Westpac

Institutional Bank

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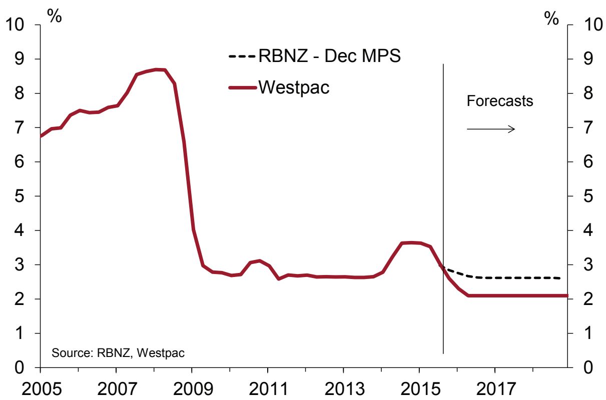
The door opens a crack

December 2015 MPS Review: RBNZ cuts OCR to 2.50%

- The Reserve Bank reduced the Official Cash Rate by 25bp to 2.50% as expected.
- The RBNZ accepts that inflation will remain low in the near term, and has emphasised that its Policy Targets Agreement requires a medium-term focus on inflation.
- The statement noted that the RBNZ is comfortable with current interest rate settings, but is prepared to cut further if circumstances change.
- Our view is that economic activity, house prices and inflation will be subdued enough over coming months to prompt further OCR cuts next year.
- We continue to expect that the OCR will reach 2.0% in 2016.
- But we have fine-tuned the timing of our OCR call – we are now forecasting cuts in June and August next year (previously March and June).

90-day interest rate forecasts



In its recent statements, the Reserve Bank had indicated that a further cut in the Official Cash Rate was “likely” given its view of current conditions. Today it delivered that cut, taking the OCR back down to its record low of 2.50%. This move was widely expected by economists, although financial markets were only pricing around a 65% chance of a cut, and had wavered back and forth on those odds in recent days.

The bottom line of the statement was in line with our expectations. The RBNZ believes that current interest rate settings will be enough to bring inflation back to the 2% midpoint of its target range over the medium term. However, it also opened to door a crack to the possibility of further OCR cuts, by saying it would cut if circumstances warrant. The accompanying *Monetary Policy Statement* provided an unusually wide range of scenarios in both directions, underscoring the RBNZ’s uncertainty.

This was encouraging for our long-held view that the OCR will eventually reach 2.0%. We think that circumstances will indeed change enough to prompt the RBNZ into further interest rate cuts next year. That said, today we have decided to fine-tune the timing of our OCR forecast. Previously we had pencilled in cuts in March and June. We still view the March and April meetings next year as “live”. But given the parameters the RBNZ has set out, it now seems that the more likely date for the next cut is June. Consequently, we are now shifting our forecast to OCR cuts in June and August next year.

Details

Compared to the September *MPS* forecasts, today’s document was more upbeat in some ways and more cautious in others. On the positive side, world dairy prices have come off their lows and house prices have risen more than expected, both supporting a stronger outlook for private consumption. However, emerging market economies are looking weaker, unemployment has risen, and a rebound in the New Zealand dollar will have a dampening effect.

The most striking change to the RBNZ's forecasts was around inflation. Previously, the RBNZ expected that the fall in the New Zealand dollar would generate a substantial lift in tradable goods inflation, enough to offset the softness in domestic inflation pressures and bring the overall inflation rate back to 2% by September next year. Now, the higher New Zealand dollar means that tradables inflation is forecast to be more subdued. Consequently, overall inflation is projected to remain just above 1% over most of 2016, and doesn't reach 2% until the end of 2017.

However, this outcome still falls with the RBNZ's target, as defined in the Policy Targets Agreement: future inflation of 1-3%, on average, over the medium term. Indeed, the RBNZ has gone to some effort this time to remind people what the PTA actually says: as well as specifying the inflation target, it also requires the RBNZ to avoid "unnecessary volatility" and to consider financial stability risks. The latter in particular is obviously relevant right now, given the rapid rise in Auckland house prices this year.

The MPS considered four scenarios of risks to the RBNZ's central view: stronger than expected household spending due to the 'wealth effect' from housing, a further lift in net migration, an El Nino-led drought, and a renewed decline in export prices. The last scenario in particular was likely to prompt further OCR cuts, which is not surprising given that the plunge in world dairy prices was a key motivation for the previous OCR cuts this year.

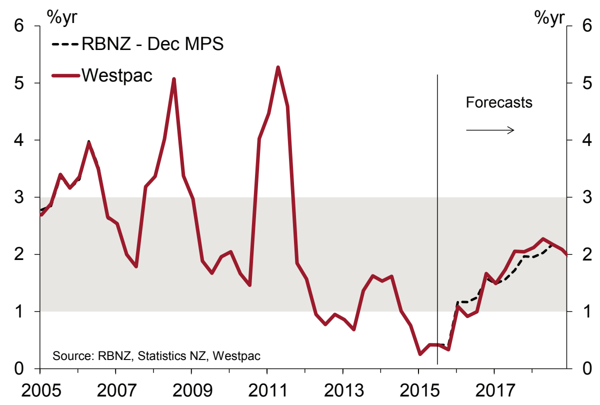
The RBNZ's renewed emphasis on the medium-term outlook doesn't mean that it will be insensitive to near-term developments. We identify three concerns in particular:

Inflation: We think that inflation will continue to fall short of forecasts in the near term. In fact, while the situation around oil prices is quite fluid at the moment, after OPEC's decision to keep pumping, based on current fuel prices alone there is a real chance that inflation will remain below the 1-3% target range for most of next year too. And with that, there's a greater risk that low inflation feeds into price- and wage-setting behaviour over the RBNZ's medium-term horizon.

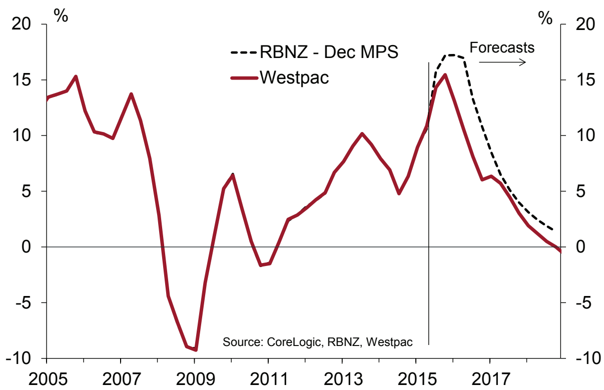
Housing: The RBNZ has assumed that the impact of the new tax rules and LVR limits will have only a temporary impact on the housing market, and its outlook for nationwide house prices is remarkably bullish, with increase of around 17% for this year and 11% next year. We suspect there is more heat yet to come out of the housing market following the 'rush to the door' ahead of the new regulations – especially in Auckland, which is really the only region where house prices qualify as a financial stability concern.

Growth: Beyond next week's release of September quarter GDP, where we expect a strong 0.9% increase, our forecast of growth over the next couple of years is substantially softer than the RBNZ's. We think that the low dairy payout over the last two seasons will weigh on spending and investment, and that drought will further undermine growth over the first half of next year. The RBNZ has not incorporated a drought in its central view, but included it as a risk scenario. And while that scenario doesn't envisage further OCR cuts, that would depend on a lower exchange rate providing the necessary easing.

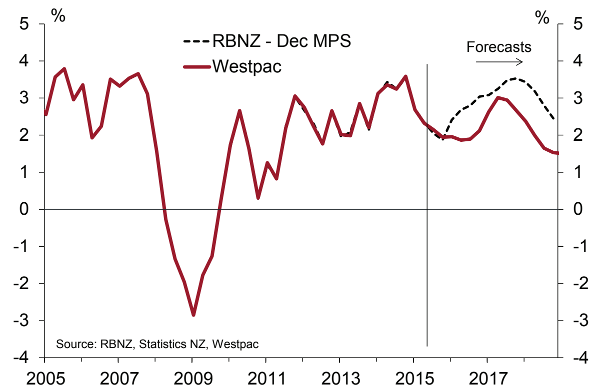
CPI Inflation forecasts



House price inflation forecasts



GDP growth forecasts



We think that these factors together will be enough to prompt the RBNZ to reduce the OCR further to 2% next year. However, the likely timing of those rate cuts remains uncertain. With the exception of January, we consider any of the RBNZ's upcoming *Monetary Policy Statements* and OCR Reviews as live possibilities for OCR cuts. But we now consider the most likely timing is 25 basis point OCR cuts in June and August next year.

Dominick Stephens
Chief Economist

Michael Gordon
Senior Economist

RBNZ media release

The Reserve Bank today reduced the Official Cash Rate (OCR) by 25 basis points to 2.5 percent.

Globally, economic growth is below average and inflation is low, despite highly stimulatory monetary conditions. Financial markets remain concerned about weaker growth in emerging economies, particularly in China. Markets are also focused on the expected tightening of policy in the United States and the prospect of an increasing divergence between monetary policies in the major economies.

Growth in the New Zealand economy has softened over 2015, due mainly to lower terms of trade. Combined with increases in the labour supply from strong net immigration, the slowdown has seen an increase in spare capacity and unemployment. A recovery in export prices, the recent lift in confidence, and increasing domestic demand from the rising population are expected to see growth strengthen over the coming year.

The New Zealand dollar has risen since August, partly reversing the depreciation that occurred from April. The rise in the exchange rate is unhelpful and further depreciation would be appropriate in order to support sustainable growth.

House price inflation in Auckland remains high, posing a financial stability risk. Residential building is accelerating, and recent tax and LVR measures are expected to reduce housing pressures. There are some early signs that Auckland house price inflation may be moderating.

CPI inflation is below the 1 to 3 percent target range, mainly due to the earlier strength in the New Zealand dollar and the 65 percent fall in world oil prices since mid-2014. The inflation rate is expected to move inside the target range from early 2016, as earlier petrol price declines will drop out of the annual calculation, and the lower New Zealand dollar will be reflected in higher tradables prices.

There are a number of uncertainties and risks to this outlook. In the primary sector, there are risks that dairy prices remain weak for longer, and the current El Niño results in drought conditions and weaker output. Risks to the domestic outlook include the prospect of net immigration staying high for longer and of household expenditure picking up on the back of strong house prices.

Monetary policy needs to be accommodative to help ensure that future average inflation settles near the middle of the target range. We expect to achieve this at current interest rate settings, although the Bank will reduce rates if circumstances warrant. We will continue to watch closely the emerging flow of economic data.

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Anne Boniface, 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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