Westpac
Institutional Bank

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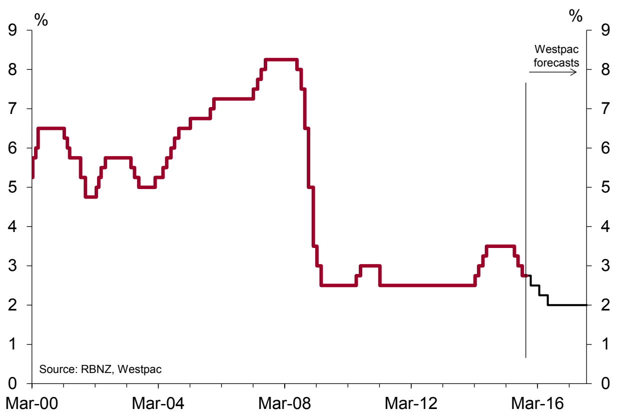
Should I stay or should I go

Preview of RBNZ Monetary Policy Statement, December 2015

- Next week's Monetary Policy Statement is highly uncertain, and could produce large market reactions.
- The OCR remained on hold in October, but since then the outlook has shifted in a direction that favours OCR cuts.
- The RBNZ is most likely to cut the OCR 25bps, while sounding neutral about future OCR changes. In this case, the exchange rate and interest rates would fall modestly.
- It is less likely, but possible that the RBNZ will keep the OCR on hold while firmly signalling cuts for early-2016. In that case, the exchange rate and interest rates would rise sharply.

Westpac OCR forecast



Some OCR decisions are clear cut affairs, and others are uncertain right through to the last minute. Next week's December *Monetary Policy Statement* is of the uncertain variety, which will make it a key event for markets.

The OCR is currently 2.75%, and the RBNZ's forecasts and communications have all indicated that it sees 2.5% as the low-point in the current OCR cycle. That means the RBNZ expects to deliver only one more OCR cut. Next week's OCR decision comes down to whether the RBNZ wants to fire what it sees as its final bullet, or whether it wants to keep its powder dry.

We think the most likely outcome is a 25 basis point OCR cut. The RBNZ held off in October, but since then the situation has evolved more clearly in a direction favouring OCR cuts. Reasonable arguments can still be constructed for either immediate action or for waiting (as shown below). But on balance, the arguments for cutting immediately are more compelling.

If the RBNZ does cut next week, then the accompanying statement will seek to avoid commitment. In particular, the RBNZ is unlikely to remove the possibility of further rate cuts by signalling a *"period of stability"*, for fear of markets overreacting and the exchange rate rising. Neither would we expect the RBNZ to adopt an explicit easing bias. Instead, we expect the RBNZ to adopt language that is open to either keeping the OCR on hold or reducing it, such as:

"Future OCR decisions will depend on the emerging flow of data."

Presumably the context of the Monetary Policy Statement, including the usual alternative scenarios, will make it clear that OCR hikes will be off the table for a long time. The RBNZ may even go as far as to emphasise that point in the press release, by saying something along the lines of:

"The OCR is expected to remain low for some time."

We consider it less likely – but not inconceivable – that the RBNZ will leave the OCR unchanged next week, but will firmly signal that a cut is likely in the months ahead.

If I go there will be trouble

While there are arguments both for and against an OCR cut in December, we find the arguments for a cut more compelling. These include:

- **Low dairy prices.** This was a major concern of the RBNZ's in September. An encouraging rise in dairy prices was probably a factor in the RBNZ leaving the OCR on hold in October. But global dairy prices have subsequently fallen again, and many farmers are facing a second season of negative returns.
- **The exchange rate remains higher than the RBNZ would like.** In October, the RBNZ drew an explicit link between the exchange rate and the OCR: *"...the exchange rate has been moving higher since September, which could, if sustained, dampen tradables sector activity and medium-term inflation. This would require a lower interest rate path than would otherwise be the case."* The high exchange rate has indeed been sustained.
- **Inflation is likely to prove lower than the RBNZ's previous forecast.** The RBNZ's previous forecast for December quarter inflation was 0.2%. But after observing a drop in petrol prices, food prices and general weakness in retail prices, we have concluded that quarterly inflation in December will actually be closer to -0.2%. Some might be tempted to "look through" inflation weakness emanating from the likes of food and petrol prices. That would be a mistake – this is a continuation of the very global themes that caused New Zealand inflation to fall so low in the first place.
- **The Auckland housing market slowed with a thump in October.** This should ameliorate the RBNZ's concerns about low interest rates stoking financial stability risks.
- **An on hold decision would cause the exchange rate to rise.** If the RBNZ keeps the OCR on hold for a second consecutive meeting, markets would cast doubt on any signal about future cuts. Instead, markets would probably conclude that there is little chance of the OCR going below 2.75%. Two year swap rates and the exchange rate would rise accordingly – the latter being something the RBNZ is keen to avoid.

If I stay it will be double

There are, of course, reasonable arguments against cutting the OCR, including:

- Recent data on economic activity in New Zealand has tended to be quite strong – for example, retail sales volumes were up 1.6% in the September quarter, and business confidence has risen convincingly.
- It now seems highly likely that the Federal Reserve will hike US interest rates in December (a week after the RBNZ's decision date). If the Fed does hike, the New Zealand dollar could be driven down, which would boost inflation in New Zealand.
- The RBNZ might down-weight the weak October housing data, and instead focus on the fact that the level of Auckland house prices is too high for comfort.
- Given the uncertainty around the exchange rate and housing market, the RBNZ may decide it is prudent to wait before taking action on the OCR. If a cut is needed, there is little harm in delaying it a few months. Conversely, delivering an OCR cut that proves unwarranted would be a difficult mistake to unwind.

While these are all valid points, we find them less compelling than the arguments in favour of an immediate OCR cut. In particular, even if the Fed hikes, the exchange rate tumbles, and house prices keep rising, there is still little chance of inflation exceeding 2% on a sustained basis. By contrast, if the exchange rate stays high, Auckland house prices fall, and global inflation remains low, it is quite plausible that inflation will settle well below the RBNZ's 2% target. So the balance of risks seems clear enough to warrant immediate action.

Market reaction

This is a highly uncertain OCR Review that could produce large market reactions. It is best to consider the range of possible market reactions that match the range of possible RBNZ actions:

- If the RBNZ keeps the OCR on hold, the exchange rate and interest rates will rise sharply, even if the RBNZ signals that future easing is likely.
- If the RBNZ cuts the OCR but rules out further cuts, the exchange rate and interest rates would rise more moderately. (This is the least likely scenario).
- If the RBNZ cuts the OCR, and is neutral and non-committal about future OCR changes, the exchange rate and interest rates would fall moderately. (The most likely scenario).
- If the RBNZ cuts the OCR and expresses a likelihood of further cuts to come, the exchange rate and interest rates would fall sharply.

Westpac's OCR call

Since July this year we have been of the view that the OCR will eventually fall to 2.0%. We remain firmly of that view. We are forecasting OCR cuts in December 2015, March 2016, and June 2016.

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