Flatlining

Preview of RBNZ statement and change of Westpac OCR call

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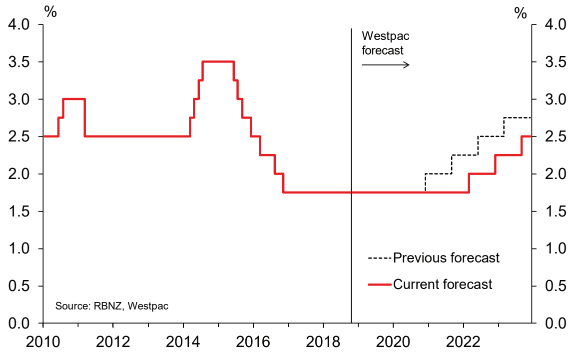
- This week we expect the RBNZ will leave the OCR on hold but to shift to a strictly neutral monetary policy outlook.
- We expect the RBNZ will say something similar to "the next move could be up or down". The RBNZ's OCR forecast will be flat until at least 2021.
- Separately, we have changed our OCR call. We are now forecasting no change in the OCR for 2019, 2020, and 2021 (previously we forecast hikes from Nov-2020).
- That's as good as saying that the OCR outlook is evenly balanced for the foreseeable future, with risks on both sides.
- The biggest motivation for changing our OCR call is the construction outlook – it now looks as though construction activity will peak in 2019 and dissipate from 2020. Second, there is increasing evidence that the economy lost momentum in late-2018.
- Markets are pricing an 80% risk of an OCR cut in 2019, but we think the odds are below 50% because we expect the economy to regain some momentum in 2019.

Official Cash Rate forecast



A return to "up or down" – the RBNZ's statement this week

We expect the Reserve Bank of New Zealand to follow its US and Australian counterparts this week, and return to a neutral outlook for monetary policy.

In its last missive, the Reserve Bank said it expected to keep the OCR on hold through 2019 and into 2020. However, it dropped the phrase that "the next move in the OCR could be up or down," and forecast very gradual OCR increases from mid-2020.

This week we expect the reintroduction of language very similar to "up or down." The RBNZ may underscore its change of view with something like "We expect to keep the OCR on hold over the whole of 2019 and 2020, longer than previously projected." And we expect the RBNZ's OCR forecast will be flat until around mid-2021 instead of mid-2020.

There will be three key reasons for the RBNZ's change of stance. First and foremost, the exchange rate is higher than previously projected (mainly because the US Federal Reserve has gone off the idea of lifting official interest rates, meaning a weaker US dollar). A higher exchange rate means less tradables inflation for New Zealand.

Second, the New Zealand economy has clearly lost momentum in late-2018, to a greater extent than the RBNZ expected. GDP growth for the September quarter printed at just 0.3%, and the latest data indicates that the December quarter was similar. The slowdown was due to slowing net migration, the cooling housing market, a rapid rise in petrol prices and low business confidence resulting in slower business investment growth.

And third, Stats NZ has dramatically revised its estimates of net migration, with the effect that the population is smaller, and growing more slowly, than previously thought. If the RBNZ has done the same analysis as we have, it will conclude that slower population growth implies less need to build houses and therefore a lower outlook for construction activity than previously forecast. In turn, this would flow on to its GDP and inflation forecasts.

There have been a couple of offsetting positive developments – global dairy prices have unexpectedly risen 19% since late November, and non-tradables inflation was stronger than expected in December. But these are not enough to completely counter the negatives.

Will the Reserve Bank cut soon? Not based on the current conditions.

Financial markets are now pricing an 80% chance that the RBNZ will cut the OCR by the end of 2019. That is certainly a risk, but we think markets are overstating the odds. The New Zealand economy has lost momentum, but that has not created conditions requiring an OCR cut. On the contrary, the New Zealand economy is currently in an extraordinarily ordinary position – pretty much anything that matters for monetary policy is neutral at present:

- The output gap is roughly zero.
- Core inflation is only a touch below the two percent mid-point of the RBNZ's target.
- The labour market is in a roughly neutral position.
- The exchange rate is very close to its post-float inflation adjusted average against the US dollar, and is broadly at fair value on a trade-weighted basis.
- House price inflation is moderate at 2.6%.

Based on the economy's current position, there is no reason to either raise or lower the OCR.

Economy to regain momentum in 2019

Our view is that the New Zealand economy will regather momentum over 2019. We don't expect anything spectacular, but it will at least be enough to arrest the current downward momentum. We forecast quarterly growth over 2019 to be in the 0.5% to 1% range, rather than the 0.3% per quarter rate of late-2018, for four main reasons:

- Petrol prices have fallen 15% since November, which will be a boon for consumers' budgets.
- A very large dose of fiscal stimulus is hitting the economy right now, which will boost consumer spending via transfers and employee salaries, as well as stimulating GDP via government consumption and investment.
- We know from consent data that there will be one last leg higher in Auckland construction activity over 2019.
- Agricultural growing conditions have (until recently) been excellent, and global prices are good. This will increasingly boost the rural economy of New Zealand.

As economic momentum returns, we expect the case for OCR cuts this year will dissipate. Even so, we see no case for OCR hikes either. Inflation has been too low for years, and has only slowly and tentatively struggled to around two percent. The Reserve Bank needs GDP growth to pick up in the fashion we are forecasting just to ensure inflation settles at two percent. A modest pickup in GDP growth would not see inflation rise above target.

Our new OCR call – no change as far as the proverbial eye can see

Today we are shifting our OCR call. Previously we were forecasting gradual OCR hikes from November 2020. We are now forecasting no change in the OCR over 2019, 2020, and 2021. That is as far as the proverbial eye can see – what we are really saying is that the OCR outlook is evenly balanced over the foreseeable future, with risks on both sides.

Beyond 2019, we expect that the economy will gradually cool towards a trend rate of GDP growth, around 2%. Over the early 2020s we expect population growth to slow. Combined with the unwinding Canterbury and Kaikoura rebuilds, that will cause a cooling of the current construction boom. Meanwhile, tax changes (including a possible capital gains tax) will be weighing on the housing market, leading to modest house price decline and therefore a subdued consumer.

If GDP growth slows to around trend, the output gap will remain close to zero and the economy will be in the Goldilocks zone with neither rising nor falling inflation, and with employment close to the "maximum sustainable" level.

At the same time, the Reserve Bank's proposed bank capital requirements will be coming into force over the early 2020s. Asking banks to hold more capital will likely to lead to higher mortgage rates, lower deposit rates, and tighter credit conditions than otherwise. Any autonomous lift in mortgage rates would further reduce the need for the Reserve Bank to lift the OCR.

Much of the above was already factored into our existing OCR forecast, including the bank capital requirements.[1] The catalyst for the change of call this time is the softer starting point for the economy and the new outlook for construction. As mentioned above, Stats NZ dramatically revised its estimates of net migration lower. We have concluded that the outlook for population growth is lower. In turn this means less need to build houses, a lower construction outlook, and therefore a lower GDP forecast than we were previously factoring in.[2]

The biggest risk to the outlook concerns the housing market. Our forecast for nationwide house price inflation is 3% this year. That is a balance between low mortgage rates, which are very stimulatory for house prices, and tax changes and the foreign buyer ban, which are restraining house prices. If the tax changes end up dominating and house prices drop sharply, the RBNZ would have no hesitation in cutting the OCR.

The biggest upside risk is wage growth. The labour market is tight and, when one is talking to employers, anecdotes of rising wages abound. On top of that, this year the minimum wage will rise by over 6%. If wage growth really gets going, and translates into rising inflation, the RBNZ would have to hike the OCR – although we suspect this would be a slow process.

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[1] Our assessment of how the bank capital requirements will affect the OCR can be found at https://www.westpac.co.nz/assets/Business/Economic-Updates/2019/Bulletins-2019/Bank-Capital-Requirements-January-2019.pdf

[2] Analysis of the migration revisions and construction outlook can be found at https://www.westpac.co.nz/assets/Business/Economic-Updates/2019/Bulletins-2019/Net-Migration-February-2019.pdf

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