Starting with a bang

The outlook for the OCR

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- We expect the RBNZ will cut the OCR at the May *MPS*.
- The RBNZ is particularly concerned about the global economy, and that won't change by May. Yesterday's QSBO also supported the case for a cut.
- Cutting the OCR will seem reasonable to the new Monetary Policy Committee, because inflation is struggling to reach two percent.
- There is a risk of a follow-up cut in June or August. But we expect that improvements in the global and domestic economies will stay the RBNZ's hand over the remainder of 2019.
- The RBNZ move has already delivered a large monetary stimulus via sharply lower swap rates.
- We have long been concerned about the economic outlook in the early-2020s. We now expect the RBNZ to react to that by cutting the OCR in May 2020, taking the OCR to a new low of 1.25%.

Last week the RBNZ surprised everybody by announcing that the *"more likely direction of the next OCR move is down."* This bulletin sets out our thinking on whether or not the RBNZ is actually going to follow through and cut the OCR.

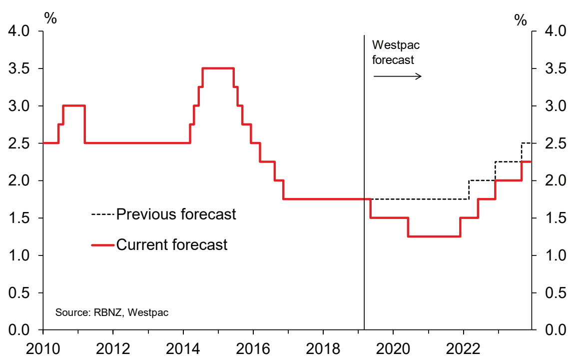
Our conclusion is that the RBNZ will cut the OCR in May. The new Monetary Policy Committee will start with a bang.

The RBNZ will leave the door open to a follow up cut, and that is certainly what markets will expect. We see a risk of a follow up cut, but we think it is more likely that improvements in global economic sentiment and the New Zealand economy will see the RBNZ hold off for the remainder of 2019.

A single cut in a year would be historically unusual. However, the introduction of the Monetary Policy Committee has changed the rules of the game, and Adrian Orr is no slave to tradition. Past experience of monetary policy need not apply. We would also point out that the drop in swap rates already delivered by the RBNZ amounts to a large monetary stimulus that will have a potent effect on the housing market and economy.

We have long been concerned that the economy will slow in the early-2020s due to the introduction of a capital gains tax, the end of the construction boom, and slowing

Westpac OCR forecasts



Westpac OCR forecasts

Date	New forecast
27 Mar 2019	1.75
8 May 2019	1.50
26 Jun 2019	1.50
7 Aug 2019	1.50
25 Sep 2019	1.50
13 Nov 2019	1.50
12 Feb 2020	1.50
25 Mar 2020	1.50
13 May 2020	1.25
24 Jun 2020	1.25
12 Aug 2020	1.25
23 Sep 2020	1.25
11 Nov 2020	1.25

population growth. Given the RBNZ's newfound activism, we now expect the RBNZ to react to that by cutting the OCR again in the early-2020s. We have pencilled a second cut for May 2020, which would take the OCR down to 1.25%.

The timing of these proposed OCR cuts is highly uncertain. Between now and the May *MPS*, inflation and labour market data could change the outlook. But the biggest risk is the Government's announcement on capital gains tax, which is due in April. This could affect business confidence and house prices in either direction, depending on what is announced. Beyond the May *MPS*, our view relies on the global and domestic economy improving. If evidence of that that doesn't come through by August, a follow up cut in 2019 will shift from risk to reality.

Back to basics

The May OCR decision will be the first made by the RBNZ's new Monetary Policy Committee, so the RBNZ's past pronouncements will hold less weight than usual. We have taken the analysis back to basics – given a blank slate, could a committee of seven people conclude that a lower OCR is the way to go?

The answer is yes. Reducing the OCR would be reasonable, although it's not imperative.

Except for one petrol-soaked quarter in 2017, inflation has been below two percent for seven years. The latest annual inflation read was 1.9%, but inflation is going to drop back to 1.6% when the March 2019 data comes out on April 17, in response to petrol prices unwinding their earlier spike. Measures of core inflation are rising, but they are still only around 1.5% to 1.7%.

We expect the economy to pick up over 2019 on the back of substantial fiscal stimulus, which will generate a bit of inflation pressure and push inflation towards two percent. Even so, the persistent forces which have suppressed inflation in recent years are still there, so there remains more risk of inflation undershooting than overshooting.

The RBNZ's plan for dealing with lowflation has long been to keep the OCR at 1.75% for an extended period. We thought that strategy would take a long time to work – we predicted that the OCR would have to remain at 1.75% until 2022, a year longer than the RBNZ itself thought.

A valid alternative strategy for the RBNZ is to cut the OCR now, which would return inflation to two percent more quickly. That's looking more like the way to go now that business confidence has stayed low and the exchange rate has held up better than expected.

But the big risk with cutting the OCR is the housing market. Fixed mortgage rates have been falling recently, and last week's dovish tone from the RBNZ is likely to cause a further substantial drop. Mortgage rates at these levels will be hugely stimulatory for house prices. House prices are already booming in many regions of New Zealand. But they are being held back in Auckland by changes in tax and the foreign buyer ban. An OCR reduction could cause mortgage rates to fall even further, and that could tip the balance back in favour of rising house prices nationwide.

Whether to run the risk of reigniting the housing market, or whether to focus on returning inflation to two percent quickly, is a matter of judgement. With nationwide house price inflation currently at 2.6% and inflation flagging, it is now looking more reasonable to opt for a modestly lower OCR than it looked last year.

The labour market leg of the RBNZ's dual mandate gives less basis for cutting the OCR – unemployment is low. However, estimates of whether the employment is at its maximum sustainable level or not are so uncertain that the employment target is unlikely to get in the way if a modest OCR reduction is warranted on inflation grounds.

The RBNZ's views are unlikely to change by May

We have concluded that a "blank slate" committee could reasonably cut the OCR. But of course, the slate is not entirely blank. The current leaders at the RBNZ, four of who will be on the new Monetary Policy Committee, have already switched their view from an on hold OCR outlook to opening the possibility of cuts. There were two key drivers of that, neither of which will change by the time of the May *Monetary Policy Statement*.

First and foremost, the RBNZ is getting worried about the global economic outlook. The fact that foreign central banks are moving towards more dovish monetary policy stances has been particularly influential. The RBNZ's thinking is that if New Zealand fails to follow suit, the exchange rate could rise unhelpfully.

We think global economic sentiment is going to improve, but not by May. A large fiscal stimulus in China combined with substantially lower interest rates in many OECD countries will shore up the big economies, and the fundamentals remain strong for US households. But that won't be apparent by May. Consequently we expect international factors will remain a strong argument in favour of reducing the OCR at the May *MPS*, but not later in 2019.

The second reason the RBNZ altered its stance is that it is losing faith in its long-held view that the economy is about to accelerate on the back of fiscal stimulus. The RBNZ was expecting GDP growth to accelerate sharply over 2018 and 2019, and placed particular emphasis on KiwiBuild. Instead, GDP growth slowed a bit in 2018, and KiwiBuild has fizzled so far.

The latest data on the economy has been mixed. Consumer spending, construction and farm revenue have all been very strong. But this week's Quarterly Survey of Business Opinion (QSBO) revealed that businesses remain loath to invest, and suggested that the overall economy is ticking over rather than accelerating. The RBNZ is likely to get a second consecutive downside surprise on GDP when March 2019 numbers are revealed in June.

We doubt that the RBNZ's overall impression that the economy is treading water will change by May. The one data point that could have an impact is labour market data, released on 1 May. However, labour market data is often considered too volatile to send much of a signal on a quarterly basis, so it would have to be quite compelling to affect the RBNZ's decision.

Beyond May, our long-held view is that the New Zealand economy will pick up a bit over 2019, due to fiscal stimulus, lower petrol prices and strong construction activity in Auckland. We can now add the possibility that the housing market will strengthen due to the reduction in wholesale interest rates already delivered by the RBNZ. And as already mentioned, we expect global economic sentiment to improve. We expect all of that will be enough to prevent the RBNZ from cutting the OCR again in 2019.

But as noted earlier, we have long been concerned about the economy slowing in the early-2020s due to the introduction of a capital gains tax, the end of the construction boom, and slowing population growth. We have pencilled in a May 2020 OCR reduction to reflect that, although the timing is highly uncertain.

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