

Popping down to the dairy

June 2015 MPS Review: RBNZ cuts OCR to 3.25%

- The Reserve Bank surprised the market by cutting the Official Cash Rate by 25bp to 3.25%, and signalled another 25bp cut later this year.
- The RBNZ has become significantly more concerned about the impact of low dairy prices on domestic demand.
- These concerns about dairy trumped the weaker New Zealand dollar and the rampant Auckland housing market.
- The RBNZ was vague about the timing of the follow-up cut.
- We now expect one more 25bp OCR cut, in September. This is based on our forecast of Q2 CPI exceeding the RBNZ's expectation.
- But upcoming dairy auctions will be critical. If dairy prices continue to fall we may change our OCR forecast to a July cut and further cuts beyond that.

The Reserve Bank surprised much of the market, including us, by reducing the OCR by 25 basis points to 3.25% today. The forecasts in the accompanying *Monetary Policy Statement* signalled another 25 basis point cut this year, though noting that “this will depend on the emerging data”. The New Zealand dollar fell by almost two cents after the announcement, while the two-year swap rate fell by 17 basis points. Markets are now pricing in a 50% chance of a follow-up cut in July, a full cut by September, and a 50% risk of another cut on top of that later in the year.

While we recognised that the case for interest rate cuts this year was growing, we didn't expect the RBNZ to move as soon as today, based on the criteria it had laid out in recent statements:

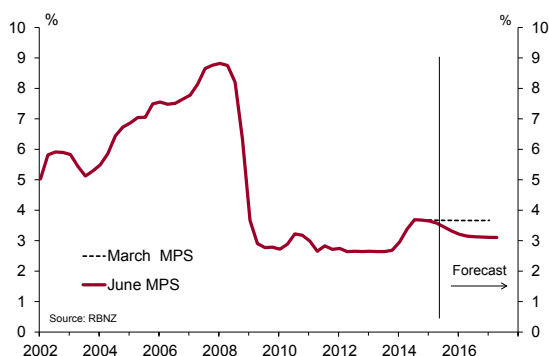
“It would be appropriate to lower the OCR if demand weakens, and wage and price-setting outcomes settle at levels lower than is consistent with the inflation target.”

It's clear that wage and price inflation has been subdued lately, although it's a marginal call as to whether they have 'settled' below the target. And as for a weakening in demand, there's been precious little sign of that in the data to date.

However, the RBNZ judged that the fall in New Zealand's terms of trade – specifically the weakness in dairy prices – will slash domestic income and demand over the coming months, requiring easier monetary conditions in order to bring inflation back up to the 2% target midpoint. In short, today's rate cut was all about dairy, and dairy could heavily influence the timing of any further reduction in the OCR.

Interestingly, the RBNZ has actually lifted its inflation forecast compared to the March MPS – a forecast that, at the time, left the RBNZ firmly on hold. However, the breakdown of the forecast is substantially different: the RBNZ has substantially raised its forecast of tradables inflation on the basis of a declining New Zealand dollar – an assumption that itself is presumably contingent on interest rate cuts. In contrast, the RBNZ has slashed its forecasts of non-tradables inflation, reflecting weaker domestic demand and a smaller output gap.

RBNZ 90-day interest rate forecasts



The RBNZ's projections show the 90-day interest rate falling to 3.1%, which implies one more 25bp cut to the OCR this year (and probably an ongoing easing bias). However, the RBNZ was noncommittal as to whether the next cut might come in the July or September OCR reviews, simply noting that it will "depend on the emerging data".

There are compelling arguments either way. On the one hand, with only one more rate cut anticipated, there isn't a great deal of urgency to get to the endpoint quickly, and waiting until the September MPS would provide an opportunity to rationalise the move and assess whether any further easing may be needed.

On the other hand, why delay a rate cut that has already been signalled to the market? Strong domestic demand, rampant Auckland house prices, a weaker New Zealand dollar and a rebound in fuel prices weren't enough to stay the RBNZ's hand today, so presumably it would need to see something else in the "emerging data" to prompt a pause in July.

The reason we prefer to call a September cut is the June quarter CPI, which will be published a week before the July OCR review. We're now forecasting a 0.8% rise in prices for the quarter, as a result of the lower NZ dollar and the rebound in fuel prices. By comparison, the RBNZ's forecast of 0.4% looks on the low side (even lower in fact than it was three months ago). A CPI print in line with our forecast would cause the RBNZ sufficient pause for thought to delay until September.

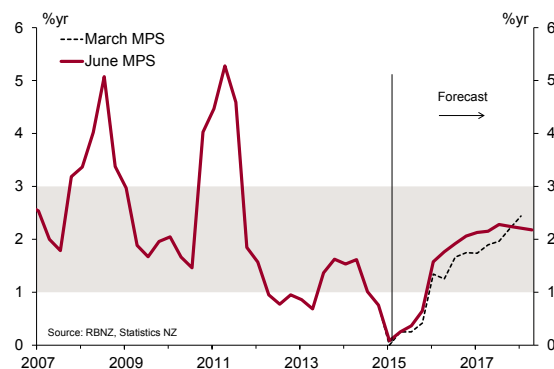
However, there are three GlobalDairyTrade auctions between now and the July OCR review. If world dairy prices continue to soften at these auctions, we'll have no qualms about bringing forward our rate cut call to July. And in that scenario, we would probably look to forecast the OCR falling below 3.0%. A stabilisation or a rise in dairy prices would give us some comfort, though realistically we'd still be looking at a farmgate milk price with a \$5 handle for this season, well below the average of recent years.

The other key piece of "data" to watch will be the exchange rate – the New Zealand dollar is under considerable downward pressure at present. If it falls further, as we expect, the case for a July OCR cut will diminish. If the NZD stabilises at current levels, the case for a July cut would be bolstered.

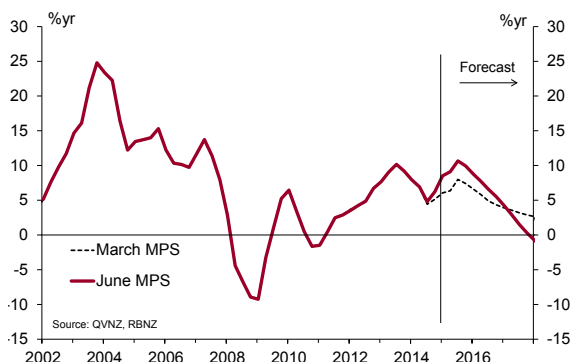
A risky decision

We feel the monetary policy situation is more finely balanced than the RBNZ's assessment. New Zealand is torn between rampant house prices and strong domestic demand on one hand, and a weak export sector and low inflation on the other. The RBNZ has chosen to emphasise the latter and downplay the former. But today's OCR cut does run the risk further stimulating the Auckland housing market. Since today's OCR cut wasn't fully anticipated by the market, wholesale interest rates have fallen, which in turn is likely to flow through to fixed-term mortgage rates. Today's REINZ House Price Index showed that Auckland house prices have risen 25.6% in a year, and if that continues, domestic demand (and consequently domestic inflation) is sure to get a lift. The RBNZ has presumably decided that this is a risk worth running.

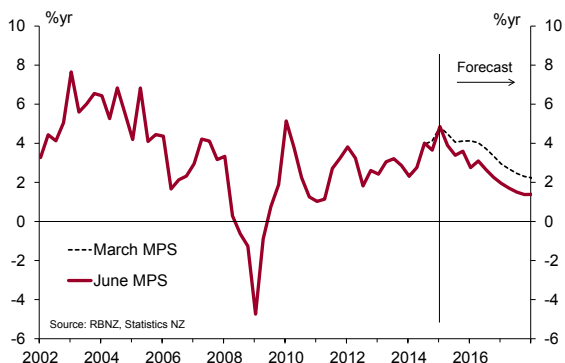
RBNZ Inflation forecasts



RBNZ house price forecasts



RBNZ private consumption forecasts



Nor does the RBNZ really make a case that the risks around the housing market have been adequately addressed through other measures. For instance, the proposed restrictions on loan-to-value ratios for investor lending in Auckland are expected to reduce house price inflation by 2-4%. That is less than the gain made in the month of May alone, according to today's REINZ House Price Index. There is every likelihood that we will see yet another tightening of macroprudential policy, as a result of the lower OCR.

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RBNZ media release

The Reserve Bank today reduced the Official Cash Rate (OCR) by 25 basis points to 3.25 percent.

Growth in the global economy remains moderate. Data on economic activity in the US, China and Australia has been mixed, although there has been some improvement in the euro area and Japan. Volatility in financial markets has increased.

The New Zealand economy is growing at an annual rate around three percent, supported by low interest rates, high net migration and construction activity, and the decline in fuel prices. However, the fall in export commodity prices that began in mid-2014 is proving more pronounced. The weaker prospects for dairy prices and the recent rises in petrol prices will slow income and demand growth and increase the risk that the return of inflation to the mid-point would be delayed.

Inflation has been low due to falling import prices and the strong growth in the economy's supply potential. Wage inflation and inflation expectations have been subdued.

With the fall in commodity prices and the expected weakening in demand, the exchange rate has declined from its recent peak in April, but remains overvalued. A further significant downward adjustment is justified. In light of the forecast deterioration in the current account balance, such an exchange rate adjustment is needed to put New Zealand's net external position on a more sustainable path.

House prices in Auckland continue to increase rapidly, and increased supply is needed to address this. The proposed LVR measures and the Government's tax initiatives planned for 1 October 2015 should ease the impact of investor activity.

A reduction in the OCR is appropriate given low inflationary pressures and the expected weakening in demand, and to ensure that medium term inflation converges towards the middle of the target range.

We expect further easing may be appropriate. This will depend on the emerging data.

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