Economic Bulletin.

2 March 2020

Change of OCR call: RBNZ to cut 25bp in March.

- **We now expect the RBNZ to cut the OCR by 25 basis points to 0.75% at the 25 March review.**
- **That would follow an expected 25bp cut in Australia and a 50bp cut in the US this month.**
- **The risks to the global economy from the spread of Coronavirus have escalated substantially in recent days.**
- **Central banks are likely to respond in order to shore up confidence and soften the impact on demand.**
- **We continue to expect a low of 0.75% for the OCR this year, but we will continue to update our view as the global situation evolves.**

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The spread of Coronavirus, and its potential for disruptive effects on the global economy, have escalated substantially in the last week. We now expect the Reserve Bank of New Zealand to cut the Official Cash Rate by 25 basis points to 0.75% at its next review on 25 March.

While we had already been highlighting the likelihood of further central bank easing this year, it's becoming apparent that a rapid, worldwide response to the outbreak is warranted. Our forecast for an RBNZ rate cut follows an expected a 25bp cut by the Reserve Bank of Australia at tomorrow's review, and a 50bp cut by the US Federal Reserve after its meeting on 17-18 March.

The last few days alone have seen some major developments in the outlook for central bank policy:

- Following a further sharp sell-off in the US sharemarket on Friday, Fed Chair Powell made a highly unusual unscheduled statement near the close of trading, noting that: "We will use our tools and act as appropriate to support the economy".
- Chinese activity indicators for February showing a plunge from 50.0 to 35.7 in the manufacturing PMI (even lower than the previous record low of 38.8 during the GFC), while the services PMI fell from 54.1 to 29.6. Both these levels were significantly below market expectations.
- Developments outside China continue to alarm. In the last five days we have seen cases reported in 20 new countries, with 20 countries now reporting local transmission.
- Financial market pricing has rapidly shifted to interest rate cuts in the immediate future.

In that light, it looks increasingly likely that we'll see central banks around the world (including the RBNZ) ease monetary policy further, as both a confidence-boosting measure and to counter the still-uncertain impact on demand.

An OCR cut in March would be a major turnaround compared to the RBNZ's February *Monetary Policy Statement*, which assumed only a small temporary hit on GDP and regarded the outbreak as a look-through event. However, we know that the RBNZ is part of a whole-of-government group looking at the potential impacts of the outbreak, and the Finance Minister's speech last week suggested that that group's thinking has since moved on, with the base case now being a drawn-out impact on economic activity over 2020.

Of course monetary policy can't solve every problem, and is particularly ill-suited for dealing with supply-side disruptions, which at least during the early stages of the outbreak looked like they would be a major channel for the impact on the New Zealand economy. But the situation is increasingly taking the form of a shock to demand, which will weigh on export prices and volumes, international travel, consumer spending patterns, and firms' hiring and investment plans.

It's also true that monetary policy is a blunt tool, but that may be a virtue in this instance – interest rates "get into all the cracks" as the saying goes. In any case, the blunt tool of monetary policy can be (and most likely will be) coupled with more targeted fiscal measures.

Our forecasts already included a 25bp OCR cut in August this year, based on a slowing in global growth and further rate cuts from the Fed and the RBA this year. As such, our change of call represents a bringing-forward of the timing of that cut. We haven't made a call on the likelihood of further OCR cuts beyond March; that will depend on how the global situation evolves.

What about a more aggressive 50bp cut in March? We acknowledge that's a possibility, but we expect that the RBNZ will act proportionately. The RBNZ is coming off a more favourable starting point than its overseas counterparts, with inflation and employment both broadly in line with its mandate. The Government has both the scope and the willingness to use fiscal measures to soften the blow. And the falling exchange rate provides a useful safety valve for the New Zealand economy, more so than it might in a relatively closed economy like the US.

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