

RBNZ keen to stay ahead of global slowdown

Preview of June OCR Review and change of OCR call

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- We expect the RBNZ to leave the OCR on hold next week.
- The RBNZ will probably reiterate that it has an easing bias.
- The RBNZ will express concern about deepening risks to the global economy.
- The increasing likelihood that other central banks will reduce interest rates will also be mentioned.
- The domestic outlook has not changed much, but these global risks increase the likelihood that the RBNZ will cut again.
- We are now forecasting an August OCR cut.
- The consequent drop in mortgage rates gives us even more reason to expect an upturn in the housing market and the New Zealand economy over the year ahead.

In May the RBNZ cut the OCR and said that the outlook was finely balanced between having to cut once more at some stage, or leaving the OCR on hold at 1.5% for an extended period. The RBNZ has repeatedly said that it is now in “data watching mode”, meaning it could jump either way depending what happens.

Given the strategy articulated in May, we expect the RBNZ to leave the OCR on hold at next week’s June OCR Review. The balance of risks has evolved in the direction of another cut, mainly due to global developments. But not so emphatically that the RBNZ needs to appear panicked by cutting the OCR again so soon. The RBNZ would probably prefer to see more data, and to assess better the impact of the May cut, before making the call between an OCR of 1.5% and 1.25%.

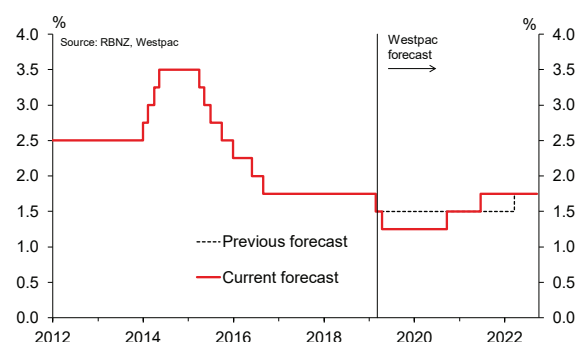
Next week the RBNZ is going to publish more information than it used to at OCR Reviews. In addition to the traditional one-page press release, the RBNZ will publish a record of the MPC meeting that includes the economic outlook, the risks and policy options discussed, and any material differences of view among the committee. This will probably be appended to the press release and will be about two pages long.

We expect that the top-line policy guidance parts of the press release will highlight the RBNZ’s explicit easing bias. Perhaps something to the effect that *“The outlook for monetary policy is finely balanced. Whether we reduce the OCR again will depend on the data.”*

Beneath that headline, we expect the press release and the record of meeting to express concern about deepening downside risks to the global economy, and may even state that the RBNZ is ready to reduce the OCR should those risks materialise. The RBNZ will probably express particular concern about official interest rate reductions in Australia and the increasing likelihood of reductions in the US, as this could impact the exchange rate. However, to date the exchange rate has stayed low despite moves towards cuts overseas, so this would still be in the future risk bucket rather than being something requiring an immediate OCR move.

Meanwhile, we expect the RBNZ’s commentary on the New Zealand economy to be more balanced. The overall

Official Cash Rate forecast



domestic situation has not changed much since May. The economy has clearly slowed, but low interest rates, fiscal stimulus and burgeoning construction activity are good reasons to expect an upturn over the remainder of 2019. Some key recent domestic developments that the RBNZ might mention are:

- The Government's Budget was stimulatory. This is probably the single most important development. The plan to spend much more will have a stimulatory effect on the economy equivalent to about one OCR cut.
- GDP was stronger than the RBNZ expected in the March quarter.
- However, manufacturing and consumer spending data, combined with low business confidence, suggest that GDP growth in the June quarter remained slow rather than accelerating as the RBNZ previously expected.
- Housing market data over the past two months has been very weak. Like us, the RBNZ expects low interest rates and the cancellation of capital gains tax to lead to a modest housing market upturn. But it is now clear that the market will be starting that process from a weaker base.
- The exchange rate is a bit lower than the RBNZ expected.
- Inflation is likely to be a bit higher than the RBNZ's previous forecasts, although mainly due to volatile petrol prices.
- Dairy auction prices have declined, but other agricultural export prices have increased.

We now expect a cut in August

At the time of the May MPS we said it was a finely balanced call as to whether the RBNZ would eventually cut the OCR to 1.25%. At the time we thought no cut was slightly more likely, because we expected an economic improvement later this year on both the global and New Zealand stages.

We still expect an improvement in economic conditions. However, we now doubt that there will be sufficient sign of this by August to stay the RBNZ's hand. There is still a great deal of uncertainty, but we now think the odds favour the RBNZ cutting the OCR to a new low of 1.25% in August.

The key reason for this is the evolution of the global economic outlook. Evidence of a global slowdown in manufacturing and trade has deepened over the past few months. China and Australia, our two biggest trading partners, both posted lower-than-expected GDP growth in the March quarter. And although GDP data in the US has remained strong, other recent data has been on the weak side.

The real clincher is a change to our expectations of US interest rates. Until recently, we had been of the view that US/China trade tensions would be resolved, growth in the US would remain above trend, and therefore the Federal Reserve would keep US interest rates on hold. However, the repeated doubling down of President Trump on trade now leads us to believe that, even if a conflict is resolved

(as for Mexico), another is to be expected. It now looks as though intense and ongoing political unpredictability will keep business investment and general confidence in the US low. Consequently, we now expect the Federal Reserve to cut interest rates twice this year. This week the Fed itself has moved surprisingly quickly in that direction, with many voting members this week saying they expect interest rates to fall this year.

The RBNZ this year has put particular emphasis on global economic risks and the actions of foreign central banks, especially the Fed. A worldwide trend of central banks abandoning previous plans to lift interest rates was a key ingredient to the RBNZ's decision to cut in May. Things have now moved much further in that direction - the Fed and the European Central Bank are talking cuts, and Australia has actually reduced its cash rate.

Although we are optimistic on the domestic economy over the coming year, we doubt that signs of a domestic upturn will be sufficient by August to offset the RBNZ's global worries.

The consequences of a cut... times two.

If the RBNZ does cut the OCR again in August, then our key call on the economy will get even stronger. We already expect that the reduction in mortgage rates to date will prove a major stimulus for the housing market, and will drive 7% house price inflation next year. Another cut in August could push mortgage rates even lower, creating even more stimulus for the housing market (and by extension consumer spending). Meanwhile, we have long expected government spending to drive stronger GDP growth in 2019. The recent budget strengthened that source of stimulus too, creating another source of upside risk to near-term GDP growth.

If we are correct, the RBNZ may have to start hiking the OCR again by late next year. We are now forecasting very slow increases in the OCR from late-2020.

Market reaction

If the RBNZ leaves the OCR on hold next week but expresses deepening concern about the global economy, market reaction would be neutral to slightly positive on interest rates and the exchange rate. Markets are currently pricing a roughly 20% chance of a cut next week, and a 95% chance that the OCR will be 1.25% by August. Leaving the OCR on hold next week will create a tendency for interest rates and the exchange rate to rise simply due to the removal of the June cut risk. But if the RBNZ expresses concern about global developments in the manner we propose, markets will become even more convinced about the likelihood of a cut in August, which is downward in direction for interest rates and the exchange rate. The balance will be neutral to slightly upward.

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