Westpac

Institutional Bank

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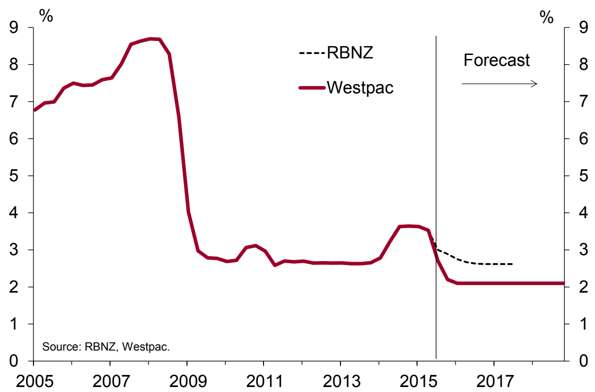
Doubling down on the dollar

September 2015 MPS Review: RBNZ cuts OCR to 2.75%

- The Reserve Bank reduced the Official Cash Rate by 25bp to 2.75%, and signalled that one further rate cut was likely at an unspecified date.
- This was in line with what we anticipated.
- Whether the RBNZ cuts in October is a close call.
- The RBNZ has slashed its forecasts of domestic demand, leaving it increasingly reliant on the effects of a weaker New Zealand dollar to bring inflation back to the target.
- We're sceptical that a lower exchange rate can provide such a sustained boost to the rate of inflation.
- Consequently, we continue to expect that the OCR will eventually fall to 2.0%.

RBNZ 90-day interest rate forecasts



The September *Monetary Policy Statement* delivered very much the message that we and the market were anticipating. The Reserve Bank reduced the OCR by another 25 basis points to 2.75%, and signalled that one further rate cut is likely, albeit data-dependent. Interest rates were only slightly lower after the announcement. The New Zealand dollar had a stronger reaction, down more than a cent, although this effectively reversed its unexplained gains over the previous few days.

Today's statement doesn't strongly suggest that the RBNZ is prepared to cut rates again at the October review, as we're currently forecasting. So in regard to the near-term outlook for interest rates, we are firmly in 'data watch mode'. In addition to the full gamut of New Zealand data, the US Federal Reserve's interest rate review next Thursday will be critical. The RBNZ has made no secret of the fact that it would like to see US interest rates rise, boosting the US dollar and helping to push the NZ dollar lower. If the Fed kicks off that process next week, and exchange rates respond accordingly, the hurdle for an October OCR cut would be fairly high.

However, we remain of the view that the OCR will need to go lower than the 2.5% trough that the RBNZ is signalling, if the RBNZ is to achieve its target of 2% inflation over the medium term. The RBNZ shares our view that the slowing economy will make it harder to generate home-grown inflation pressures. Yet the RBNZ is still predicting a rapid return to 2% inflation, on the basis that a lower NZ dollar will lead to a sustained rise in tradables inflation. We don't fully agree with that. We think the lower NZD will only provide a one-off boost to tradables prices; to generate sustained inflation, more action on interest rates will be needed. We expect the OCR to eventually be cut to 2%, even if the timing of OCR cuts is uncertain.

Not surprisingly, the dairying downturn and the peaking of the Christchurch rebuild have prompted the RBNZ to dramatically lower its growth forecasts, compared to the June *Monetary Policy Statement*. The loss of dairying income in particular is expected to drag down growth in consumption and business investment. We broadly share the RBNZ's view, though we have gone even further, projecting growth to drop below 2% next year.

Slowing growth, at a time when output is already running below its potential, foretells a further softening in domestic inflation pressures over the next couple of years. Indeed, the RBNZ's forecast of non-tradables inflation is truly dismal – dropping to 1.1% early next year, and remaining at around 1.3% for the following year. The only time on record that non-tradables inflation has fallen below this level was in early 1993, and even that was short-lived.

Despite this, the RBNZ has more or less retained its forecast of overall inflation from the June *MPS*. Annual inflation is expected to rise back above 1% by early next year, as this year's steep fall in fuel prices drops out of the calculation, and to stabilise at around 2% by September next year.

The RBNZ expects this recovery will happen via a strong and sustained lift in tradables inflation. The NZ dollar has fallen substantially over the last year, down about 12% on a trade-weighted basis, and the RBNZ anticipates a further modest decline over the coming year. The RBNZ believes that not only the *change* in the exchange rate, but the lower level, will generate a sustained burst of inflation in tradable goods and services, peaking at over 3% by the end of next year.

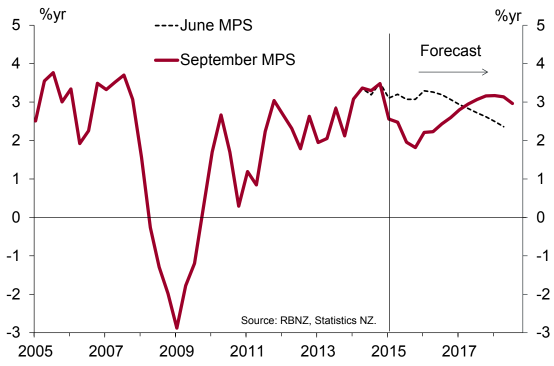
That said, the RBNZ acknowledges that the behaviour of the pass-through from the exchange rate to consumer prices is highly uncertain. Our own view is that the falling exchange rate would produce a smaller and shorter-lived burst of inflation than the RBNZ expects. There's no question that changes in the exchange rate will have a temporary impact on inflation. But we see no real evidence that the *level* of the exchange rate affects the *rate of change* in consumer prices.

Moreover, the degree of tradables inflation that the RBNZ is projecting seems a tall order. Outside of GST increases and spikes in world oil prices, tradables inflation has rarely exceeded 3% a year. And the only time it has been sustained at anything like these levels was in 2000-01, after the currency had fallen to a record low and oil prices had tripled over the previous three years, from $10 to $30 a barrel.

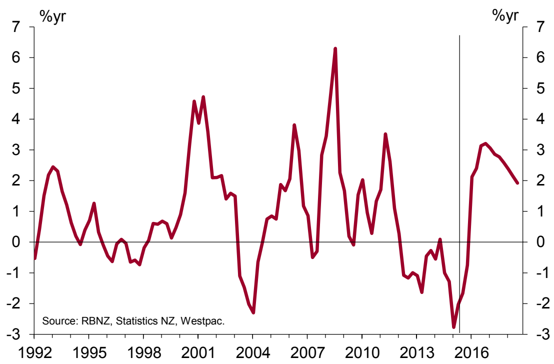
In our view, the fall in the NZ dollar to date will push inflation close to 2% next year, but the impact will fade again by 2017, in the absence of further action to generate home-grown inflation pressures. So we remain very comfortable forecasting a 2.0% low-point for the OCR, even if the timing is uncertain.

It's worth noting that the RBNZ did detail an alternate scenario in which it might reduce the OCR to as low as 2%. This was based on a sharp slowdown in the global economy, weighing on commodity prices and domestic demand. Furthermore, in the press conference the Governor mentioned that there was scope to reduce the OCR "substantially" if global growth slowed or the current El Nino weather pattern resulted in drought in New Zealand. By publishing this scenario, the RBNZ has opened the door – just a crack – to the idea of a sub-2.5% OCR.

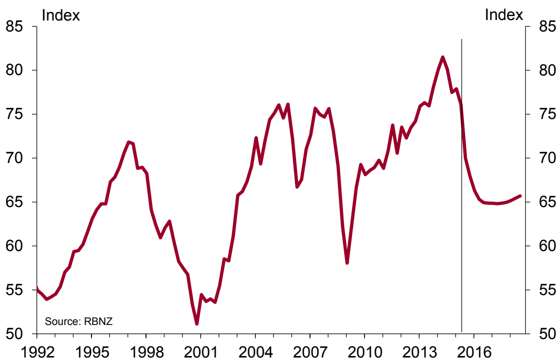
RBNZ GDP growth forecasts



RBNZ tradables inflation forecast, ex GST



RBNZ Trade Weighted Index forecast



That is an important development for markets. In recent weeks markets have been behaving as though 2.5% is a "line in the sand" below which the OCR cannot go. That will change over the coming weeks –if New Zealand experiences a run of weak data, markets will now feel licenced to price in some risk of the OCR dropping below 2.5%.

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RBNZ media release

The Reserve Bank today reduced the Official Cash Rate (OCR) by 25 basis points to 2.75 percent.

Global economic growth remains moderate, but the outlook has been revised down due mainly to weaker activity in the developing economies. Concerns about softer growth, particularly in China and East Asia, have led to elevated volatility in financial markets and renewed falls in commodity prices. The US economy continues to expand. Financial markets remain uncertain as to the timing and impact of an expected tightening in US monetary policy.

Domestically, the economy is adjusting to the sharp decline in export prices, and the consequent fall in the exchange rate. Activity has also slowed due to the plateauing of construction activity in Canterbury, and a weakening in business and consumer confidence. The economy is now growing at an annual rate of around 2 percent.

Several factors continue to support growth, including robust tourism, strong net immigration, the large pipeline of construction activity in Auckland and other regions, and, importantly, the lower interest rates and the depreciation of the New Zealand dollar.

While the lower exchange rate supports the export and import-competing sectors, further depreciation is appropriate, given the sharpness of the decline in New Zealand's export commodity prices.

House prices in Auckland continue to increase rapidly and are becoming more unsustainable. Residential construction is increasing in Auckland, but it will take some time to correct the imbalances in the housing market.

Headline CPI inflation remains below the 1 to 3 percent target due to the previous strength in the New Zealand dollar and the halving of world oil prices since mid- 2014. Headline inflation is expected to return well within the target range by early 2016, as the earlier petrol price decline drops out of the annual inflation calculation, and as the exchange rate depreciation passes through into higher tradables prices. Considerable uncertainty exists around the timing and magnitude of the exchange rate pass-through.

A reduction in the OCR is warranted by the softening in the economy and the need to keep future average CPI inflation near the 2 percent target midpoint. At this stage, some further easing in the OCR seems likely. This will depend on the emerging flow of economic data.

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