Economic Bulletin.

31 January 2020

There or there abouts – Update on the OCR outlook.

- The RBNZ may shift to a neutral OCR outlook at the February MPS.
- Previously, the RBNZ implied there was a 50/50 chance of an imminent OCR cut.
- We think the RBNZ will shift to saying that it "expects to keep the OCR on hold but will react to the data as necessary".
- The RBNZ's OCR forecast is likely to be flat at 1.0%, compared to the previous 0.9%.
- Recent strong housing and economic data, as well as the announcement of a large increase in government infrastructure spending, will prompt the RBNZ's change of stance.
- This is all based on what we know to date. The coronavirus and data next week on the labour market and inflation expectations are key uncertainties that could change the outlook.

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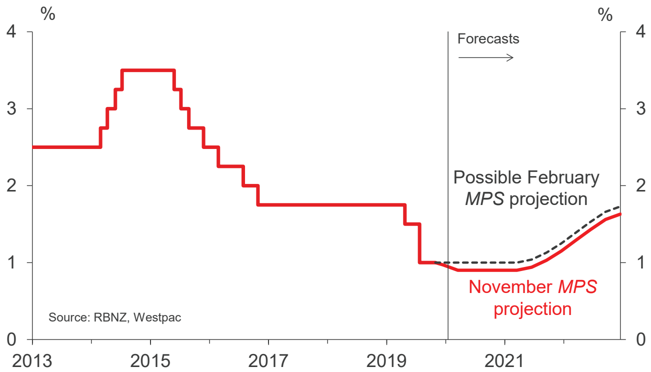
The Reserve Bank will issue its next Monetary Policy Statement (MPS) on February 13. There is still important data to come, such as next week's labour market report and inflation expectations data. And there are major uncertainties around the coronavirus. But based on what we know to date, we suspect the RBNZ is going to change its stance on the OCR outlook.

At both the August and November MPSs, the RBNZ implied there was a 50/50 chance of an OCR cut in the near future. The RBNZ's finger was on the OCR-cut trigger. This was implied not only by the RBNZ's language (*"We will add further monetary stimulus if needed"*), but also by the RBNZ's OCR forecast. The OCR forecast was 0.9%, half way between keeping the OCR at 1.0% and dropping it to 0.75%.

We think the RBNZ will abandon this strong easing bias and move to a more neutral monetary policy outlook. We expect the OCR forecast will be steady at 1.0% for at least the coming year. The flavour of the RBNZ's language may be that it expects to keep the OCR at its current level for an extended period, but will react to evolving data as necessary.

RBNZ Official Cash Rate forecasts



This would leave the RBNZ open to the *possibility* of an OCR cut, *if required*. For example, the RBNZ will almost certainly say that it stands ready to cut the OCR should the coronavirus severely impact the economy, or if something else untoward happens. However, we think an OCR cut would now require a higher burden of proof than previously.

The RBNZ will probably also repeat its long-held line that it expects to keep the OCR low for an extended period, to help ensure that markets do not overreact to the change of stance.

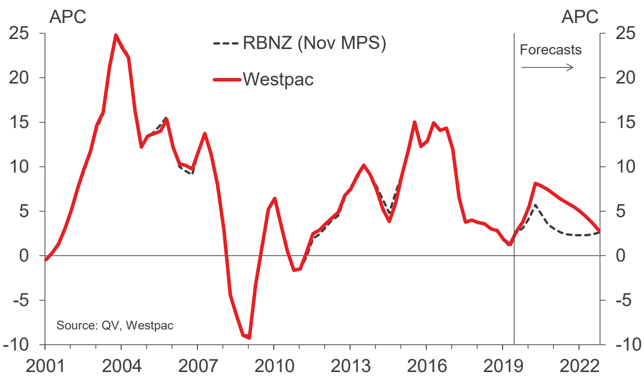
This would be a small surprise to financial markets, which have been steadily moving away from the idea of OCR cuts, but probably still expect the RBNZ to maintain its easing bias.

Neither inflation nor employment give the RBNZ immediate cause to shift the OCR. In recent times the battle has been below-target inflation. But 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%. Data next week will provide an update on the labour market, but it is unlikely to shift the RBNZ away from its assessment that employment is close to its maximum sustainable level.

Meanwhile, three recent developments will give the RBNZ cause to upgrade its assessment of where the OCR should be:

The housing market is heating up. Last year the RBNZ treated the warming housing market as a blip – the RBNZ's forecasts assumed that house price inflation would cool again in the immediate future. That assumption is no longer tenable. House prices are now rising much faster than the RBNZ previously expected. Whereas early last year we were the only major forecasters picking a housing market upturn, high-single-digit house price inflation is now almost universally expected.

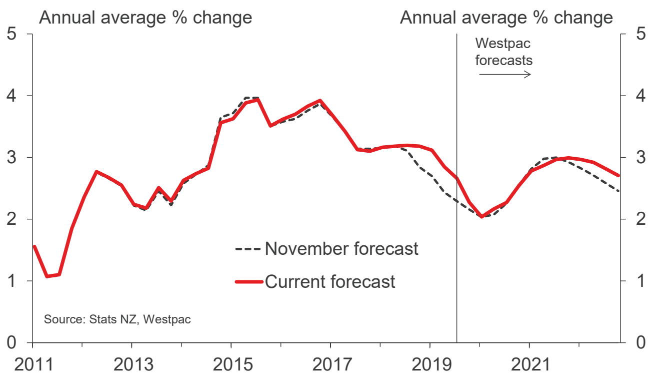
House price forecasts – RBNZ and Westpac



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. The RBNZ will be more circumspect – like us, it may worry that the Government won't get that spending out the door as quickly as planned. Even so, this will still amount to a large fiscal stimulus, equivalent to about 15 basis points on the OCR.

New Zealand economic data has been stronger than expected. GDP growth in the September quarter was much stronger than the RBNZ expected, and a range of other data suggests the economy is recovering from the 2019 slowdown. Importantly, the latest GDP data showed that 2018 economic growth was higher than previously thought. That will affect the RBNZ's assessment of where the economy is relative to its non-inflationary potential.

GDP growth revisions



There has also been a general improvement in global economic sentiment, following the US-China trade deal and the UK election. The RBNZ argued in a recent speech that global economic developments last year impacted New Zealand primarily via business sentiment. By that logic, the recent improvement in global economic sentiment will be what matters for the New Zealand economy. However, we are reluctant to add the global economy to the list of positives for monetary policy. Actual economic data has not improved much – in fact, Consensus forecasts of economic growth in New Zealand's trading partners have fallen since the November MPS. Not to mention that there are new sources of uncertainty such as the coronavirus.

As always, some recent developments will actually be negative for the OCR outlook, but in our assessment these are less important for monetary policy than the positives:

The exchange rate has risen. The trade weighted index is now around 1% higher than the RBNZ's most recent forecast.

Some export commodity prices have fallen. Late last year, prices for New Zealand meat exports were sky-high due to African Swine Fever affecting China's pork production. But the Chinese Government has subsequently loosened restrictions on meat imports and liquidated some stockpiles, causing meat prices to fall. Furthermore log prices, which were slowly rising late last year, have dropped a bit and look likely to fall further in the near term.

Uncertainties ahead.

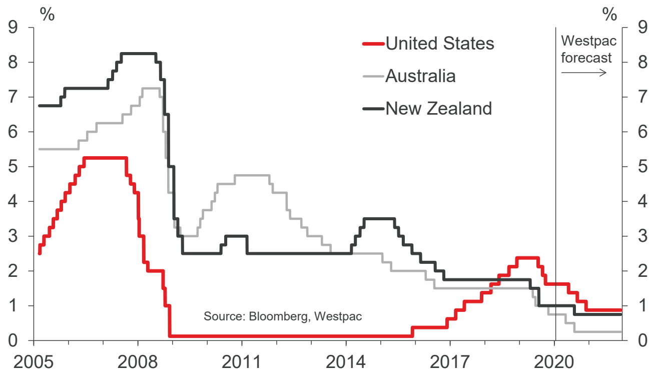
The coronavirus outbreak is a key uncertainty. If the situation worsens enough over the coming week, then the RBNZ could maintain its easing bias. More likely, the RBNZ will adopt a "wait and see" approach, saying that it will monitor the coronavirus and react if necessary. The RBNZ's central forecasts are unlikely to factor much impact from the coronavirus, as the situation is too uncertain to adequately predict at this stage.

The other key uncertainties are next week's labour market and inflation expectations data, either of which could affect the Reserve Bank's deliberations. Our expectation is that both pieces of data will be unremarkable, but if either produces a large surprise the RBNZ's overall stance could be affected.

Westpac OCR forecast.

We are expecting the RBNZ to keep the OCR on hold over the first half of 2020, so a shift in the RBNZ's tone this month would be consistent with our forecasts. However, we still think the longer-term risks are more tilted towards a lower OCR than higher. We expect the economic data to deteriorate in both the US and Australia. Consequently, we expect both the Fed and the RBA to reduce official interest rates this year by more than markets currently anticipate. If we are correct about that, the RBNZ may be forced to follow suit lest the exchange rate rise unhelpfully. We have pencilled in an OCR for August this year, reflecting where we think the balance of risks lie.

Westpac forecasts of central bank interest rates



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