A risk to be taken seriously

Change of OCR call

14 August 2018

- We have shifted out our forecast for OCR hikes.
- We are now forecasting that the OCR will remain on hold until May 2020 (previously November 2019).
- This is due to a change in the RBNZ's behaviour, rather than any surprise about the state of the economy.
- We take the risk of OCR cuts over the coming year seriously. We put the odds of a cut at at least one in three.
- However, we expect the economic data to improve shortly, so we think cuts are more likely to be averted.

Westpac OCR forecasts

Quarter	New forecast	Previous forecast
Sep 18	1.75	1.75
Dec 18	1.75	1.75
Mar 19	1.75	1.75
Jun 19	1.75	1.75
Sep 19	1.75	1.75
Dec 19	1.75	2.00
Mar 20	1.75	2.00
Jun 20	2.00	2.25
Sep 20	2.00	2.25
Dec 20	2.25	2.50
Mar 21	2.50	2.50
Jun 21	2.75	2.75
Sep 21	2.75	2.75
Dec 21	3.00	3.00

Today we are changing our OCR call. Previously, our forecast was that the OCR would remain on hold at 1.75% until November 2019, and would rise slowly after that. Our new forecast is that the OCR will remain on hold until May 2020 and will rise slowly thereafter.

This change has nothing to do with the state of the economy. An economic slowdown has taken businesses, markets, the RBNZ and the Treasury by surprise. But from our perspective, the slowdown is no surprise. In November last year we forecast annual GDP growth in 2018 of 2.4%. At that time, we predicted that the RBNZ would become more dovish when it inevitably downgraded its overly-optimistic GDP forecasts. This is all broadly proceeding as anticipated.

The OCR call change is slightly related to the evolving outlook for inflation. It looks as though the forces that have been restraining tradables inflation are set to persist longer than previously expected. Even though wage pressures are clearly emerging, our forecast for inflation in 2019 is just 1.4%.

But even inflation is only a minor element of today's change of OCR call.

The main reason for the change of OCR call is what appears to be a change in the RBNZ's behaviour since the new Governor took office. The RBNZ has consistently surprised on the dovish side recently, especially at last week's *Monetary Policy Statement*. Communications have made it clear that the RBNZ is now actively considering OCR reductions and is less inclined towards hikes. The bluntest comment came from Assistant Governor John McDermott on Thursday, when he said "We've been pushed nearer to that trigger point" of cutting rates. This is a marked change from earlier this year, when the RBNZ's OCR bias was neutral-to-higher.

The change of rhetoric from the RBNZ is more than can be explained by data surprises alone. It seems there has been a systemic change of approach at the central bank. We strongly suspect that the new regime will prove keener to shore up GDP growth when it flags, and more willing to take a risk when inflation shows signs of rising. They may also be keener on a low exchange rate, and more averse to rising unemployment, than the RBNZ under the previous Governor. In the parlance of financial markets, we suspect that the Reserve Bank has become more dovish.

That is why we no longer think that the Reserve Bank will hike the OCR in late-2019.

Fiddling while Rome may be about to burn

Shifting our forecast of when the OCR will rise out by six months feels like we are fiddling while Rome may be about to burn. The real question is whether or not the RBNZ will cut the OCR in the foreseeable future.

The RBNZ has explicitly warned that it is “near the trigger point” for cuts. We take that warning seriously. If the data weakens much more from here, the RBNZ will indeed cut. We put the odds of that happening at around one in three.

But in our view, it is more likely that the data will surprise the RBNZ on the upside, and OCR cuts will be averted.

Strike one against cuts is the exchange rate, which has plunged in recent days and now sits well below the RBNZ’s forecasts.

Strike two is June quarter GDP, which is released in mid-September. The RBNZ is forecasting 0.5%, but our read is that we’ll get a monster print of around 1%. This may just be due to the quarterly vagaries of agricultural production and the like, but such a number would still prevent the RBNZ from hiking.

Strike three is September quarter inflation, which the RBNZ predicts will be low at 1.4%. Our own forecast is 1.7%.

Not only is the near-term data going to surprise the RBNZ on the upside, but more fundamentally, we suspect that the economy is about to start improving. A very large lift in government transfers has just hit households’ wallets, Government consumption spending has ramped up, the low exchange rate will buoy exporters and those who compete with imports, and the previously flatlining construction sector has recently registered a surprise lift in building consents. Our long held forecast is for GDP growth in 2019 to accelerate slightly, to 3.1%.

While we think that OCR cuts are most likely to be averted, we must emphasise once again that they are a genuine risk. As we have been saying since February, a downward move in the OCR this year is more likely than an upward move.

To our mind, the main risk that could bring about an OCR cut is the housing market. The foreign buyer ban is about to come into force, and we simply do not know how it will affect the market. Our expectation is that nationwide annual house price inflation will drop to around zero by the end of 2018. But if the foreign buyer ban creates a greater downdraft in prices, then the game could change. The RBNZ would likely react with OCR cuts in such a scenario.

The other risk in favour of cuts is the labour market. We expect unemployment to rise to 4.7% in a lagged response to the recent economic slowdown. While we view that as a temporary rise, there is a chance of the RBNZ overreacting.

We have been consistently at the dovish end of the market’s OCR forecasts over the past three years. We have been warning that the RBNZ, Treasury and financial markets were going to have to adjust their forecasts of growth and the OCR. But last week the RBNZ went further than even we were expecting. That leaves us less convinced that the RBNZ could hike next year, and more convinced that there is a risk of OCR cuts over the coming year. The question markets should be asking is not whether the RBNZ will hike, but whether it will cut. The best answer we can give at this stage to that question is no, but there is always a chance that data surprises could change that answer.

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