The floodgates are open

Preview of the RBNZ August 2019 Monetary Policy Statement

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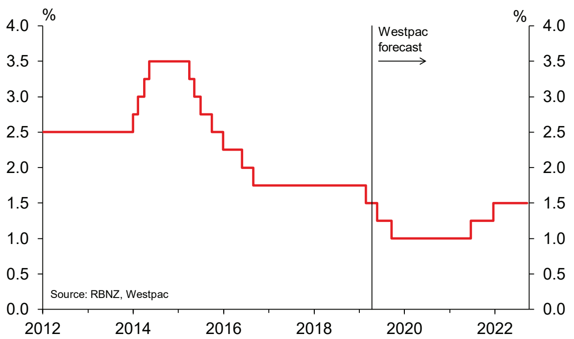
- The RBNZ is likely to lower the OCR to 1.25% next week.
- We expect the RBNZ to signal that a further OCR reduction is possible, depending on the data.
- The RBNZ's OCR forecast will probably drop to 1.1%.
- Commentary in the MPS will probably focus on the domestic economy remaining weak, a change from the previous focus on global conditions.
- We expect the RBNZ to revise its near-term GDP forecasts lower, and to focus particularly on signs that the labour market is weakening.
- We expect a follow-up OCR cut in November, but we see a risk that could be brought forward to September.
- Cutting the OCR will have consequences. We expect house price inflation to accelerate from 2% now to 7% next year.
- A housing market recovery would prevent OCR cuts in 2020.

Westpac OCR forecast



At next week's *Monetary Policy Statement*, we expect the Reserve Bank will lower the OCR and will signal that further OCR reductions are possible. This would be more dovish wording than the RBNZ used in the May *MPS*, when the OCR was cut but there was no real signal of further OCR cuts to come.

We doubt that the RBNZ would want to commit strongly to further OCR cuts. Rather, we expect the RBNZ will leave itself some optionality with wording in the Press Release and Summary of Meetings along the lines of:

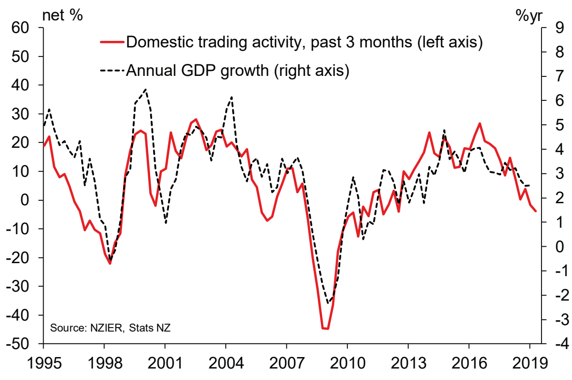
"The OCR may need to be lowered again, depending on the data over the coming few months."

Consistent with this slight ambiguity, we expect that the RBNZ will issue forecasts showing the OCR dropping to around 1.1% over time. That would imply a good chance of the OCR dropping again, but not a certainty.

We expect the RBNZ's focus will shift a little at this MPS. In March, May and June the RBNZ's dovish commentary was very much focussed on the slowing global economy and the fact that overseas central banks were minded to reduce interest rates. The RBNZ will continue to comment on the global slowdown, particularly now that the US Federal Reserve has reduced interest rates. But for this MPS, we expect more of the RBNZ's commentary to focus on the domestic economy. Previously, both the RBNZ and we were expecting the New Zealand economy to pick up in response to a large dose of fiscal stimulus and lower interest rates. But as we explained in our recent bulletin[1], the latest data instead suggests that the economy has stayed slow. Businesses continue to report low business confidence and slow domestic sales, consumer spending basically flat lined in the June quarter, and the housing market has been slow. The RBNZ is highly likely to reduce its near-term GDP forecasts – previously they were forecasting 0.7% growth in the second quarter of 2019, but that now looks more likely to be 0.4%. And they will probably also have to reduce their Q3 forecast below the previous 0.9% (our current forecast for Q3 is 0.6%).

1 https://www.westpac.co.nz/assets/Business/Economic-Updates/2019/Bulletins-2019/Change-of-OCR-call-July-2019.pdf

QSBO business activity and annual GDP growth



As well as the slowing domestic economy, we are now seeing the first cracks appear in New Zealand's previously-strong export sector. The price of export logs has dropped 25% in a month. That is particularly concerning because when log prices drop some forest owners stop harvesting, resulting in job losses.

To cap it all off, the trade weighted exchange rate rose 3% from mid-June to mid-July. Even though it has retraced about half of that move over the past few days, it is still a little higher than the RBNZ forecast in the May MPS.

Most important for the RBNZ will be early signs that the labour market is weakening. Surveys of firms' hiring intentions have weakened, and firms also report that it is getting easier to find labour. The government measure of job ads has weakened a little, and our own count of job ads on TradeMe (which is less complete but more up to date) has dropped very sharply. All of this suggests that the unemployment rate could rise a little over the coming couple of quarters. The RBNZ will be keen to emphasise the labour market, given that it was recently given a dual mandate to target both inflation and maximum sustainable employment.

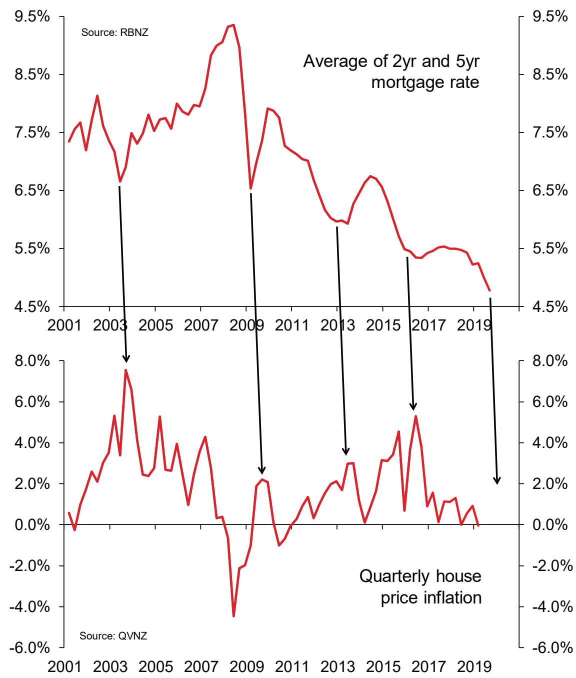
Stats NZ's quarterly labour market data will be released the day before the MPS is released next week. We are expecting a small rise in unemployment, but employment growth may be quite strong as it rebounds from an odd fall last quarter. That will probably create a mixed feel to that particular labour market report. If the data defies our expectation and comes in unambiguously weak, the Monetary Policy Committee could make last-minute changes to the press release, but would not be able to alter the forecasts or the main body of the *Monetary Policy Statement*.

After next week's OCR cut, we expect that the domestic economy will remain slow for long enough to prompt the RBNZ to cut the OCR once more in 2019. That cut is most likely to be delivered in November, when the Monetary Policy Committee has the benefit of the full quarterly analysis undertaken by bank staff. However, a cut in September is possible, despite the truncated analysis underpinning that decision, if data between now and then is weak enough.

As explained in last week's bulletin and elsewhere, we remain firmly of the view that cutting the OCR will have consequences for asset prices. There are already signs that a search for yield environment has developed. Growth in bank deposits has been weak, as people have been turned off by low term deposit rates. Meanwhile, share market prices have risen very sharply, particularly for dividend-paying stocks, and we have heard anecdotes that fund managers are seeing an influx of investment funds.

We think it is inevitable that Kiwis will soon turn their attention to the housing market. Since 2000, there have been four episodes of sudden decline in fixed mortgage rates. Each and every one has been followed shortly afterwards by a lift in the rate of house price inflation. This pattern has been followed even in the most unlikely of circumstances, such as in 2010 shortly after the GFC. We forecast that annual house price inflation will accelerate from 2% now to 7% next year. And we expect that this will prevent the RBNZ from cutting the OCR any further in 2020.

Mortgage rates and house prices



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