Economic Bulletin.

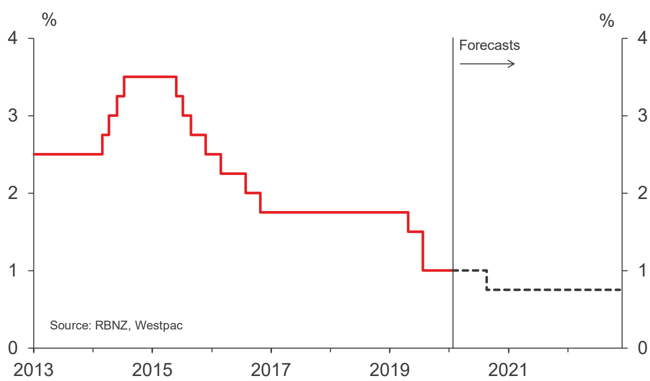
7 February 2020

Forecasting is like a box of chocolates – Preview of the RBNZ's MPS, Wed 12 February, 2:00pm.

- We expect the RBNZ to keep the OCR on hold at next week's Monetary Policy Statement.
- The OCR outlook will be on-hold with a risk of cuts if coronavirus severely disrupts the economy.
- Before coronavirus broke out, the RBNZ was probably ready to abandon its easing bias and switch to a neutral stance.
- But coronavirus is a huge unknown and has rekindled the risk of a lower OCR.

Dominick Stephens, Chief Economist
+64 9 336 5671

Westpac OCR forecast



In late January we announced that we expected the RBNZ would abandon its strong easing bias and move to a more neutral monetary policy outlook.[1] But in the forecasting game you never really know what you are going to get next. Coronavirus has stolen the show over the past week, altering the outlook. There is likely to be at least some economic impact, with a ban on foreigners travelling from China to New Zealand and forestry exports to China virtually halting.

The obvious strategy now is for the Reserve Bank to signal that the OCR is most likely to remain on hold, but they will stand ready to cut the OCR should that be required by the coronavirus situation. Should coronavirus quickly blow over like SARS did, then the Reserve Bank can revert to an on-hold outlook for the OCR at its next communique. Should economic disruptions from coronavirus intensify, the RBNZ may consider cutting the OCR to help offset any negative impact on employment.

We have fielded questions about whether the RBNZ might cut the OCR next week in response to coronavirus. We find that highly unlikely. Cutting the OCR now would be inappropriate because the uncertainty about how coronavirus might play out is so wide.

The Reserve Bank will face some communication challenges next week, because it will want to convey three separate messages:

1) The New Zealand economy and housing market have exceeded the RBNZ's expectations recently, to the point that the OCR outlook would have shifted to "on hold" had coronavirus not emerged.

2) If the coronavirus has a sharp but short disruptive impact on the economy, followed by a rapid recovery, then there would be little requirement for monetary policy to respond. This would constitute a "look through" event.

[1] Stephens, D. January 2020. "There or there abouts – Update on the OCR outlook" Westpac Economic Bulletin.

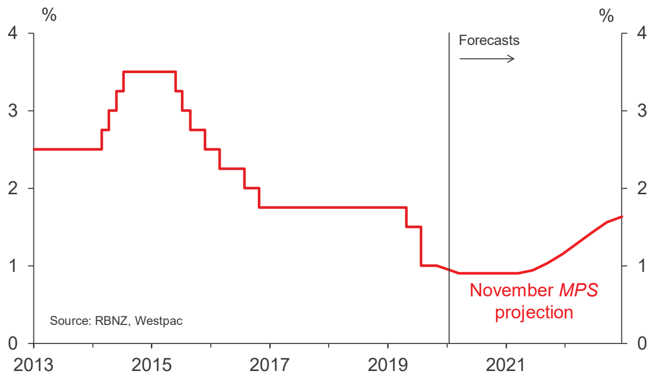
3) Should coronavirus have a longer-lasting or more severe disruptive impact on the economy, then the RBNZ would probably cut the OCR.

This would all be fairly simple for the RBNZ to express in words, just as we have. The RBNZ's key phrase could be something like "While we expect to keep the OCR on hold, we stand ready to reduce the OCR if warranted." This would amount to a conditional easing bias.

What the RBNZ does with its economic and OCR forecasts is trickier to anticipate. Most likely, the RBNZ's economic forecasts will be based on the coronavirus having a short, sharp disruptive impact followed by a rapid recovery. This would be based on known events such as the travel ban. We have already developed such a scenario and incorporated it into our forecasts, so the RBNZ should be able to do so too.[2] The RBNZ could then write a special topic on the possible economic impact of a pandemic, based on existing research.[3]

In this scenario the RBNZ's OCR forecast would probably be 0.9%, similar to the November MPS. This would reflect the possibility of OCR cuts in the near future (although the risk now relates to coronavirus whereas the risk in November stemmed from the general inflation outlook). However, the OCR forecast would probably begin rising above 1% earlier than the November MPS forecasts, to reflect the fact that the overall inflation outlook has lifted.

RBNZ Official Cash Rate forecast November 2020



An alternative option for the RBNZ would be to publish "ex coronavirus" economic forecasts. These would feature an OCR forecast of 1.0%. This could be accompanied by much verbiage about the range of possible coronavirus impacts, from nothing to severe.

What might have been.

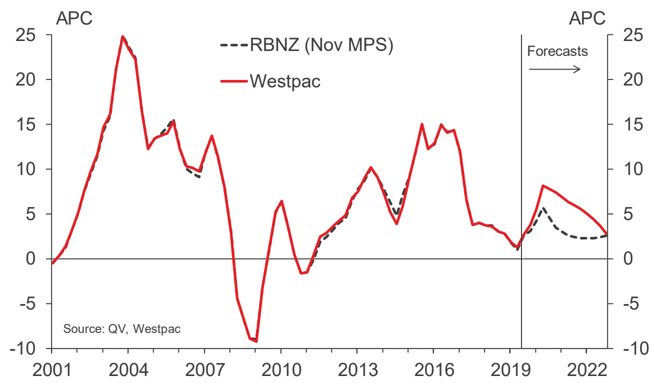
While coronavirus has stolen the show, it is still worth reviewing how the New Zealand economy has been shaping up in recent times, in order to set out the "ex-coronavirus" baseline. If it weren't for coronavirus, we think the RBNZ would have been ready to shift to an "on hold" OCR outlook.

Neither inflation nor employment give the RBNZ immediate cause to shift the OCR. Inflation has surprised to the upside over the past two quarters, and is going to pop above 2% briefly next year. Although that will prove fleeting, the best overall assessment is that core inflation is now only a shade below 2%. Meanwhile, the unemployment rate remains low at 4% and wage inflation is accelerating. Both unemployment and wages have exceeded the RBNZ's forecasts, so the RBNZ is likely to maintain its assessment that employment is close to its maximum sustainable level.

Meanwhile, there have been three recent economic developments that were stronger than the RBNZ expected:

The housing market is heating up. Last year the RBNZ treated the warming housing market as a blip, but that is no longer tenable. House prices are now rising much faster than the RBNZ previously expected, and the RBNZ will now have to switch to forecasting high-single-digit house price inflation over the period ahead.

House price forecasts – RBNZ and Westpac

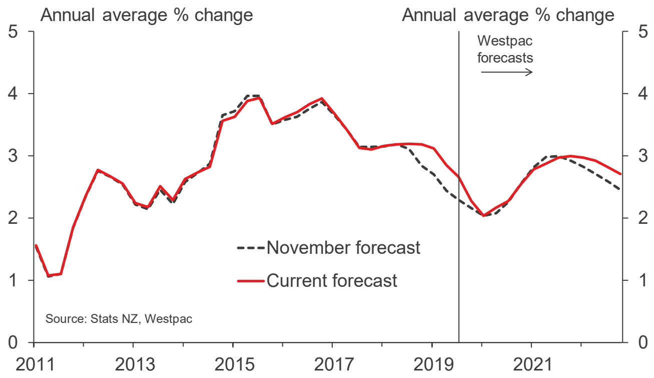


The Government announced a major infrastructure spend-up. Treasury estimated that the Government's $12bn of investment spending would boost GDP by 0.4 ppts over the coming four years, amounting to a significant fiscal stimulus.

New Zealand economic data has been stronger than expected. GDP growth in the September quarter was much stronger than the RBNZ expected, other data suggests the December quarter was also robust, and Stats NZ revised its estimates of 2018 economic growth significantly higher.

[2] Clark P and Stephens, D. February 2020. "Going viral – The economic impact of coronavirus on New Zealand" Westpac Economic Bulletin.
[3] Fukac, M and Lees, K. July 2009. "Swine flu: what are the impacts on the New Zealand economy – a macro-modelling approach" RBNZ Research Paper.

New Zealand GDP growth



These three developments will have outweighed the negatives, which are that until recently the exchange rate was higher than the RBNZ had forecast, and commodity prices have dropped. In particular, meat export prices were sky-high last year due to African Swine Fever infecting China's pigs, but meat prices fell hard recently after the Chinese Government loosened import restrictions and liquidated some inventories.

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

Past performance is not a reliable indicator of future performance. The forecasts given in this document are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Disclaimer.