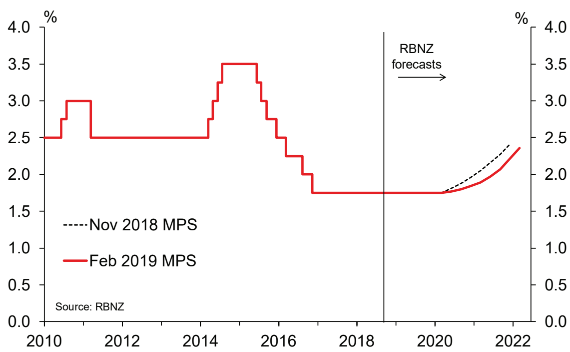
Yesterday's news, today's fish and chip paper

Review of the February 2019 Monetary Policy Statement

13 February 2019

- The RBNZ downgraded its OCR projection and sounded slightly more dovish than November, which is exactly what we anticipated.
- However, some details were not so dovish.
- The RBNZ remains upbeat on the economy and is focussed on burgeoning capacity pressures.
- Some of the RBNZ's analysis is out of date. There may be a further dovish tilt once the latest information is incorporated.
- Like us, the RBNZ views the impact of bank capital requirements on the OCR as transitory, not as something that could affect the neutral OCR.
- There was nothing in today's missive to alter our view that the OCR outlook is flat for the coming three years.

RBNZ Official Cash Rate forecasts



In its first review of 2019, the Reserve Bank left the OCR at 1.75%. The tone of the statement was more dovish than in November. The RBNZ's OCR projection was about 20 basis points lower than its previous forecast; the RBNZ said it expects to keep the OCR on hold "through 2020" (previously "into 2020"); and the "the next OCR move could be up or down" was returned to the statement, having been removed in November after a run of strong data.

This was all bang on our expectation. However, some of the details of the *Monetary Policy Statement* were a little less dovish than we might have expected.

The RBNZ's downside concerns centred around the global economy and were couched as risks. In contrast, the RBNZ remains upbeat on the New Zealand economic outlook. There was a great deal of emphasis placed on the tightening labour market and emerging capacity pressures. The RBNZ remains very much of the view that New Zealand GDP growth will pick up due to government spending, thereby helping to lift inflation to target.

One reason for the RBNZ's sanguine view may be because its analysis is a little out of date. The *MPS* included a forecast of December quarter GDP growth of 0.8%. That cannot possibly incorporate the information in the Quarterly Employment Survey, which as very weak, is an important indicator of GDP, and came out not long before the RBNZ finalised its projections. Our own forecast of December GDP growth is now 0.3%.

Similarly, the RBNZ made no allowance in their forecasts for Stats NZ having revised its estimates of net migration dramatically lower. This loomed large in our own thinking, because it implies lower future population growth, less need to build houses, and therefore a softer construction outlook than we previously understood.

The RBNZ's assessment of the New Zealand economy will probably soften once a weak December quarter GDP and lower population growth are incorporated into their thinking. That means the next monetary policy update is already "preloaded" in the direction of a dovish shift (partially offset by the fact that commodity prices are probably already stronger than the RBNZ allowed for).

Adding to the sense that the RBNZ could have been more dovish, there was surprisingly little mention of the exchange rate, which is higher than previously forecast.

As well as downgrading the OCR forecast, the Reserve Bank downgraded its medium-term inflation forecasts to around 2%. In other words, the higher exchange rate and lower GDP outlook have affected both the RBNZ's OCR and inflation forecasts, which is standard. This is a contrast to last November, when a run of strong data resulted in the RBNZ lifting its inflation forecast but not altering the OCR forecast.

There was nothing in today's statement to alter our OCR view. We remain of the view that the OCR outlook is flat for the coming three years. A move in either direction over that time would require an unexpected development.

Bank capital requirements impact on the OCR

Much of the press conference after the *MPS* was devoted to the Reserve Bank's recent proposal to require banks to hold much more capital. The argument about the size of the economic impact is ongoing. But one important point stuck out for us – the Reserve Bank views the impact on the OCR as transitional and not something that will affect the neutral OCR.

Some analyses have focussed on the fact that higher capital requirements will push lending rates up, and have argued that the neutral OCR will fall by an equivalent amount. The implication is that the OCR will be much lower than it would otherwise have been.

We disagree. The capital requirements will push lending rates higher *and* push deposit rates lower relative to the OCR. There is no reason to suppose that the neutral OCR will change when the interest rates prevailing in the economy are moving in two different directions.

Of course, we do expect the OCR will react to the economic consequence of the bank capital requirements, but that is transitional only.

The Reserve Bank appears to be thinking along the same lines. They emphasised that the capital requirements will affect both deposit and loan rates and made no mention of a lower neutral OCR, but did say that the OCR could react to the economic consequences.

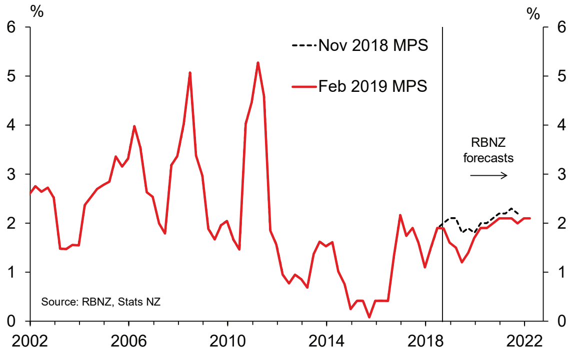
For the record, we reduced our OCR forecast by 25 basis points over a five year period after the bank capital requirements were proposed.

Market reaction

Financial markets have been moving towards pricing in the possibility of an OCR cut by the end of this year. Today's statement was a definite mark against that view. Consequently, the New Zealand dollar rose by 0.7 cents to 0.6800 and swap rates rose by 4 basis points.

Dominick Stephens
Chief Economist

RBNZ inflation forecasts



Full RBNZ statement

The Official Cash Rate (OCR) remains at 1.75 percent. We expect to keep the OCR at this level through 2019 and 2020. The direction of our next OCR move could be up or down.

Employment is near its maximum sustainable level. However, core consumer price inflation remains below our 2 percent target mid-point, necessitating continued supportive monetary policy.

Trading-partner growth is expected to further moderate in 2019 and global commodity prices have already softened, reducing the tailwind that New Zealand economic activity has benefited from. The risk of a sharper downturn in trading-partner growth has also heightened over recent months.

Despite the weaker global impetus, we expect low interest rates and government spending to support a pick-up in New Zealand's GDP growth over 2019. Low interest rates, and continued employment growth, should support household spending and business investment. Government spending on infrastructure and housing also supports domestic demand.

As capacity pressures build, consumer price inflation is expected to rise to around the mid-point of our target range at 2 percent.

There are upside and downside risks to this outlook. A more pronounced global downturn could weigh on domestic demand, but inflation could rise faster if firms pass on cost increases to prices to a greater extent.

We will keep the OCR at an expansionary level for a considerable period to contribute to maximising sustainable employment, and maintaining low and stable inflation.

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