Let's be frank

RBNZ OCR Preview, September 2018

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- We expect the RBNZ will leave the OCR unchanged at next week's OCR Review.
- However, there is still a one in three chance that the RBNZ cuts the OCR over the coming year.
- We expect the tone of the OCR Review to be either neutral or dovish from a market point of view.
- A neutral Review would simply restate that the next move could be "up or down."
- The other possibility is that the RBNZ adopts a "soft" easing bias, explicitly warning that if the economy fails to accelerate as expected, the OCR could fall.
- This would match RBNZ comments made in the media, and would be in the spirit of open and frank communication that the RBNZ has embraced.
- It seems very unlikely that the RBNZ will issue a hawkish statement that causes interest rates and the exchange rate to rise. The balance of risks for next week's OCR Review is in the direction of lower interest rates and a lower exchange rate.

The Reserve Bank sharply altered its stance at its last missive, the August *Monetary Policy Statement*. In a move that we had long thought inevitable, the RBNZ finally acknowledged that its economic growth forecasts had been too bullish, and consequently it revised its OCR guidance lower. The RBNZ announced that it now expected to keep the OCR at its current low level "through 2019 and into 2020," longer than previously forecast. Assistant Governor John McDermott went further in commentary to the media, when he said that the RBNZ had "been pushed nearer to that trigger point" for cutting the OCR. McDermott said that the RBNZ's OCR forecast was predicated on the economy accelerating – if that acceleration failed to materialise, the RBNZ would have to consider cutting.

We took this warning about a possible cut seriously, but predicted that an impending bout of strong data would stay the RBNZ's hand. Specifically, we predicted that June quarter GDP would be around 1%, compared to the RBNZ's forecast of 0.5%. Furthermore, we noted that the falling exchange rate would diminish the case for OCR cuts.

That seems to be the way things are panning out. Although business and consumer confidence has weakened, most hard economic data has been reasonable, and June quarter GDP did indeed print at 1%. It would be odd to cut the OCR after that kind of data. Hence we predict an on hold decision from the RBNZ next week.

But we aren't out of the woods yet – we still put the odds of an OCR cut over the coming year at one in three. The RBNZ still has big expectations for the economy – they are forecasting 3.5% annual GDP growth for 2019, compared to our forecast of 3.1%. The RBNZ is probably still in wait and see mode, wary of the possibility that inflation and the labour market are not yet strong enough. Any false step from the data could still be met by an RBNZ OCR cut over the coming year.

Wording of the OCR Review

The first paragraph of next week's OCR Review will almost certainly reiterate the headline from August: *"We expect to keep the OCR at this level [1.75%] through 2019 and into 2020"*. And the RBNZ will almost certainly repeat that it expects to *"keep the OCR at an expansionary level for a considerable period."*

Beyond that, we see two ways that the Review could conceivably go – and we ascribe equal probabilities to either.

The RBNZ may simply repeat its key comment that the next move in the OCR could be "up or down", before going on to discuss the details of recent economic developments. That would be a fairly bland statement, and would elicit little market reaction in either interest rates or the exchange rate.

The other possibility is that the RBNZ decides to bring into the official commentary language similar to McDermott's OCR cut warning – that would be in the spirit of open and frank communication that the RBNZ has embraced. This would take the form of a "soft" easing bias, warning that

OCR cuts are a risk scenario rather than a central view. Perhaps something along the lines of:

"If the economy fails to accelerate as anticipated, we may have to reconsider the OCR outlook."

In this scenario, we would expect swap rates to fall between 5 and 10 basis points and the exchange rate to fall between half a cent and a cent.

One of our plausible scenarios involves no market move, while the other involves a fall in interest rates and the exchange rate. Consequently, we regard the balance of risks for markets on the day as being in a downward direction.

We regard a scenario in which the RBNZ issues a hawkish surprise to markets as very unlikely.

Equally, we regard a "hard" easing bias, which would indicate that OCR cuts are likely or imminent, as unlikely.

We noticed that the June OCR Review was very much an update document – it briefly restated the main points from the previous MPS, and then spent most of the time focussing on recent developments. If that pattern is repeated, the detail of the OCR Review would cover the following recent changes:

- June quarter GDP was much stronger than the RBNZ expected, and other hard data has been reasonably firm.
- Business and consumer confidence has fallen further, and there is a risk that this could portend weaker-than-expected GDP growth in the future.
- Although export conditions are still strong, there have been signs of deterioration. Most notably, dairy auction prices have fallen well below the RBNZ's assumed levels.
- The exchange rate has fallen sharply, which will help to boost the economy and inflation in time.
- The fact that fixed mortgage rates have fallen sharply, and that this will tend to boost the housing market, might rate a mention.

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