Westpac

Institutional Bank

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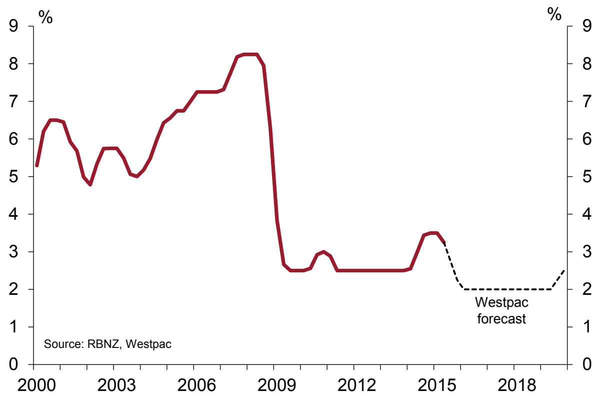
A tough line to cross

Preview of RBNZ Monetary Policy Statement, September 2015

- The RBNZ will almost certainly cut the OCR 25bps to 2.75% next Thursday.
- The forecasts and language will probably imply one further OCR cut.
- The RBNZ will probably seek to keep its options open as to the timing of the next cut.
- Whether the RBNZ cuts in October depends on New Zealand data and the Fed's decision.
- Currently, markets and the RBNZ are resistant to the idea of the OCR falling below 2.5%.
- We believe the weak economy and low inflation will break that resistance by the end of the year.
- We remain comfortable calling a 2.0% low-point for the OCR.

Westpac OCR forecast



Back in June the RBNZ cut the OCR, and signalled that it expected one follow-up cut at an unspecified date later in the year. Shortly afterwards, New Zealand was subject to a shocking run of data. Global dairy prices plunged, GDP growth turned out much weaker than expected, and core inflation fell. It became apparent that the Canterbury rebuild had levelled off early, and business and consumer confidence fell.

All and sundry reassessed their interest rate, exchange rate, and economic growth forecasts. In our case, we shifted to forecasting an immediate OCR cut in July, and follow-up cuts that would rapidly take the OCR to an all-time low of 2.0%.

At the July OCR Review the RBNZ did indeed cut the OCR 25 basis points, and bluntly stated *"At this point, some further easing seems likely."* This was a clear signal that a September OCR cut would follow, and that the OCR would fall below 3.0%.

But in a speech shortly after the July OCR Review, the RBNZ tried to rein in expectations of how far the OCR would fall. That speech created an impression that 2.5% is a "line in the sand", below which the RBNZ will not take the OCR except in recession. Financial markets have steadfastly refused to price any material risk of the OCR falling below 2.5%, despite turmoil on global markets, and this has lent support to the exchange rate.

Developments since July have been mixed, although the negatives have outweighed the positives. Key developments pointing in the direction of lowering the OCR more aggressively are:

- The global economic backdrop has clearly deteriorated, reflected in falling equity and commodity prices.
- Expectations for US Federal Reserve hikes have been pushed out. (Fed hikes are significant for New Zealand monetary policy, because they have the potential to weaken the New Zealand dollar, thus boosting inflation.)
- New Zealand's unemployment rate rose.
- The dairy outlook deteriorated further, with Fonterra revising down its payout forecast.
- Business confidence has plunged, indicating slower economic growth ahead.

However, there have also been developments that lean against OCR cuts:

- The housing market has strengthened even more than the RBNZ was forecasting, and credit growth has accelerated.
- Net immigration has accelerated, instead of falling sharply as the RBNZ forecast.
- Surveys of inflation expectations have, for the most part, risen, suggesting that the RBNZ's 2% target is still credible.

Given the balance of developments, we suspect that next week's *Monetary Policy Statement* will strike a slightly more dovish tone than the July OCR Review and speech – that is, the RBNZ will sound a little more predisposed to lowering the OCR.

However, recent developments have probably **not** been sufficient for the RBNZ to signal that it is willing to cross the line in the sand at 2.5%. We suspect that the RBNZ's forecasts will show 90-day rates falling to around 2.6% or 2.7%, implying a 2.5% low-point for the OCR. This would imply just one more OCR cut in the current cycle.

As to when the RBNZ plans to fire what it believes is the "last bullet in the chamber", the idea will probably be to keep options open. To achieve that, the RBNZ will have to reintroduce some conditionality and uncertainty into the forward guidance contained in the Statement. Whereas July featured a blunt signal that another cut would soon follow, we suspect September's policy guidance sentence might be more along the lines of:

"At this point, some further easing seems likely. The timing will depend on the data."

The OCR outlook beyond September

We remain very comfortable with the idea that, sooner or later, the RBNZ will cross the 2.5% threshold. New Zealand is entering a significant economic slowdown at a time when core inflation is already well below the RBNZ's target, meaning monetary policy has a great deal of work to do. We do not believe that the falling exchange rate will generate enough inflation to meet the RBNZ's medium-term target.

We are forecasting consecutive 25bps OCR cuts between September and January. This would take the OCR to a new all-time low of 2.0%. But at this stage the RBNZ does not share our view, and that creates a risk that the OCR takes longer to get to 2.0%.

In particular, what the RBNZ does at the October OCR Review is genuinely uncertain and data dependent. If New Zealand's housing market were to turn, inflation data (due mid-October) were to weaken, or the Federal Reserve were to signal a delay to its hikes, then the RBNZ would most likely cut the OCR in October. However, we could just as easily imagine a scenario in which global dairy auction prices continue to rise, Fed hikes occur, and New Zealand's housing market holds up. In that case, the RBNZ may very well choose to pause in October. We will adjust our forecast as the data emerges.

Beyond October the path to a lower OCR should be clearer. Our view is that New Zealand's economic backdrop will have weakened materially and the housing market will have slowed by December. If we are correct about that, the idea of the OCR dropping below 2.5% will enjoy wider acceptance.

Market reaction

If next week's Monetary Policy Statement is along the lines we have outlined above, market reaction would probably be minor. Financial markets are already almost fully priced for a 25bps cut next week, and are pricing in roughly a 50% probability of a follow-up cut in October. At the margin, there is perhaps some scope for interest rates and the exchange rate to fall if the RBNZ confirms that it is targeting a 2.5% OCR.

The risk scenario for markets is one in which the Reserve Bank crosses the line in the sand immediately, and signals that the OCR could fall below 2.5%. This would generate a very strong market reaction, but the chances of it happening don't seem high.

It is very hard to imagine a scenario in which the RBNZ delivers a material hawkish surprise to markets – that would require the RBNZ to signal a terminal OCR of 2.75%, which seems unthinkable in the current environment.

Dominick Stephens
Chief Economist

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Satish Ranchhod, Senior Economist
+64 9 336 5669

David Norman, Industry Economist
+64 9 336 5656

Any questions email:
economics@westpac.co.nz

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