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Time to hop off the fence

Bottom line

- We have changed our OCR call. We are now forecasting a 25bp cut in the Official Cash Rate in November 2019, with a further 50bps of cuts to come over 2020, taking the OCR to 1.0%.
- There are multiple drivers of this changed call but in short they come down to a weaker outlook for medium-term inflation, risks around global growth and liquidity, and the proposed capital changes for banks. Our view of the New Zealand growth outlook has not materially changed.

Key points

We have changed our OCR call, and we now expect the next move to be a cut. We are picking November 2019, with the risks skewed to earlier rather than later should global risks materialise.

There are a number of reasons behind our changed call.

- **The RBNZ is likely to conclude that economic momentum is insufficient to deliver inflation sustainably at the midpoint.** September quarter GDP growth at just 0.3% was well below the November MPS forecast of 0.7% q/q, presenting downside risks to the RBNZ's outlook for growth to accelerate to 3.4% in 2019. We have not changed our view that GDP growth will muddle along in the 2½-3% range over coming years, and indeed see upside risks to our forecast for growth in Q4 (of 0.5%), with some rebound expected from the weaker Q3 outturn. It is certainly not a case of us expecting that the economy is about to roll over, and it is ironic that we are changing our call just as business sentiment indicators are improving. But economic momentum is nonetheless a little softer. And equally importantly, upward revisions to historical GDP imply a higher potential growth rate of the economy. This suggests that the RBNZ will conclude that a stronger growth rate is required in the future to see CPI inflation return sustainably to target. We don't see that happening without further monetary stimulus. In short, growth is now decelerating from its revised rate of around 3½% at the end of last year (previously estimated to be around 3%), and yet core inflation remains well south of where it needs to be.
- **Global downside growth risks.** It is becoming patently clear that global growth is slowing. The RBNZ relies on Consensus forecasts for global growth, which were downgraded last month for both 2019 and 2020. For New Zealand, China is the most important player. For a number of reasons, including rapid debt accumulation and tariff wars with the US, their economy and its consumers are coming under pressure. Soft commodity prices have proven remarkably resilient so far, but there would seem to be a great deal more downside risk than upward.
- **Global liquidity risks.** The global liquidity cycle is looking mature, with quantitative easing giving way to quantitative tightening. Both global equity and credit markets are coming under pressure. Equity market moves can both reflect and contribute to economic developments, but it is the latter that are arguably of most direct relevance to New Zealand. Although

the current account balance has remained relatively contained this cycle, it remains the case that we are poor savers and are reliant on foreigners to fund our borrowing. That funding is getting more expensive as liquidity dries up and lenders reassess risk of all kinds.

- **Proposed RBNZ bank capital changes.** The RBNZ has proposed a **substantial increase in banks' required** capital ratios. This would impact both the price and the availability of credit to the broader economy. It therefore implies a lower long-run neutral OCR, but also an even lower OCR over the transition period, while banks are building their buffers. It is only a proposed change at this stage, with a final decision expected in June 2019, but is highly likely to go ahead in some form. We will put out a brief thought piece discussing the changes tomorrow.
- **A weaker outlook for tradable inflation.** At this stage, CPI for Q4 looks **set to come in a little below the RBNZ's expectations, due to weaker** tradable inflation. The RBNZ cares primarily about non-tradable and core inflation, but headline inflation matters too, in that it can have an impact on inflation expectations, which can then have persistent impacts on domestic inflation. This is especially important in the context of core inflation sitting below the target midpoint: downside risks to inflation are more problematic than upside ones. To be fair, the picture of Q4 CPI is still coming together, so there is uncertainty around where this will land, but what we know so far nonetheless adds to the weight of evidence that suggests that inflation is looking softer.

It is important to note that it is unlikely to be a smooth path for interest rates between now and an eventual OCR cut. Market pricing is likely to continue to wax and wane, and we would not be surprised to see the data cause some volatility in the interim, especially given the recent increase in business confidence and potential upside to Q4 GDP. The economy is still performing well. But over time, we expect that it will become clear that the economy needs more of a leg up from monetary stimulus if inflation is to lift sustainably to target.

There are risks on both sides around the timing of the first cut, reflecting uncertainty about what the eventual catalyst will be to spur the RBNZ into action. An eventual cut could be brought forward should the global environment deteriorate more quickly, or domestic growth or inflation indicators turn softer. The Governor is not the type to die wondering, and appears likely to be proactive in managing downside risks. On the other hand, growth in the range 2½-3% is not to be sneezed at, and there remain upside risks to the domestic inflation outlook too, including squeezed margins and the very tight labour market.

But while the timing may be uncertain, and the path to a cut not necessarily a straight one, we simply find it extremely difficult to envisage an OCR hike over the next couple of years, with the global growth cycle turning. Our current expectation is that the OCR will eventually need to be lowered to 1%, with one cut in November 2019 and another two in 2020 (pencilled in for February and March).

Upward revisions released this morning mean the economy is now known to have been growing very strongly in recent years, yet inflation remains south of target. If this is **"as good as it gets"** for growth, **it's not bad at all. But the Reserve Bank's primary job is to deliver inflation at target**, and that remains on the to-do list. With downside risks accumulating, we are happy to jump to the cut side of the fence.



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