Economic Bulletin.

13 November 2019

Half marks for showing your working – Review of RBNZ Monetary Policy Statement, November 2019.

- The RBNZ kept the OCR on hold at 1.0%.
- Markets were shocked, but we are less surprised.
- This was always a close call, and even the RBNZ said it could have gone either way.
- The RBNZ remains 50/50 on the odds of a future OCR cut, setting up February as another nail biter.
- We are forecasting a February cut, based on our view that global volatility will return.
- However, we retain our view that 0.75% will be the low point for the OCR, because anything lower would overstimulate house prices.

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The Reserve Bank has kept the OCR on hold at 1.00%, although the final sentence of the press release said: "We will add further monetary stimulus if needed." The RBNZ's OCR forecast reached a trough of 0.9%, which implies that it thinks there is a 50/50 chance that it will have to reduce the OCR again at some point.

Financial markets were shocked, but we are less surprised. In October we pointed out that the RBNZ had never signalled a November cut, and the information available up to that time did not justify a change in stance. At that time, we predicted that the RBNZ would leave the OCR on hold and issue a 0.9% OCR forecast.

However, yesterday's weak inflation expectations data changed the balance of available information, prompting us to switch to forecasting a cut. Of course, we are ruing that now! But what our vacillation really illustrates is that this was always a close call. The RBNZ confirmed that, saying that the Monetary Policy Committee (MPC) debated the costs and benefits of cutting or remaining on hold, noting that "both actions were broadly consistent with the current OCR projection." It really could have gone either way.

We are sticking to our long-held view that 0.75% will be the low-point of the current economic cycle, whereas most others are forecasting a lower terminal OCR. We are now pencilling in the final cut in the cycle for February, on the basis that we expect a deterioration in global economic news between now and then. However, February is going to be another tough call given the RBNZ's 50/50 stance. We will watch carefully how the data evolves relative to the RBNZ's forecasts, and will update our forecasts accordingly.

The RBNZ's assessment today was that "economic developments since the August *Statement* have been offsetting for the monetary policy outlook," and we more or less agree with that. GDP growth is currently weak, and as anticipated the RBNZ downgraded its near-term GDP forecast. However, the RBNZ pointed out that commodity prices remain robust, the exchange rate has fallen, inflation surprised to the upside, and the labour market remains tight. Given this mix, the RBNZ decided to leave the OCR unchanged this time.

There were two aspects of today's decision that did stick out for us. We were surprised that the RBNZ placed so little weight on the drop in inflation expectations observed in yesterday's survey. This was justified by the RBNZ pointing out that market-based measures of inflation expectations had actually risen, and in the press conference the Governor said that inflation expectations surveys can be backward-looking.

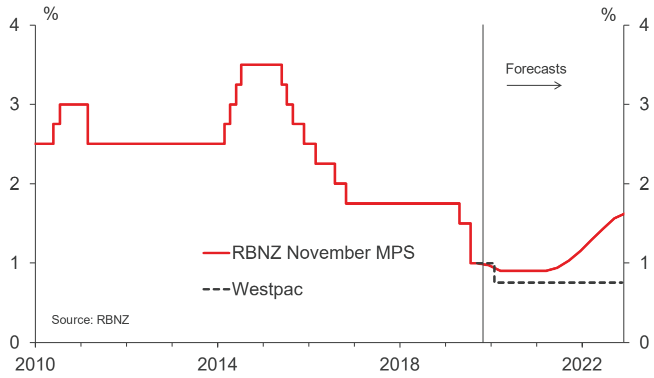
Second, the RBNZ has downgraded its assessment of potential GDP growth (the economy's non-inflationary growth rate). We suspect that this was an important part of the decision to keep the OCR on hold. A general narrative running through the *Monetary Policy Statement* was that domestic inflation is increasing. The RBNZ noted that despite slowing GDP growth the labour market remained tight, there were various other signs of capacity pressures in the economy, and domestic inflation seems to be rising. The conclusion from this was that potential growth is lower, meaning inflation will rise earlier in the next growth upturn.

The next OCR decision is in February, and once again the outcome will depend on the data between now and then. Given the RBNZ's current 50/50 stance, it would take a downside surprise of some kind to prompt the RBNZ to cut. We suspect that such a downside surprise could occur on the international front – our view is that global economic sentiment will deteriorate early next year as a slowdown in the US economy becomes more apparent. On that basis, we are forecasting a cut to 0.75% in February.

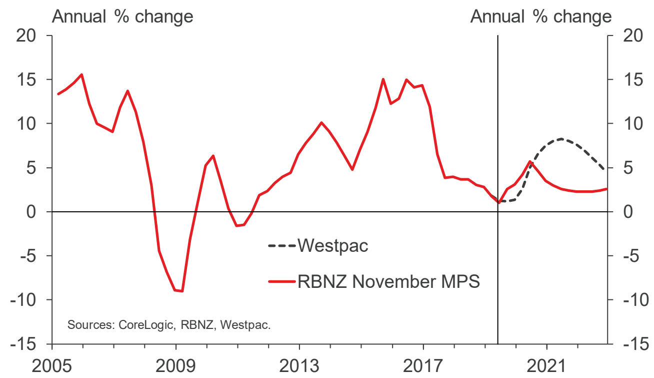
Secondly, the RBNZ has not yet incorporated its proposal for higher bank capital requirements into its monetary policy projections. The final decision on bank capital requirements will be announced in early December, and so it must form part of the Monetary Policy Committee's thinking in February. Furthermore, by that point the RBNZ will know more about how interest rates are actually going to respond to the capital requirements.

However, the key vulnerability to our February call is the housing market, which is currently picking up courtesy of low interest rates and the cancellation of plans to implement a capital gains tax. The RBNZ presumably thinks that this will fizzle, because its house price inflation forecast for 2020 is just 3.5%. Our own forecast is 7.4%. If there is sufficient heat in the housing market as early as February, the RBNZ may keep the OCR on hold.

RBNZ and Westpac Official Cash Rate forecasts



House price forecasts



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