Economic Bulletin.

31 October 2019

Hold the horses – Change of OCR call.

- We are now forecasting no change in the OCR at the November MPS.
- The balance of recent domestic data does not justify a cut, global sentiment has improved, and overseas central banks have indicated they will pause.
- We expect the RBNZ will remain open to future OCR cuts if necessary, similar to the rhetoric issued in September.
- The RBNZ's OCR forecast will continue to imply a 50/50 chance of a future cut.
- We are now forecasting a cut in February, based on our view that global economic sentiment will worsen again.
- Holding the OCR in November would surprise financial markets, causing a lift in interest rates and the exchange rate.

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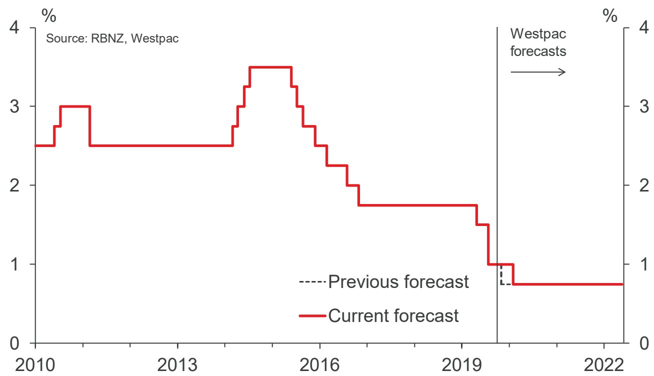
Westpac Official Cash Rate forecast



We are now forecasting that the RBNZ will keep the OCR unchanged at the November Monetary Policy Statement.

Previously, we were forecasting a 25 basis point cut in November, although we considered it a very close call. The RBNZ's forecasts and rhetoric had been 50/50 on whether a cut might be required at some stage, but we thought a rash of downside surprises would prompt the RBNZ to cut as soon as November.

That is not the way the dice have fallen. True, economic growth remains subdued and business confidence is very low. But on balance the outlook for inflation and employment has actually lifted a little since August, because the exchange rate is well down, inflation has surprised to the upside, and the housing market is stirring. In addition, global financial market sentiment has improved and the US and Australian central banks are suggesting that they have cut rates far enough for now.

Given all of this, we now favour no cut in November. However, we do expect the RBNZ will remain open to the possibility of future cuts, depending on how the data evolves – this will be an ongoing pause for information, rather than the end of the easing cycle. We expect the RBNZ's rhetoric will be similar to the September OCR Review, when it said *"new information since the August* Monetary Policy Statement *did not warrant a significant change to the monetary policy outlook."* But like September, we expect the RBNZ to repeat that *"there is scope for more fiscal and monetary stimulus, if necessary"* and to publish an OCR forecast that reaches 0.9%, thereby implying a 50/50 chance of an OCR cut next year.

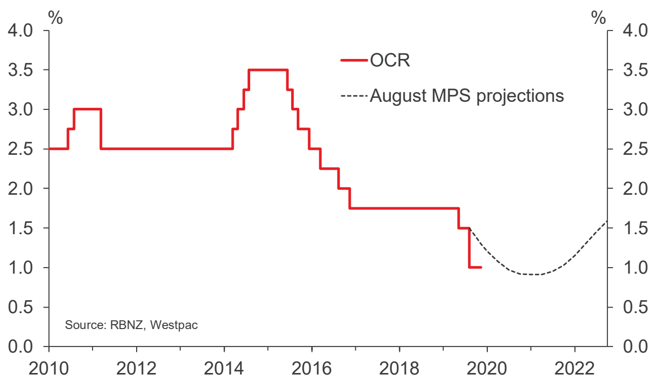
We still expect the RBNZ to cut the OCR to 0.75%, but we now expect that will occur in February next year. By that stage, we forecast that the current phase of improving global market sentiment will have given way to renewed uncertainty, particularly as the US presidential election race heats up. We expect that both the US Federal Reserve (Fed) and the Reserve Bank of Australia will have to restart their easing cycles, creating conditions more conducive to an RBNZ cut.

The November MPS remains a very close call. Between now and November 13 there are two key events that could either cement our on-hold forecast or tip the balance back in favour of a cut: the quarterly labour market figures on November 6, and the RBNZ survey of inflation expectations on November 12.

Developments since the August MPS have been neutral at worst.

The RBNZ's forecasts in August had the OCR reaching a low of 0.9%, which implied a 50/50 chance of another OCR cut at some point. Since August there has been a mix of positive and negative developments, as detailed below. Our analysis suggests that the balance of these developments has been slightly *positive* for the RBNZ's inflation and employment forecasts. However, the RBNZ is acutely sensitive to downside risks at present, so we expect they will discount some of the inflation-positive developments. We expect that the published OCR forecast will be the same as the forecast issued in August, featuring a low in the OCR of 0.9%.

RBNZ OCR forecast

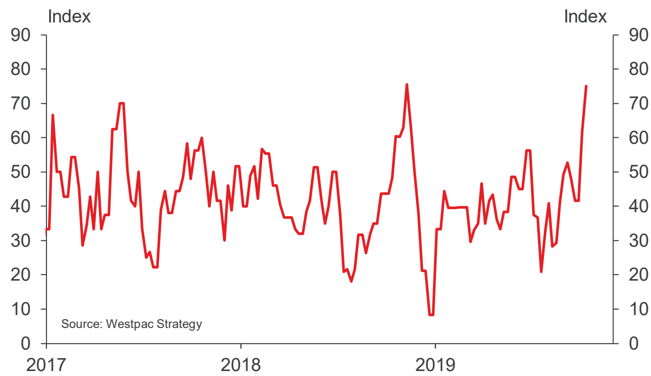


The economy is weaker than the RBNZ expected. The key negative development since August has been ongoing low business confidence and slow economic growth. GDP growth patently did not live up to the RBNZ's forecast of 0.6% quarterly growth in September – we are thinking more along the lines of 0.3%. The RBNZ will have to downgrade its GDP forecast, and that will put downward pressure on its inflation and employment forecasts.

However, there are other developments that will put upward pressure on the inflation forecast, and to a lesser extent on the employment forecast.

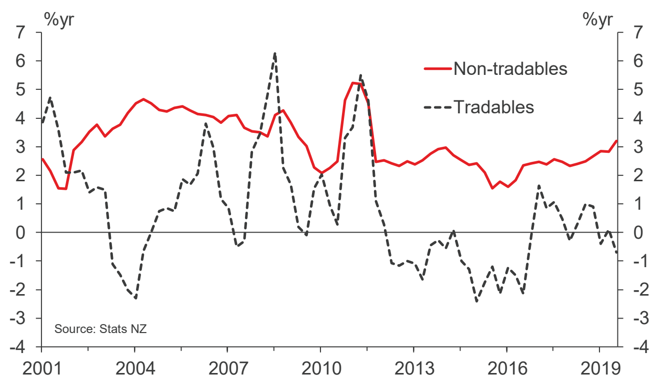
Recent high-frequency data has been stronger. Second-tier data such as electronic card transactions, job ads and car sales have been picking up recently. Westpac's data surprise index, which measures recent data relative to expectations, was very low in August but has subsequently risen to its strongest level since late-2018. This may give the RBNZ some comfort that the economy is on track to recover over 2020.

New Zealand data surprise index



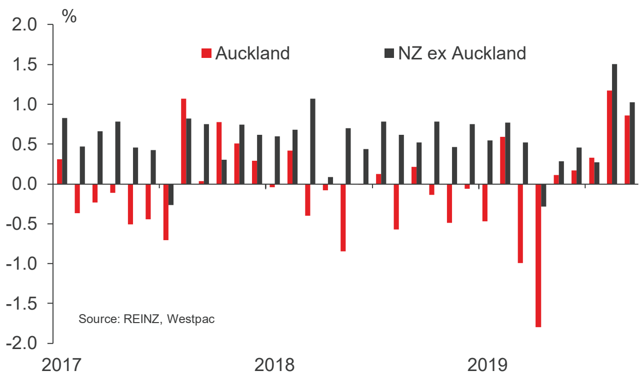
Inflation was stronger than expected. The RBNZ was braced for inflation dropping to 1.3%, but it actually only fell to 1.5% in the September quarter. Importantly, the domestically-generated, non-tradable part of inflation is now lifting more rapidly than the RBNZ anticipated. This will support the RBNZ's forecast of inflation returning to 2% by 2021.

Tradables and non-tradables inflation



The housing market is picking up. Over the past two months nationwide house prices have risen 2.6%, with a distinct turnaround in trajectory evident both in Auckland and elsewhere. The RBNZ had not been expecting a housing market pickup, but it was cognisant of the risk. Stronger house prices will tend to boost consumption spending, which is one aim of monetary stimulus. However, rising house prices could also create political and financial stability headaches for the RBNZ, so they will be wary of being seen to push the market too far.

Monthly seasonally adjusted increase in House Price Index



The exchange rate is much lower. On a trade-weighted basis the exchange rate has plunged since August, and is now more than 4% below the RBNZ's previous forecasts. A lower exchange rate tends to boost inflation, reducing the need for OCR cuts.

Global economic and financial market sentiment has improved. The RBNZ has been very sensitive to the ebb and flow of sentiment around the global economy and financial markets this year. It is fair to say that sentiment overall has lifted a bit recently – alarm about BREXIT and trade wars has not gone away, but it seems to have diminished. In August, the RBNZ made a lot of the fact that global long-term interest rates had fallen, indicating that markets expect a long period of low inflation and low interest rates. Fast forward three months and those same interest rates have risen 30 to 40 basis points across most countries. Similarly, share markets have continued to lift. Recent data on New Zealand exports has also been a little more positive, with rising dairy and forestry prices and even a small lift in tourist arrivals over the past few months.

Other central banks are pausing. The RBNZ would remain in step with key overseas central banks if it were to keep rates on hold in November. True, the Fed has just cut its policy rate. But another way to look at it is that the RBNZ, RBA and Fed have now all cut 75 basis points, and the RBA and the Fed have now shifted towards signalling pauses for information, which is what we expect from the RBNZ.

Strategy and tactics.

Even if the RBNZ keeps its OCR forecast at 0.9%, it could still decide to cut the OCR for tactical reasons. The strongest argument for doing so is that markets expect a cut. Keeping the OCR on hold could cause interest rates and the exchange rate to rise – even if the RBNZ "manages the market" by leaving the door open to future cuts if required, we still estimate that two-year swap rates would rise 10 to 20 basis points and the exchange rate would rise one to two percent. In turn, that would undo some of the inflation- and employment-boosting work that the RBNZ has done recently.

While this is a powerful point, we doubt it will be enough to push the RBNZ into cutting. First of all, it is a circular argument. The RBNZ is supposed to lead, not follow, markets. In recent times the RBNZ has shown absolutely no compunction about surprising financial markets. In a speech just this week Assistant Governor Christian Hawkesby bemoaned the fact that market pricing is often based on what markets think the RBNZ thinks, rather than providing independent information about how the economy is evolving:

"It can be easy to fall into the trap of delivering on market pricing out of fear of creating significant market volatility. However, this does not recognise how dependent markets have become on the communications from central banks in setting their own expectations."

In any case, financial markets are actually steadily shifting away from the idea of a cut in November – the implied odds of a cut have dropped from 100% to 70% and could fall further, making it easier for the RBNZ to remain on hold.

And finally, our analysis suggests that even if the exchange rate was two percent higher and mortgage rates rise a touch, the balance of recent developments would still leave the RBNZ's OCR forecast at 0.9%.

Risks abound.

There are two huge risks ahead that could either cement our call, or flip the balance back in favour of an OCR cut in November. Our current forecasts for these numbers suggest they will not justify a strong case for a move in November. However, if we are surprised on either variable, we will adjust our forecast as appropriate.

Labour market data on November 6 is likely to be weak. Back in August the RBNZ forecast that unemployment would rise to 4.4% by September 2019. June unemployment figures were released one day before the RBNZ's decision, but after their forecasts had been completed. They showed that unemployment had actually dropped to an eleven-year low of 3.9%. We expect that will reverse when the September figures are released next week – we predict an unemployment rate of 4.2%, and no doubt the RBNZ has something similar in mind. But the uncertainties are wide. If unemployment stays low, then an on-hold OCR decision would become even more likely. A jump in unemployment to 4.5% or higher could tip the balance in favour of a cut.

Inflation expectations data on November 12 could do anything. In August the RBNZ heavily emphasised falling inflation expectations to justify the 50 basis point cut. There were two legs to this. First, financial market pricing for inflation (derived from inflation-linked bond prices) implied low long-term inflation around the world. These measures have risen sharply since August, including in New Zealand, which is another argument for keeping the OCR on hold. However, the second leg to the RBNZ's concern was its own survey of inflation expectations, which dropped sharply just prior to the August MPS. The RBNZ knows the result of this survey before it is released to the market – the September quarter results will be in the RBNZ's hands already, whereas the market will not find out until November 12, the day before the MPS. We expect two-year ahead expectations to remain roughly steady at around 1.86%. However, if surveyed expectations instead drop further, we would probably revert to calling an OCR cut in November.

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