Hinting strongly

Review of the RBNZ's June OCR Review

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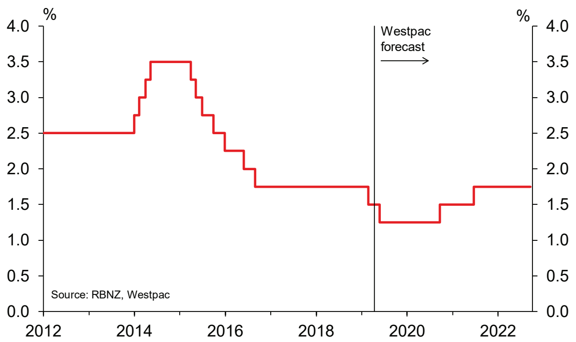
- The RBNZ kept the OCR on hold at 1.5%.
- However, it said that a lower OCR "may be needed" or "was likely" in different parts of the document.
- This was very blunt language, and is a strong signal for a cut in the future.
- The RBNZ remains mainly focussed on the global economy, and particularly the trend towards lower interest rates at overseas central banks. It is more ambivalent about the domestic economy.
- We remain happy to forecast an OCR cut at the August MPS meeting.

Official Cash Rate forecast



As expected, the Reserve Bank left the OCR unchanged at 1.5% at its June OCR Review.

However, the RBNZ strongly hinted that it could reduce the OCR to 1.25%. The press release repeatedly stated that the outlook had weakened, and twice said that "a lower OCR may be needed."

The record of Monetary Policy Committee (MPC) meetings was stronger, stating that "members agreed that more support from monetary policy was **likely** to be necessary" (our emphasis). The MPC "discussed the merits" of an immediate cut, but decided against such a move, instead noting again that a lower OCR may be needed over time.

This is very blunt language from the RBNZ, which has tended to keep its signalling fairly ambiguous in recent times. For example, back in March the RBNZ's language was the innocuous-sounding "the more likely direction of our next OCR move is down." That was followed by an actual OCR cut at the next meeting. By comparison, this is a very direct signal that the OCR is likely to head lower at some time.

The tone of the RBNZ's language leaves us happy with our call that the OCR will be cut in August. Markets are now pricing roughly a 75% chance of an OCR cut at that time, which seems about right to us.

The detail of the press release and record of meeting confirmed that the RBNZ remains heavily focussed on the global economy. The fact that the global economic outlook has weakened, and that downside risks have intensified, got plenty of column inches. The new feature was the RBNZ's claim that the global slowdown is affecting the New Zealand economy via confidence, for example by dampening business investment, as well as via trade and financial channels.

Meanwhile, the RBNZ's assessment of the domestic economy was more mixed, and was broadly in line with our own assessment of recent developments. The press release emphasised the negatives, but the record of meeting revealed that both positives and negatives were discussed.

GDP was stronger than the RBNZ expected, but the Committee discussed whether this would continue. That aligns with our own observation that some recent data has been quite weak.

The housing market recently has been weaker than the RBNZ expected, but the RBNZ noted the impact that lower mortgage rates and the cancellation of capital gains tax could have. We interpret that to mean that the RBNZ is standing by its forecast of accelerating house price inflation, as are we.

The RBNZ acknowledged that increased government spending was a positive for the outlook, although they discussed the possibility that the spending will be delayed. Again, that accords with our own assessment that stimulatory fiscal policy is an important, and often overlooked, element of the monetary policy debate in New Zealand.

One interesting strand of thinking that remains in the RBNZ's commentary is capacity constraints, which were discussed in the context of the labour market and the construction sector. Our interpretation is that one or more members of the MPC remain worried about capacity constraints and the potential for inflation. However, the dominant theme was certainly downside risks, and the RBNZ was very explicit that the outlook for inflation and employment has weakened.

Over all, this was a fairly clear signal from the RBNZ that sets the scene for an August OCR cut, although it by no means seals the deal.

This statement was close to market expectations. However, interest rates and the exchange rate rose slightly simply because the small chance of an OCR cut today was removed from market pricing.

Full RBNZ Statement

Official Cash Rate unchanged at 1.5 percent

The Official Cash Rate (OCR) remains at 1.5 percent. Given the weaker global economic outlook and the risk of ongoing subdued domestic growth, a lower OCR may be needed over time to continue to meet our objectives.

Domestic growth has slowed over the past year. While construction activity strengthened in the March 2019 quarter, growth in the services sector continued to slow. Softer house prices and subdued business sentiment continue to dampen domestic spending.

The global economic outlook has weakened, and downside risks related to trade activity have intensified. A number of central banks are easing their monetary policy settings to support demand. The weaker global economy is affecting New Zealand through a range of trade, financial, and confidence channels.

We expect low interest rates and increased government spending to support a lift in economic growth and employment. Inflation is expected to rise to the 2 percent mid-point of our target range, and employment to remain near its maximum sustainable level.

Given the downside risks around the employment and inflation outlook, a lower OCR may be needed.

Meitaki, thanks.

Summary record of meeting

The Monetary Policy Committee agreed that the outlook for the economy has softened relative to the projections in the May 2019 Statement.

The Committee noted that inflation remains slightly below the mid-point of the inflation target and employment is broadly at its maximum sustainable level. The Committee agreed that a lower OCR may be needed to meet its objectives, given further deterioration in the outlook for trading-partner growth and subdued domestic growth.

Relative to the May Statement, the Committee agreed that the risks to achieving its consumer price inflation and maximum sustainable employment objectives are tilted to the downside.

The members noted that global economic growth had continued to slow. They discussed the recent falls in oil and dairy prices, and that several central banks are now expected to ease monetary policy to support demand.

The Committee discussed the ongoing weakening in global trade activity. A drawn out period of tension could continue to suppress global business confidence and reduce growth. Resolution of these tensions could see uncertainty ease.

The Committee discussed the trade, financial, and confidence channels through which slowing global growth and trade tensions affect New Zealand. The members noted in particular the dampening effect of uncertainty on business investment. Some members noted that lower commodity prices and upward pressure on the New Zealand dollar could see imported inflation remain soft.

While global economic conditions had deteriorated, the Committee noted that domestic GDP growth had held up more than projected in the March 2019 quarter. The members discussed disparities in growth across sectors of the economy, with construction strong and services weak. The members also discussed whether some of the factors supporting growth in the quarter would continue.

The members noted two largely offsetting developments affecting the outlook for domestic growth: softer house price inflation and additional fiscal stimulus.

The Committee noted that recent softer house prices, if sustained, are likely to dampen household spending. The Committee also noted the recent falls in mortgage rates and the Government's decision not to introduce a capital gains tax.

The Committee noted that Budget 2019 incorporated a stronger outlook for government spending than assumed in the May Statement. The members discussed the impact on growth of any increase in government spending being delayed, for example due to timing of the implementation of new initiatives and current capacity constraints in the construction sector.

The members discussed the subdued nominal wage growth in the private sector and the apparent disconnect from indicators of capacity pressure in the labour market. The Committee discussed the possibility of this relationship re-establishing. Conversely, the continuing absence of wage pressure could indicate that there is still spare capacity in the labour market. Some members also noted that reduced migrant inflows could see wage pressure increase in some sectors.

The Committee discussed whether additional monetary stimulus was necessary given continued falls in global growth and subdued domestic demand. The members agreed that more support from monetary policy was likely to be necessary.

The Committee discussed the merits of lowering the OCR at this meeting. However, the Committee reached a consensus to hold the OCR at 1.5 percent. They noted a lower OCR may be needed over time.

Attendees:

Reserve Bank staff: Adrian Orr, Geoff Bascand, Christian Hawkesby, Yuong Ha

External: Bob Buckle, Peter Harris, Caroline Saunders

Observer: Gabriel Makhlouf

Secretary: Chris McDonald

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