Scenarios and risks around the OCR outlook

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As outlined in our Monetary Policy Statement Review on Wednesday, we have updated our Official Cash Rate (OCR) forecast to include a couple more 25bp cuts. We are now forecasting cuts in April, May and July, taking the OCR to a trough of 3%, which is the middle of the RBNZ's range of estimates for the long-run neutral OCR.

Given the RBNZ is increasingly confident about the outlook for domestic inflation (given past economic weakness) and our economic forecasts are very similar, a sensible baseline forecast is that the RBNZ will follow through with their stated strategy of cutting the OCR to neutral, with a wait-and-see approach from that point.

In our view, our updated forecast balances the upside and downside risks to the OCR. Both exist. We are certainly not ruling out the possibility that cuts could stop with the OCR above 3%, given the clear signs of a pickup in economic momentum, and uncertainty about at what point growth will turn inflationary. But on the other side of the risk coin the durability of the economic upswing is not assured, and it is also very plausible the OCR could end up in stimulatory territory below 3%, sooner or later.

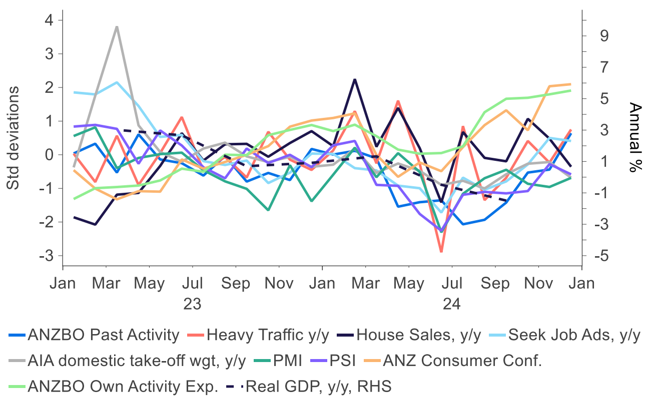
In this note, we outline some factors that could cause the RBNZ to stop cutting earlier, or alternatively, cut further than a 3% trough. Risks can be broadly divided into two camps: output and inflation evolving differently than expected in response to the conditions, and second, unexpected changes in economic circumstances. In this global environment there's plenty to think about on the latter score, but in this note we'll focus primarily on the former.

We laid out our updated macroeconomic forecasts in our Quarterly Economic Outlook published yesterday. The big picture: the worst is past, but the recovery will be fairly hard yards, given the persistent growth headwinds of still-subdued consumer confidence, a soft labour market, and a challenging environment for our exporters (though some of them are doing remarkably well in the circumstances). We'll talk about the downside and upside risks primarily relative to those forecasts, which, as noted, are actually not dissimilar to the Reserve Bank's (refer to page 7 in our RBNZ MPS Review).

Two-sided risks

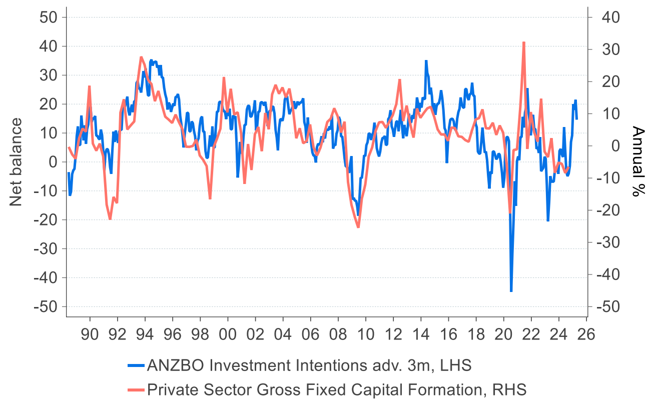
The RBNZ considers the neutral OCR to be somewhere in a 2.5% to 3.5% range. If the 'true' unobservable neutral OCR is actually around 2.5%, the bottom of the RBNZ's range of estimates, then the recovery in demand is going to sputter out fairly promptly. The flurry of optimism in indicators such as the ANZBO and Performance of Manufacturing and Services Indexes could represent little more than the fact that the bar for improvement is low. **Watch: monthly activity indicators.** On the other hand, if neutral ultimately turns out to be meaningfully higher than 3%, that means interest rates are less of a constraint than thought, and consumption and investment will recover more quickly. For example, strong dairy prices could cause a bigger bump in investment and employment than anticipated in the regions. **Watch: investment intentions.**

Figure 1. Monthly activity indicators and GDP



Source: Stats NZ, BusinessNZ, AIA, REINZ, Seek NZ, Macrobond, ANZ Research

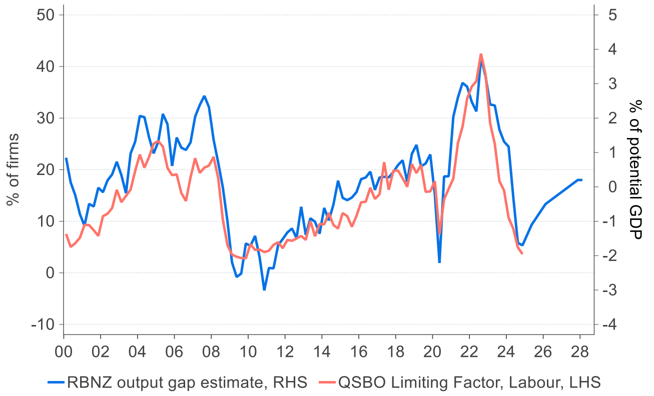
Figure 2. Investment intentions and investment



Source: Stats NZ, Macrobond, ANZ Research

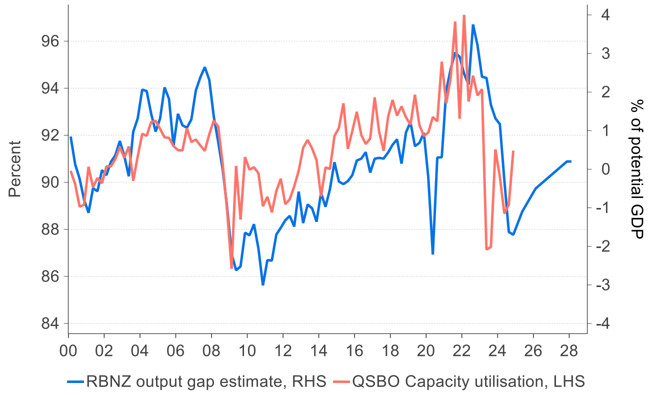
- Growth is one thing, but the amount of spare capacity in the economy (the 'output gap') is another. And what with it being invisible 'n' all, estimates of it are prone to massive revision. If there is more or less spare capacity than believed currently, then domestic inflation is going to stop falling later or earlier than expected. **Watch: QSBO capacity indicators**, which are mixed at present.

Figure 3. QSBO labour as a limiting factor and RBNZ output gap estimate



Source: NZIER, RBNZ, Macrobond, ANZ Research

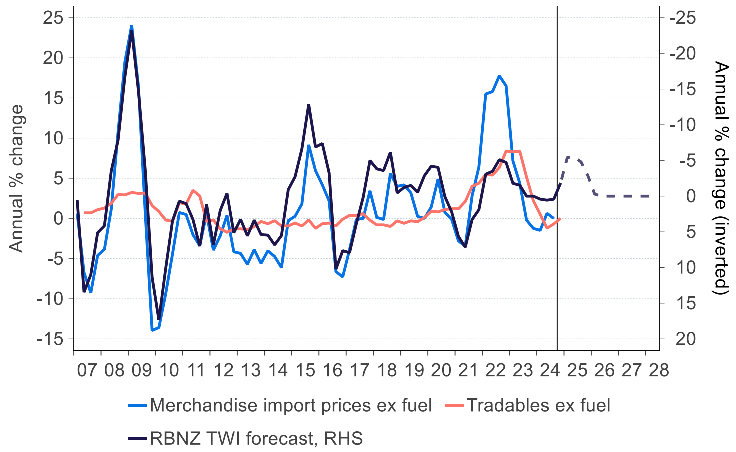
Figure 4. QSBO capacity utilisation and RBNZ output gap estimate



Source: NZIER, RBNZ, Macrobond, ANZ Research

- The NZD always has the potential to surprise in either direction. A key support currently is strong dairy prices, while headwinds for the currency include interest rate differentials, growth differentials, our still-large current account deficit, China growth risks, and global risk sentiment, given the exceptional degree of policy uncertainty currently. A larger depreciation than we are forecasting would result in a bigger bump in tradable inflation. That could cause at least cosmetic issues for headline CPI inflation, given the RBNZ is already forecasting it to reach 2.7%. It'll depend on whether inflation expectations behave themselves, but it might make the RBNZ more cautious about its easing profile. Conversely, a stronger NZD would bring import prices down, but make life tougher for exporters. The RBNZ stressed on Wednesday that they will look through noise in tradable inflation, but even so, the exchange rate is still an important component of monetary conditions that all else equal means more or less work for the OCR to do. **Watch: NZD.**

Figure 5. NZD trade-weighted index, import prices and tradeable inflation



Source: Stats NZ, RBNZ, Macrobond, ANZ Research

Dovish risks

Beyond the factors already outlined, what could cause growth or inflation to be lower than expected, warranting further cuts below 3% – perhaps after a pause?

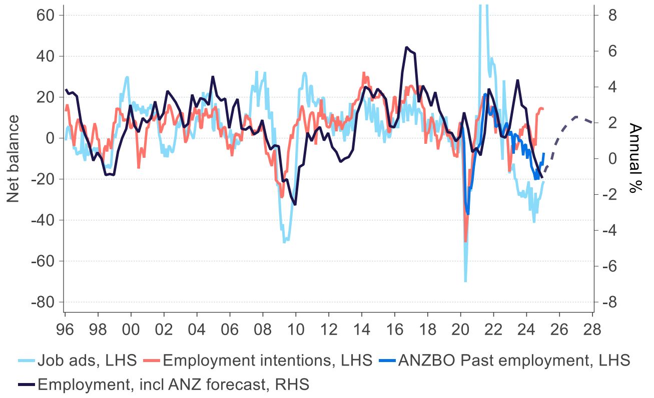
- Global markets so far seem to be taking a glass-half-full view of the highly volatile global trade and geopolitical environment, focusing on a potential bump in US growth. However, something could come along that causes a broad risk-off move and significantly hampers global growth prospects. The NZD would likely act as an automatic shock-absorber in that instance, but a net negative income shock (falling commodity prices) would be negative for growth and likely make more monetary easing appropriate. **Watch: equity valuations and volatility.**

- Assuming we wouldn't impose tariffs of our own, then a global tariff war could be disinflationary for New Zealand (at least in the near term), as stranded exports find their way to our shores – potentially at a discount – and our exporters face increased competition in offshore markets. **Watch: new and used car prices.**

Hawkish risks

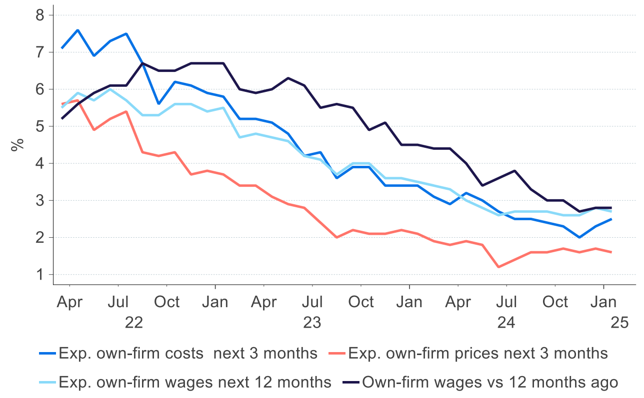
- We are anticipating a return to positive employment growth in the near term, albeit not enough initially to keep pace with labour force growth. But employment intentions have risen sharply and that could manifest in employment outcomes more quickly than we (and the RB) are assuming. Relatedly, a significant mismatch between the skillsets of available workers and what firms are looking for could see pockets of wage pressure emerge even with the overall labour market still fairly soft (particularly if Australia is cherry-picking). **Watch: job ads and ANZBO wage expectations.**

Figure 6. ANZBO employment indicators, job ads, employment



Source: Stats NZ, MBIE, Seek, Macrobond, ANZ Research

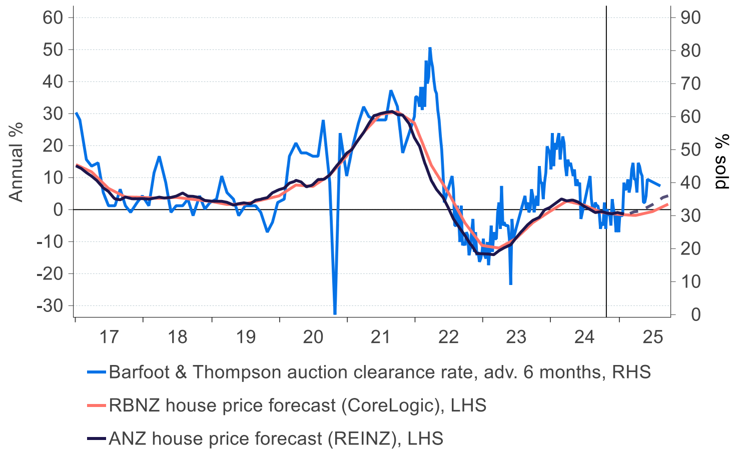
Figure 7. ANZBO cost, price and wage measures



Source: ANZ Research

- The housing market has clearly turned a corner, but given a complicated list of headwinds and tailwinds it's difficult to know if lower mortgage rates will kick off animal spirits earlier than our assumption of the second half of the year. That would likely give broader household spending a lift – and the RBNZ watches that closely. **Watch: Barfoot & Thompson auction clearance rate.**

Figure 8. B&T auction clearance rate and house prices

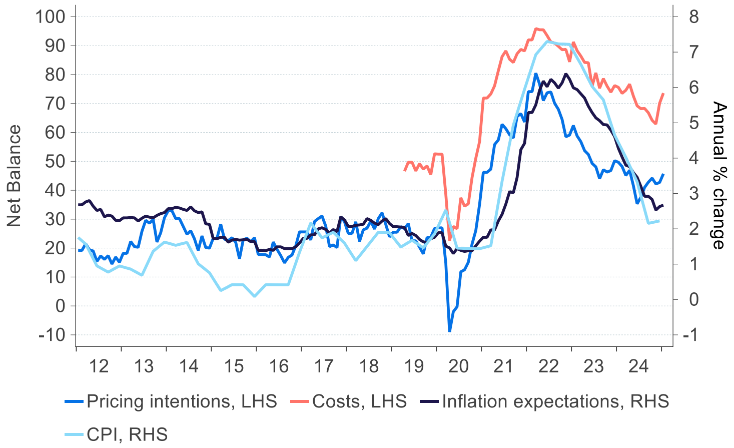


Source: REINZ, Barfoot & Thompson, RBNZ, Macrobond, ANZ Research

- Some elements of domestic inflation remain regrettably sticky, including insurance costs and council rates. These could take longer to normalise than anticipated. Electricity prices are also a risk to firm costs. There would need to be more going on for specific prices to upset the apple cart, but stickiness wouldn't be helpful.

- The RBNZ recently changed its assumption about firms' price-setting behaviour, effectively concluding that firms will 'forget' past high inflation more quickly. But whether firms in fact do this will depend very heavily on whether they think their current margins are sustainable, or whether a large proportion still feel there is catch-up due from strong previous cost inflation. Time will tell. **Watch: ANZBO costs and pricing intentions.**

Figure 9. ANZBO inflation indicators



Source: Stats NZ, Macrobond, ANZ Research

Summing up

The reality of economic forecasting (and for that matter, running monetary policy) is that the best one can hope for is to balance the risks on each side of the equation. We're comfortable our updated forecast does that, but we'll be watching the data keenly (as will the RBNZ) to see which way things are leaning.

The RBNZ has good reason to be cutting with more confidence than its international peers, given the sharp slowdown the economy has been through, but it is always ready to acknowledge that the outlook is uncertain and that the future path of policy is highly conditional, even when giving relatively explicit guidance about expected future moves.

In that context, strategy matters. The RBNZ is tasked with avoiding unnecessary volatility in both real economic outcomes and financial markets. With almost 200bp of cuts under the belt and clear signs of the economy responding, a slowing down in the pace of cutting is a sensible approach, in our view. Turning points are particularly difficult to diagnose in real time, and it behoves us all to remain open minded about where things go from here.

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