One out of the hat

RBNZ OCR Review, March 2019

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- The RBNZ surprised us by shifting to an easing bias.
- With other central banks adopting more dovish stances, the RBNZ feared that failure to follow suit could cause the exchange rate to rise.
- We interpret today as a shift in the balance of risks, not a signal of an imminent cut.
- Forecasting the OCR is clouded by the fact that a committee is about to take over the decisions.
- We will learn more about that committee, and therefore the OCR outlook, in the coming two days.

The Reserve Bank surprised us today by shifting to an easing bias for the OCR.

The RBNZ has shifted its rhetoric, now saying that *"the more likely direction of the next OCR move is down."* It also said that the balance of risks to the economic outlook *"has shifted to the downside."* This is very different to February, when the RBNZ said the next move could be *"up or down"* and that there were *"both upside and downside risks."*

This change in stance surprised us, because the economic situation has changed little since the RBNZ gave a comprehensive view on the economy, and concluded that the OCR outlook was flat, in February. Recent GDP data showed that the domestic economy has kept ticking over. Consumer spending, construction data and export commodity prices have been very strong. And the exchange rate is close to the RBNZ's expectations. The global economy continues to weaken, but the Reserve Bank was cognisant of that in February and the situation has changed little since then. Admittedly, we have had a weak read on monthly business confidence and housing market turnover has dropped sharply, but those would be flimsy grounds upon which to justify a change in monetary policy stance.

Instead, the RBNZ appears to have been driven by the actions of overseas central banks, many of whom have shifted to more dovish monetary policy outlooks. The RBNZ is worried that retaining a neutral OCR stance would make New Zealand stick out like a sore thumb, causing an undesirable rise in the New Zealand dollar. In turn, a higher exchange rate could suppress inflation.

The RBNZ might also be losing faith in its long-held view that the New Zealand economy will pick up sufficiently to boost inflation. We have long thought that the RBNZ was too bullish on the economy, and over the second half of 2018 the economy clearly fell short of their previous expectations. The question is why the RBNZ chose now to change its view, when the evidence that the economy was falling short accumulated before February. Personnel changes at the RBNZ might have been a factor.

Markets' thinking will now turn to whether the RBNZ is going to cut the OCR, and if so, when.

Our interpretation is that the RBNZ is leaving open the option of cutting the OCR if required, rather than signalling that a cut is imminent. This was a statement about a shift in balance of risks. Our current forecast is that the OCR will remain unchanged over the coming three years, but today does challenge that view. We will be watching over the next few days for further clues as to the RBNZ's intentions.

The complication with forecasting the OCR at present is that a Monetary Policy Committee is about to take over the OCR decisions. The new committee could hold different views to the current leadership. We expect the Minister of Finance to announce the membership of the RBNZ's new Monetary Policy Committee either tomorrow or Friday, given that it takes over OCR decision making on Monday 1 April. The composition of that committee will influence our thinking on what the RBNZ might do.

The next clue to the RBNZ's thinking – and how the Committee might influence that – will come on Friday at 9:00am when the Governor gives a speech on the new monetary policy decision making structure.

Then on Tuesday next week we will get the Quarterly Survey of Business Opinion (QSBO). Business confidence is highly likely to plunge, because surveying occurred shortly after the Tax Working Group gave its recommendation of a Capital Gains Tax. But beneath the headline, the QSBO will give a valuable read on whether the economy is picking up enough for the RBNZ to avoid cutting.

But perhaps the biggest influence on the RBNZ's actions will be what other central banks do, and how the exchange rate responds, given the emphasis these received today.

We expect the Reserve Bank of Australia to reduce its cash rate in August and November this year, which could well influence the RBNZ. However, we do not expect the Federal Reserve to cut.

Markets were as surprised as we were by the RBNZ's about-face. The exchange rate fell a cent, and the two-year swap rate fell 14 basis points. That drop in swap rates will probably lead to further mortgage rate reductions, on top of the sharp falls we have seen in recent weeks. In turn, that could stimulate the housing market, which is flagging in Auckland and Canterbury but booming in some other parts of the New Zealand.

Full RBNZ statement

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.

The global economic outlook has continued to weaken, in particular amongst some of our key trading partners including Australia, Europe, and China. This weaker outlook has prompted central banks to ease their expected monetary policy stances, placing upward pressure on the New Zealand dollar.

Domestic growth slowed in 2018, with softness in the housing market and weak business investment contributing.

We expect ongoing low interest rates, and increased government spending and investment, to support economic growth over 2019. Low interest rates, and continued employment growth, should support household spending and business investment. Government spending on infrastructure, housing, and transfer payments 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.

The balance of risks to this outlook has shifted to the downside. The risk of a more pronounced global downturn has increased and low business sentiment continues to weigh on domestic spending. On the upside, 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.

Meitaki, thanks.

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