Westpac

Institutional Bank

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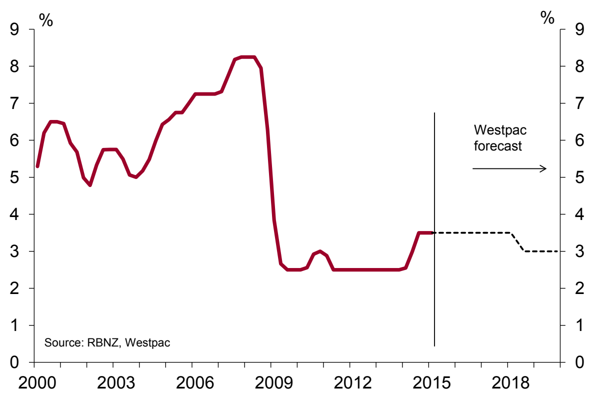
Hold your horses

Preview of RBNZ Monetary Policy Statement, June 2015

- A June cut in the OCR seems unlikely.
- Cuts later in the year are a very close call.
- If the housing market slows the RBNZ can cut, but that is a highly uncertain proposition.
- The RBNZ would need to actually see the market slow before committing to a cut.
- Consequently, the RBNZ cannot go beyond a conditional easing bias in the June *Monetary Policy Statement.*

Westpac OCR forecast



Markets are abuzz with the possibility that the Reserve Bank could cut the OCR as soon as next month. The anticipation was sparked by RBNZ Assistant Governor John McDermott's speech on April 23rd. That speech replaced the RBNZ's previous "up or down" OCR guidance with *"Evidence of weakening demand and domestic inflationary pressures would prompt us to consider lowering interest rates."* These conditions for OCR cuts were repeated in the April OCR Review the following week.

Since that time there has been an avalanche of important new developments relating to the OCR outlook – those developments are summarised in a table on page 3. Now that we have digested all of the news, this bulletin outlines the conclusions we have reached about the OCR outlook.

An OCR reduction at the June *Monetary Policy Statement* strikes us as unlikely, because the conditions the Reserve Bank laid out for a cut have not been met. Furthermore, to cut now would be out of step with the Reserve Bank's usual behaviour.

OCR cuts later in the year are a more realistic possibility. If the Reserve Bank were to cut the OCR, it would most likely happen around September or October. However, we think the odds of this happening are probably a bit shy of fifty-fifty – it is slightly more likely that the OCR will remain on hold all year. Our central forecast does not include OCR cuts this year.

We do feel strongly that the next move in the OCR will be down. New Zealand will enter an economic downturn as the Canterbury rebuild unwinds before inflation rises high enough to require OCR hikes. However, the cuts we envisage will occur late in the decade, not this year.

June cut unlikely

A June cut in the OCR is unlikely because it would be out of keeping with normal Reserve Bank behaviour and would contradict the Reserve Bank's recent messaging.

The Reserve Bank normally gives a clear warning before a series of OCR changes is about to begin. Every series of OCR changes since 2005 has been preceded by one or more *Monetary Policy Statements* or OCR Reviews in which the RBNZ has bluntly asserted that the OCR will soon start moving (except for the emergency cut that followed the Canterbury earthquake of 2011). Consider the following examples:

January 2014 (immediately prior to the 2014 OCR hikes): "In this environment, there is a need to return interest rates to more-normal levels. The Bank expects to start this adjustment soon. The Bank remains committed to increasing the OCR…"

April 2010 (immediately before two consecutive OCR hikes): "As previously indicated, we expect to begin removing policy stimulus over the coming months, provided the economy continues to evolve as projected."

June 2008 (immediately before a series of OCR reductions): "Provided the economy evolves in line with our projection, we are now likely to be in a position to lower the OCR later this year, which is sooner than previously envisaged."

January 2007 (immediately before a series of OCR hikes): "In the absence of clear indications of a moderation in housing and domestic demand, it is likely that further policy tightening will be required."

In addition, every major series of OCR changes since 2005 has been preceded by a *Monetary Policy Statement* showing a forecast of interest rates moving in the appropriate direction (except the emergency cut in 2011).

Those preconditions for an impending OCR change are not in place at present. The last MPS featured a deadpan flat interest rate forecast. And the key policy paragraph of the April OCR Review was:

"It would be appropriate to lower the OCR if demand weakens, and wage and price-setting outcomes settle at levels lower than is consistent with the inflation target."

Yes, lowering the OCR is mentioned – but only in an equivocal, conditional way. The RBNZ has not stated that it is about to lower the OCR. It has stated that it would consider lowering the OCR under certain conditions.

Even if those conditions had been met by now, the next step in the RBNZ's usual operating procedure would be to issue a clear signal of impending OCR cuts and publish a forecast of 90-day interest rates that sloped downward. The actual OCR move would then follow at a later review date.

But the conditions that the Reserve Bank set out have not been met. If the Reserve Bank were to cut now it would be contradicting its own prior guidance.

The first condition was that wage and price-setting outcomes must settle at levels below the inflation target. This one is borderline. Surveyed inflation expectations vary from 1.75% to 2.5%, a market-implied measure of inflation expectations is 1.5%, and wage inflation recently dropped to 1.7%. At a stretch, one could argue that these levels are inconsistent with the RBNZ's inflation target, which is 1% to 3% average over the medium term, with a focus on 2%. But it is not possible to suggest that wage and price-setting behaviour has *settled* below the target, given that most of these measures took a step down only very recently, and could pop higher again when the recent fall in petrol prices drops out of annual inflation calculations next year.

The second condition - that domestic demand cools – is nowhere close to being met. Domestic demand has not cooled in the slightest. Domestic demand has remained very strong as indicated by retail sales and employment data, and the housing market has strengthened considerably.

It would strike us as unusual for a central bank to cut the OCR when it has just set out two conditions for cuts, one of which has clearly not been met and the other of which is borderline.

Monetary policy later in the year depends on house prices

The key to the OCR outlook later in the year is the housing market. The Reserve Bank has recently proposed restrictions on mortgage lending to property investors, and the Government has tightened the tax rules for property investors. If these policies were to succeed in slowing the housing market then domestic demand would probably cool and the Reserve Bank would probably cut the OCR.

However, this is a highly uncertain proposition. It would not behove the RBNZ to commit to OCR cuts on the *assumption* that these housing policies will work as intended – the recent house price surge is too powerful and too poorly understood for that, not to mention that the policies themselves are untried. Instead, the Reserve Bank will probably want to actually observe the housing market cooling before it commits to reducing the OCR. The earliest such an observation could be made is July – until then, we suspect that the RBNZ will want to keep its options open, and will keep its policy guidance conditional rather than committal.

For our part, we are not certain whether these policy changes will cause a material housing market slowdown in the near term. Both policies apply to properties bought on or after October 1. Consequently there is an incentive for property investors to rush in and buy before that date – the housing market could conceivably get a boost in the short term. Alternatively, property investors' expectations of future house price growth might be dented by these policies (or by the threat of further regulations to come). In that case, property investors might seek to exit the market early, in which case prices will cool.

We have not seen any convincing analysis to help identify which of these is the more realistic prediction. The "animal spirits" of Auckland's housing market are unpredictable to say the least. Our working assumption for now is that the new housing policies will have some impact. However given that the underlying momentum in the housing market is so strong and mortgage rates have recently fallen, we do still expect Auckland prices to rise vigorously over the remainder of the year. Consequently, we are not completely convinced that the Reserve Bank will end up in a position to cut the OCR. However, we will remain open minded and will watch the housing data carefully – if the housing market does slow materially, we will switch to forecasting OCR cuts.

The risks go beyond housing

The other key uncertainty for our OCR forecast concerns the external sector, where influences on inflation are mixed. Dairy and forestry prices have been falling again recently, and Fonterra has issued a low forecast for next season's milk price. We don't expect this downdraft in export prices to extend much further, but if it does the balance could easily tip in favour of OCR cuts. Conversely, global oil prices have been rising and the New Zealand dollar has been falling, both of which tend to boost inflation. Should these trends continue the pressure for OCR cuts may be staved off.

Finally, it goes without saying that we will continue to monitor indicators of economic activity and inflation carefully – but if these continue to move in opposite directions as they have over the past year, neither our conundrum nor the Reserve Bank's will get any easier.

RBNZ messaging

Given the many uncertainties in the outlook, we expect the Reserve Bank to maintain some form of conditionality to its easing bias in the June *Monetary Policy Statement.* Our assessment of developments since the April OCR Review, summarised in the table, are that they roughly balance one another so far as the OCR outlook is concerned. So any change in the policy guidance relative to April should be modest.

We would expect the RBNZ's 90-day interest rate forecast to be either flat or slightly downward sloping. Back in March the

Major economic developments since the April 2015 OCR Review

In our assessment, the balance of these developments is roughly neutral so far as the OCR outlook is concerned – the new housing market policies are important, but so is the lower exchange rate.

Development	Comment	
Labour market data	Higher than expected unemployment and low wage growth will fuel the RBNZ's suspicion that the economy's capacity to grow without generating inflation has been enhanced. However, strong employment growth and hours worked suggested ongoing strong economic growth.	↓
ACC levy reductions for 2016	This will knock 0.3 percentage points off annual inflation in 2016. Normally policy changes are a look-through for the RBNZ. However, this could affect inflation expectations.	↓
Government budget	The new mix of spending will be slightly more stimulatory for the economy.	↑
Falling dairy prices	The RBNZ was already braced for a drop in commodity export prices, but recent dairy auction prices and Fonterra payout forecast were probably even weaker than the RBNZ anticipated.	↓
Inflation expectations	Surveys of inflation expectations stabilised instead of falling as the RBNZ would have been expecting.	↑
Retail Trade data	Retail sales volumes rose 2.7% in the March quarter, the strongest since 2006.	↑
Net immigration	Has been much stronger than the RBNZ's forecasts.	↑
Housing market	Data revealed that house prices in Auckland have been rising much faster than the RBNZ anticipated.	↑
Macroprudential policy	From October 1, the Reserve Bank will prohibit banks from lending more than 70% of a house's value to property investors in Auckland. (Currently, around half of investors borrow between 70% and 80%, while borrowing above 80% is very rare). Meanwhile, the RBNZ has loosened its restrictions on lending for areas other than Auckland. The RBNZ estimates that these restrictions will knock 2% to 4% off Auckland house price inflation. We prefer the lower end of that range, meaning this will knock around one percentage point off nationwide house price inflation.	↓
Tax changes for housing	Property investors reselling a house within two years will be subject to tax on any capital gain. This applies to properties bought on or after October 1. In theory, this should have no material effect on the value of a house. But in practice there is a possibility that housing market sentiment will take a hit – there is no real way to tell.	↓
Exchange rate	Has fallen 5% on a trade-weighted basis, and the NZD has retreated from near-parity against the Australian dollar to around 93 cents.	↑
Mortgage rates	Average advertised 6 month and one year fixed mortgage rates have fallen by around 20 basis points.	↑

forecast was studiously flat, but our analysis of recent data suggests that the Reserve Bank could now go with a 90-day rate forecast that falls away by around 20 basis points over two years. Whether the RBNZ actually bothers to show such a gentle downward slope is uncertain.

The key risk to all of this concerns the RBNZ's opinion about the neutral OCR. A few years ago the Reserve Bank revised its estimate of the neutral OCR down to 4.5%. That caused a downward recalibration to the RBNZ's entire interest rate forecast, and the accompanying *Monetary Policy Statement* was unexpectedly dovish. There is a risk that the RBNZ will once again downgrade its estimate of the neutral OCR. In that case the 90-day interest rate forecast could have a more serious downward slope to it, and the RBNZ could signal impending OCR cuts – although even in this scenario, we doubt the RBNZ would cut in June.

Market reaction

Markets would obviously be disappointed if the Reserve Bank were to keep the OCR on hold in June (at the time of writing markets were pricing a 50% chance of a June OCR cut). However market reaction could actually be quite small if the Reserve bank continues to articulate a conditional easing bias, as we expect. Interest rate markets would have to push out the timing of expected interest rate cuts, and consequently the two-year swap rate would have to rise some five basis points or so. However, interest rate markets would probably continue to price a strong risk of two or more OCR cuts at some point in the near future. And with interest rate markets in New Zealand continuing to lean towards cuts while the US Federal Reserve leans towards hikes, we can't really see scope for the New Zealand dollar to rise much, beyond the inevitable half to one cent on the day of the *Monetary Policy Statement.*

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