On a knife edge

May 2019 Monetary Policy Statement preview

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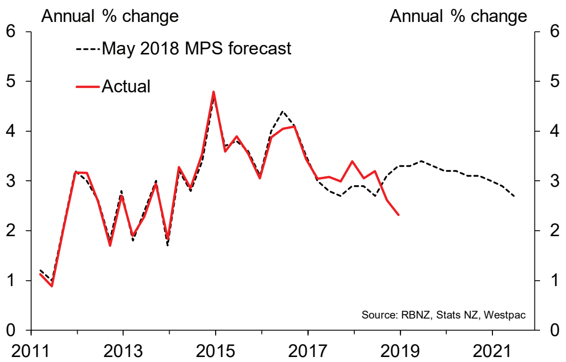
- Next week's RBNZ OCR decision is an incredibly close call.
- We think there is a 55% chance of an OCR cut, and a 45% chance of an on hold decision.
- GDP growth has fallen well short of the RBNZ's lofty expectations. If the economy stays slow, inflation will be stuck below 2%.
- Regardless of the OCR decision, we expect the RBNZ to drop its OCR forecast to around 1.4%.
- In the event of a cut, the RBNZ will leave the door open to further cuts without making promises.
- If the OCR is kept on hold, we expect the RBNZ will strengthen its easing bias.

RBNZ GDP forecasts versus reality



Next week's OCR decision is on a knife edge – we, and financial markets in general, remain uncertain about whether the RBNZ will reduce the OCR or not.

We marginally favour a cut – we think the odds of an OCR cut are about 55%, versus a 45% chance of no change.

Whether or not the OCR is cut next week, we expect the RBNZ to reduce its OCR forecast to around 1.4%, due to concerns that the domestic economy may not have the juice to push inflation up to 2%. In the event of an OCR cut, that would imply that a follow-up cut was possible but not definite. The accompanying rhetoric might be something like *"Any further move in the OCR will depend on the data."*

In the event that the OCR remains on hold, a 1.4% OCR forecast would keep markets on high-alert for a future OCR cut. The RBNZ would probably emphasise the risk of a future cut by saying something like *"If domestic economic growth remains slow, or if the global economy falters, we may need to reduce the OCR later this year."*

A unique situation

Back in March, the RBNZ said that *"Given the weaker global economic outlook and reduced momentum in domestic spending, the more likely direction of our next OCR move is down."* That was not a commitment to cut the OCR, but it did leave the door open.

Since the March OCR Review, RBNZ Governor Adrian Orr has given three media interviews that have mentioned monetary policy – something he had previously been loath to do. Orr's comments in those interviews seemed studiously neutral, and were probably designed to keep the RBNZ's options open rather than to guide markets towards or away from an OCR cut.

In any case, what the RBNZ has said in the past is less relevant than usual. Next week's decision will be the first taken by the RBNZ's new Monetary Policy Committee (MPC). And the analysis and drafting of this *Monetary Policy Statement* will be overseen by new leaders, the RBNZ having recently appointed a new Chief Economist, Head of Financial Markets, and General Manager of Economics, Markets and Banking. To some extent the RBNZ will be taking a fresh look at the economy rather than rolling over previous analysis.

Given this unique situation, we have stripped our analysis right back to basics – given a completely blank slate, what is a fresh committee likely to conclude about the OCR? As explained below, good cases can be made for either cutting the OCR or keeping it on hold, but we think the case for a cut is the more convincing of the two.

The case for cutting the OCR

Inflation is currently 1.5%, and has been below the 2% mid-point of the RBNZ's target range for almost all of the past seven years. Back in February the RBNZ was forecasting that inflation would struggle back towards 2%, reaching that mark at the end of 2020 and then sitting there. That was based on the RBNZ's long-held assumption that GDP growth would pick up substantially. But that acceleration has not materialised to date. The latest indications are that GDP is still growing not much faster than population growth, business confidence remains low, employment growth has lost momentum, and the housing market has clearly slowed.

If GDP growth stays slow, then there just won't be enough juice in the economy to push inflation up to 2%. Our sense is that the Reserve Bank has lost patience waiting for the upturn, and will conclude that the economy needs more of a helping hand to ensure that inflation returns to target.

Meanwhile, the global economy has slowed over the past year, and the RBNZ is very sensitive to the risk that it could get worse. More importantly, global inflation has fallen short of expectations, which creates two issues for the Reserve Bank. First, low global inflation portends low New Zealand inflation. And second, other central banks are shifting to easing biases, which would have meant a stronger New Zealand dollar had we not followed suit.

The state of the New Zealand labour market gives less cause for cutting the OCR. Unemployment is 4.2%, which is close to the "maximum sustainable" level the RBNZ is required to aim for. However, employment growth has distinctly slowed recently, and wage growth remains very low, so the labour market doesn't really stand in the way of a cut either.

The case for keeping the OCR on hold

Of course, a good case for keeping the OCR on hold can also be made. This hinges on the idea that the economy is going to pick up in the near future. Government spending has accelerated sharply over the past year, and the impact must be felt soon. The lacklustre housing market may soon pick up because the mooted capital gains tax has been cancelled and mortgage rates have plunged. Business confidence may pick up for the same reasons. We know that construction is about to take a leg higher because we have seen a sharp increase in issuance of building consents. Net migration appears to be rising again, which will stimulate the economy. The very latest data on the global economy has been more positive, and equity markets are up strongly. And the recent sharp increase in dairy and beef prices on global markets bodes well for farmers.

In light of these more positive recent developments, the MPC might decide that it is wiser to wait and see before cutting the OCR. If the proposed improvement in the economy still hasn't materialised in another few months, they can always cut the OCR then – after all, the need to cut the OCR is not urgent. In the meantime, the RBNZ can keep fixed mortgage rates and the exchange rate low by signalling that it may cut in the future and publishing a lower OCR forecast.

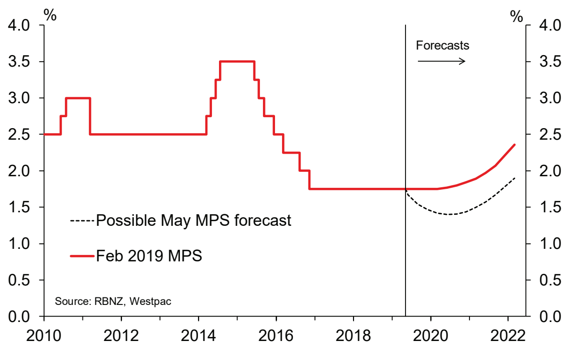
Which argument is stronger?

We think the case for keeping the OCR on hold will be less persuasive to the MPC, because it relies on a *forecast* of the economy improving. Given that the RBNZ originally forecast that the sharp acceleration in GDP growth would start in early-2018, and it still hasn't happened, the committee may well run out of patience waiting. By contrast, the arguments for cutting the OCR are all in the here and now – inflation is currently low, and GDP growth is currently lacklustre. Those on the ground facts may carry more weight than a forecast that may or may not pan out.

RBNZ communication

Whether or not the RBNZ actually cuts the OCR next week, we think the accompanying *Monetary Policy Statement* will feature an OCR forecast that drops away to about 1.4% before rising again.

Possible RBNZ Official Cash Rate forecast



The *Monetary Policy Statement*, including the OCR forecast, will be finalised before the OCR decision is made. An OCR forecast of 1.4% or so would leave the MPC latitude to make either a cut or hold decision. It is probably also a fair reflection of where the RBNZ's thinking has got to in terms of how much help the economy needs to achieve the required lift in inflation.

The details of the *Monetary Policy Statement* will emphasise the RBNZ's disappointment with the lack of GDP growth recently. The GDP forecasts will be downgraded in the near term, but will be stronger further into the future (because the RBNZ will anticipate the economy's response to lower interest rates). The RBNZ's inflation forecast will probably take a bit longer to reach two percent than the February forecast, which reached that mark in December 2020.

The other key feature of the *Monetary Policy Statement* will be the RBNZ's worries about the global economy. These may be phrased more in terms of risks to the downside rather than actualities that need to be addressed immediately.

Market reaction

At the time of writing, markets were pricing roughly a 60% chance of an OCR cut, and had 80% of a follow-up cut priced in over the coming year.

If the RBNZ does cut the OCR and leave the door open to further cuts, as we expect, markets will react strongly. Interest rate markets may move to price in more than one further cut, and the exchange rate would fall by a cent or more.

It is more difficult to say how markets would react if the RBNZ keeps the OCR on hold but delivers a sharply lower OCR forecast along with a signal that future cuts are on the agenda. Interest rates and the exchange rate would rise, but probably not by much, since markets would continue to price in OCR cuts.

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