Economic Bulletin.

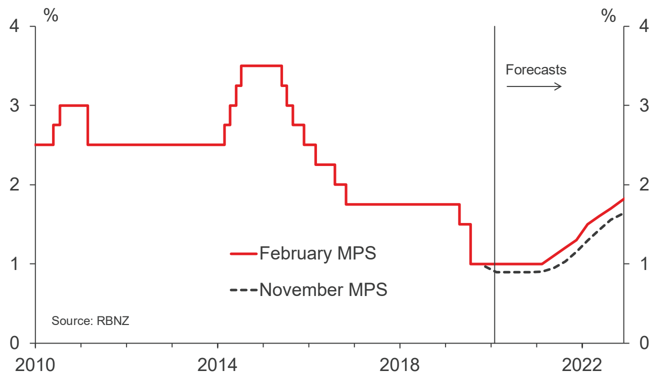
12 February 2020

Just a mild cold – Review of RBNZ Monetary Policy Statement, February 2020.

- The RBNZ left the OCR on hold and issued a neutral outlook.
- This was based on a very mild Coronavirus impact. If Coronavirus turns out more severe, the RBNZ said it would adjust the OCR as necessary.
- This was pretty much what we anticipated.
- The Government's planned infrastructure spend-up has influenced the RBNZ's outlook.
- The RBNZ studiously avoided mentioning the resurgent housing market until the second chapter. Presumably it fears copping criticism for rising house prices.
- We are still forecasting an August OCR cut, mainly because we expect global economic sentiment to deteriorate again.

Dominick Stephens, Chief Economist
+64 9 336 5671

RBNZ Official Cash Rate forecasts



At today's Monetary Policy Statement the Reserve Bank kept the OCR on hold, but upgraded the outlook. Previously the RBNZ had indicated a 50/50 chance of an OCR cut in the near future. Now the outlook is for the OCR to remain on hold, unless the economic impact of Coronavirus proves much worse. The RBNZ's OCR forecast was flat at 1.0% for this year, compared to 0.9% in the November MPS. The RBNZ said very little about the future of the OCR, except that it would have to stay low for a while and that there was time to adjust the OCR in response to Coronavirus if necessary.

Today's MPS was pretty much what we expected. Certainly, the RBNZ's assessment outside of Coronavirus was exactly what we anticipated. Their base case assumption for Coronavirus was rather mild, but anything said about Coronavirus today could be obviated by next week, so this is immaterial. The bottom line is that the RBNZ is on hold unless Coronavirus blows up into something much more severe, in which case it has scope to cut the OCR.

Markets were a little more surprised by the RBNZ's change of stance, so swap rates rose by about 5 basis points across the curve.

The RBNZ's assessment of inflation and employment has changed markedly. Whereas in November it said employment was "around" the maximum sustainable level, it is now described as "at or slightly above." Inflation has gone from being "below" to "close to" the target.

The most prominent rationale for the RBNZ's change of stance was fiscal policy. The Government's plan to spend an extra $12bn on infrastructure was (rightly) seen as stimulating the economy, reducing the need for the OCR to stay low.

The RBNZ was also influenced by signs of stabilisation in the global economic environment, recent stronger data on the labour market, and the stronger housing market and associated signs of stronger consumer spending.

What surprised us was that the RBNZ studiously avoided mentioning house prices in the press release or the Summary Record of Meetings – to the point of awkwardly dancing around the topic with phrases like "rising household wealth." This was a glaring omission. The recent turnaround in the housing market is the most obvious consequence of lowering interest rates, and is a key channel through which monetary policy is currently working. In chapter four of the MPS the RBNZ notes that stronger-then-expected house price inflation will drive higher consumer spending, and there has indeed been quite an upgrade to forecasts of both. This is presumably a key reason for the upgraded OCR outlook, yet it was not mentioned up front and there is no record of the Committee discussing it.

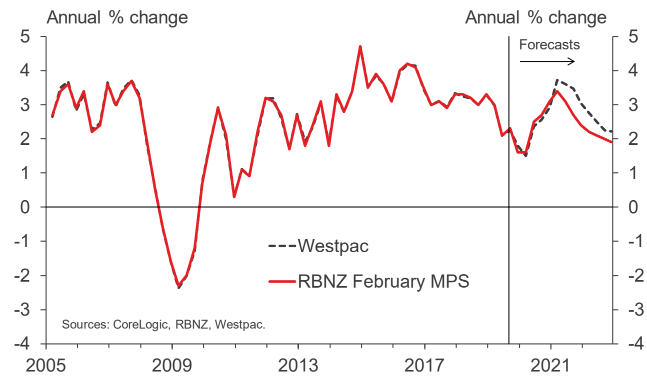
The RBNZ is on hold for now, but we still think an OCR cut is still possible

The RBNZ expects to keep the OCR on hold this year, unless Coronavirus blows up into something really severe for New Zealand. Despite that, we are forecasting an August OCR cut based on our view that the RBNZ will be surprised on certain aspects of the economy:

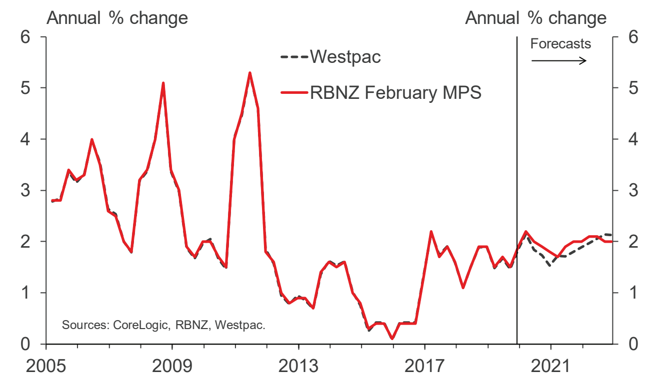
- We expect that global economic sentiment will deteriorate later this year, and a slowdown in US economic growth will lead to renewed interest rate reductions from the Federal Reserve. The RBNZ seems heavily influenced by the ebb and flow of global economic sentiment, so this would be important.
- The RBNZ expects a flat exchange rate this year, but we think it is more likely to rise as New Zealand outperforms economies like the US and Australia.
- Coronavirus may end up having a greater impact than the RBNZ anticipates.
- The RBNZ is forecasting inflation of 1.8% over 2020. We think that inflation will actually drop to 1.5% as transitory factors unwind and the exchange rate rises.
- The risks are to the downside of the RBNZ's very strong forecast of 2.5% GDP growth this year. In particular, the RBNZ is forecasting that the Government's infrastructure program will start with a hiss and a roar, whereas we are more inclined to expect delays.

On the other hand, we do expect the housing market to heat up more than the RBNZ expects. The RBNZ is forecasting peak of 7.7% house price growth, but it continues to forecast an unrealistically rapid cooling in the market. That is not going to happen as long as mortgage rates remain low. We expect a slightly higher peak rate of house price inflation, and a longer-lasting period of rising prices. However, this would not be enough to deter the RBNZ from cutting the OCR in an environment of weaker global economic sentiment.

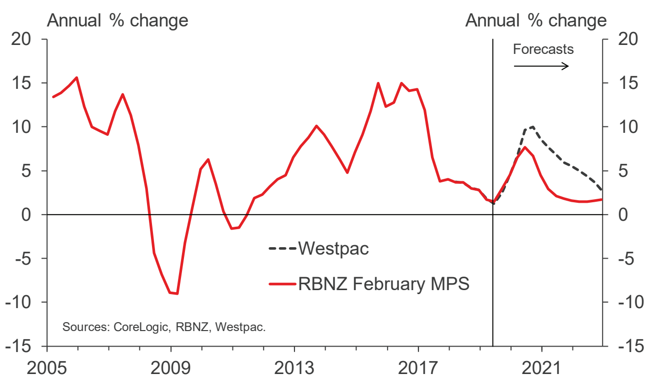
GDP forecasts



CPI forecasts



House price forecasts



Full RBNZ text:

Official Cash Rate remains at 1.0 percent

12 February 2020

Tēnā koutou katoa, welcome all.

The Monetary Policy Committee has decided to keep the Official Cash Rate (OCR) at 1.0 percent.

Employment is at or slightly above its maximum sustainable level while consumer price inflation is close to the 2 percent mid-point of our target range. Low interest rates remain necessary to keep employment and inflation around target.

Economic growth is expected to accelerate over the second half of 2020 driven by monetary and fiscal stimulus, and the high terms of trade. The outlook for government investment is stronger following the Government's announcements in December. There are also indications household spending growth will increase.

However, soft momentum in economic growth has continued into early 2020. Slower global growth over 2019 acted as a headwind to domestic growth. In addition, competitive pressures and recent subdued business confidence have suppressed business investment.

The global economic environment has shown signs of stabilising and trade tensions have receded somewhat. However, the COVID-19 (coronavirus) outbreak is an emerging downside risk.

We assume the overall economic impact of the coronavirus outbreak in New Zealand will be of a short duration, with most of the impacts in the first half of 2020. Nevertheless, some sectors are being significantly affected. There is a risk that the impact will be larger and more persistent. Monetary policy has time to adjust if needed as more information becomes available.

Meitaki, thanks.

Summary Record of Meeting - February 2020 Statement

The Monetary Policy Committee noted that employment was at or slightly above its maximum sustainable level while consumer price inflation was close to the 2 percent target mid-point. The Committee agreed that low interest rates had helped to get employment and inflation to around their target levels.

The Committee agreed that recent developments were consistent with continuing to meet their inflation and employment objectives, but the coronavirus situation was a complicating factor given how quickly it was changing and the limited information available.

The Committee discussed the reasons for an expected pick-up in growth over 2020, including monetary and fiscal stimulus and the high terms of trade.

The members noted the Government's announcement in December that it plans to invest more over the projection period. The Committee discussed that the impact of fiscal stimulus could be greater than assumed. This risk was balanced by potential delays in implementing approved spending and investment programmes.

The Committee noted that household spending growth was expected to accelerate due to lower interest rates and rising household wealth. Some members noted that the increase in consumption growth could be more persistent than projected.

The members noted that the high terms of trade has partly offset the effect of slower trading-partner growth on the New Zealand economy. Some members noted that export prices could ease by more than projected given some of the temporary factors lifting meat and dairy prices.

The Committee noted the strong labour market, and agreed it was an expected outcome of monetary stimulus. The members discussed the contribution of the tight labour market to wage pressure and any flow on to consumer price inflation, and noted the effects of recent minimum wage increases, pay equity settlements, and large collective agreements in public sector. Some members noted the potential for further upward wage pressure.

Although GDP growth was expected to rise, some members noted downside risks to near-term production.

The members noted the signs of stabilisation in global growth and that trade tensions had receded somewhat. However, they noted these signs were early and tentative and they agreed the coronavirus outbreak was a risk to global growth in 2020.

The Committee discussed the challenges facing the rural sector and the impact on the rest of the economy. The members noted the changes to environment policy, tightening credit conditions over 2019, recent dry conditions in parts of the North Island, floods in Southland, and the coronavirus outbreak. The members discussed how these challenges could dampen economic activity.

The members discussed the business investment outlook and noted that business sentiment remains low despite its recent improvement. The members noted that stretched capacity in the construction sector could see government projects compete resources away from the private sector, but they also noted the opportunities that new infrastructure creates for total investment. The members noted upside and downside risks to the business investment outlook.

The Committee discussed the initial assumption that the overall economic impact of the coronavirus outbreak in New Zealand will be of a short duration. The members acknowledged that some sectors were being significantly affected. They noted that their understanding of the duration and impact of the outbreak was changing quickly. The Committee discussed the monetary policy implications if the impacts of the outbreak were larger and more persistent than assumed and agreed that monetary policy had time to adjust if needed as more information became available.

The Committee discussed financial stability risks from ongoing low rates. The members noted the Bank's assessment that marginal changes to the OCR would not materially affect these risks at this time.

The members discussed the better mix of policy stimulus in the projections, given additional fiscal stimulus is reducing the burden on monetary policy.

The Committee discussed alternative OCR settings and the various trade-offs involved. The Committee agreed that ongoing low interest rates were needed to keep inflation and employment close to their mandated targets.

The Committee reached a consensus to keep the OCR at 1.0 percent.

Attendees

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

External: Bob Buckle, Peter Harris, Caroline Saunders

Observer: Tim Ng

Secretary: Chris McDonald

Contact the Westpac economics team.

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Paul Clark, Industry Economist
+64 9 336 5656

Any questions email:
economics@westpac.co.nz

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