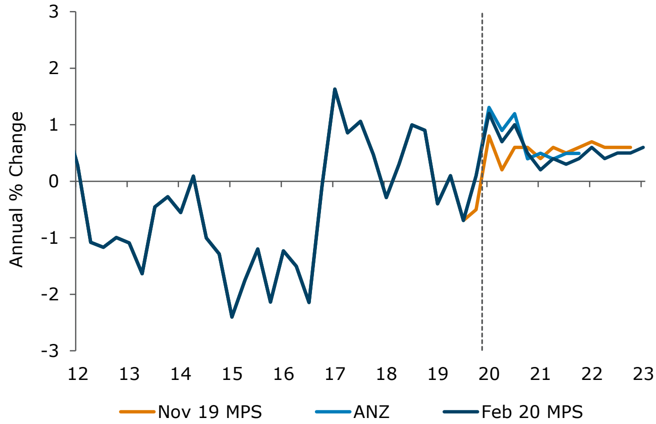
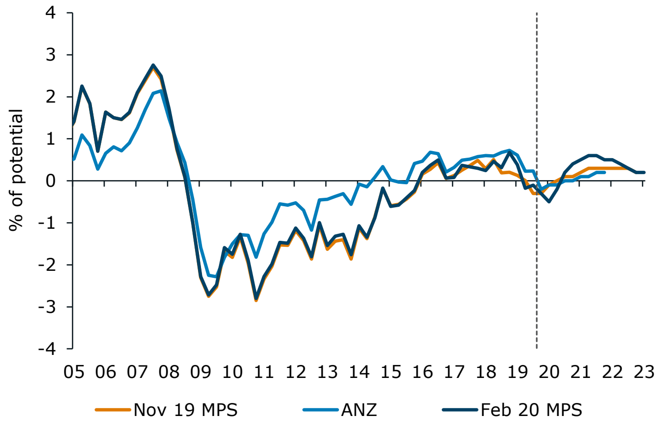


Figure 6. Output gap



Source: Statistics NZ, ANZ, RBNZ

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

	New: 12 February 2020	**Previous**: 13 November 2019
OCR decision	The Monetary Policy Committee has decided to keep the Official Cash Rate (OCR) at 1.0 percent. Employment is at or **slightly above** its maximum sustainable level while consumer price inflation **is close to** the 2 percent mid-point of our target range**. Low interest rates remain necessary** to keep employment and inflation around target.	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.
Growth outlook	Economic growth is expected to accelerate over the second half of 2020 driven by monetary and fiscal stimulus, and the high terms of trade**. The outlook for government investment is stronger following the Government's announcements in December.** There are also indications household spending growth will increase. **However, soft momentum in economic growth has continued into early 2020**. Slower global growth over 2019 acted as a headwind to domestic growth. In addition, **competitive pressures and recent subdued business confidence have suppressed business investment**.	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.
Global	**The global economic environment has shown signs of stabilising and trade tensions have receded somewhat. However, the COVID-19 (coronavirus) outbreak is an emerging downside risk.**	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.
OCR outlook	**We assume the overall economic impact of the coronavirus outbreak in New Zealand will be of a short duration, with most of the impacts in the first half of 2020. Nevertheless, some sectors are being significantly affected. There is a risk that the impact will be larger and more persistent.** Monetary policy has time **to adjust if needed** as more information becomes available.	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.

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