

Not so fast

A final word before next week's RBNZ MPS

- We remain firmly of the view that the RBNZ will leave the OCR on hold next week.
- It is possible that next week's Monetary Policy Statement will explicitly signal future cuts.
- More likely, the RBNZ will stick to its conditional easing bias.
- Developments over the past week or two have served to increase the odds of OCR cuts later this year.
- But as the New Zealand data has weakened, the exchange rate has fallen.
- Whether the OCR actually falls or not remains a close call.

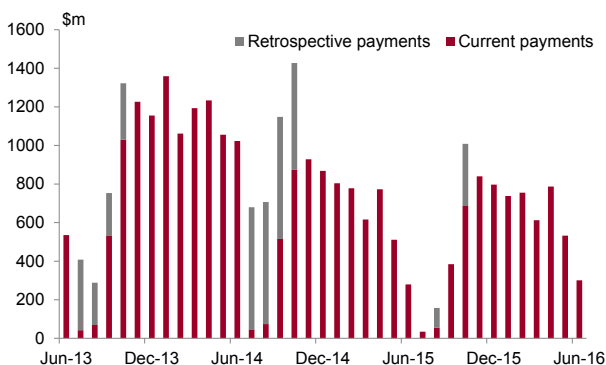
There are three reasons we consider a cut at next week's MPS unlikely:

- In April the RBNZ set out two clear conditions for OCR cuts- wage and price setting behaviour would have to settle below the inflation target, and domestic demand would have to cool. Those conditions have not been met. Indicators of current domestic demand have remained very firm (especially the housing market), and inflation expectations have not fallen as much as expected.
- Changing the OCR now would be out of keeping with normal RBNZ behaviour. Every series of OCR changes since 2005 (except the emergency cut following the 2011 earthquake) has been preceded by a blunt signal consisting of a sloping 90-day interest rate forecast and a comment in a press release along the lines of "...we are likely to.." or "...we expect to.." reduce/increase the OCR. No such signal has been given on this occasion.
- By our reckoning, the inflation outlook has not changed dramatically since April, when the RBNZ first articulated its conditional easing bias. Downside data developments have been largely offset by the falling exchange rate.

We see two plausible scenarios for the commentary accompanying next week's OCR decision. The first possibility is that the RBNZ will use this *Monetary Policy Statement* to signal an impending OCR reduction. We view this as the less likely scenario, but it is still worth articulating so that everybody is prepared. In this scenario the 90-day interest rate forecast would fall to 3.2% or lower by December 2015, and would probably be flat thereafter. The key sentence of the press release would read something like:

"Providing wage and price setting behaviour remains subdued, we expect to reduce the OCR later in the year."

Fonterra revenues distributed to farmers and shareholders



The surrounding text would contain plenty of caveats and commentary about the timing of cuts depending on the data, so that the RBNZ still has an out if needed. But the use of the word “expect” would still be a very powerful signal to markets.

The second possible scenario is the one we view as most likely – that the RBNZ retains some form of conditionality to its easing bias. In this case the 90-day interest rate forecast would be flat at 3.6% (which is close to the current level), or at most would feature a slight downward slope over the course of two years. Either forecast would imply a risk of OCR cuts but no conviction. The risk of cuts (as opposed to an expectation) could be further conveyed via alternative scenarios within the MPS. For example, back in March the RBNZ published an alternative scenario in which inflation expectations drop away and the 90-day rate falls.

The press release accompanying such an MPS would probably contain generally dovish commentary, including observations that the economy has more spare capacity than previously thought, export sector incomes are falling, and recent policy changes might help cool the overheated housing market. However, the statement would also note recent strong data relating to the housing market and domestic demand. The core policy guidance sentence would not be substantively different from April – the RBNZ would still say something along the lines of:

“If... [conditions] ...it may become appropriate to lower the OCR.”

Should our preferred scenario come to pass, markets would be disappointed. However, the potential for two-year swap rates or the exchange rate to rise is limited, because markets will continue to price in future OCR cuts.

In an effort to avoid a lurch higher in the exchange rate, the RBNZ is going to have to repeat the “unjustified and unsustainable” characterisation that has become such a security blanket for markets. Our guess at the RBNZ’s exchange rate paragraph would be something like:

“The exchange rate has fallen recently, but it remains unjustified and unsustainable given recent weakness in export commodity prices. A further fall in the exchange rate would be welcome.”

While we remain adamant that a cut next week is unlikely, the arguments in favour of OCR cuts later in the year are gaining ground. This week’s 4.3% fall in the global dairy auction price was both surprising and important. Dairy auction prices are now down almost 30% from February’s short-lived price spike, and we have downgraded our forecast of Fonterra’s farmgate milk price for 2015/16, to \$5.40 per kilogram of milk solids.

Fonterra’s own forecast, released last week, is \$5.25. Neither Fonterra’s forecast nor ours is likely to be the last word, but Fonterra’s number carries important implications for advance payments to farmers in spring. Farm cashflow has actually been quite reasonable until recently, but is about to drop off a cliff. Payments to Fonterra suppliers and shareholders over July, August and September 2014 totalled \$2.53bn. Over the same months of 2015 payments will total just \$0.58bn (see chart).

On our travels around New Zealand we have detected growing angst about this impending cashflow crunch, even if the business environment more generally remains positive. That angst appeared to show through in this week’s ANZ Business Outlook survey, which registered a marked drop in business confidence and a fair-sized drop in businesses’ own activity expectations, although the survey does remain consistent with strong economic growth.

These recent developments have bolstered the case for OCR cuts at some point later this year. However, there has also been an offset in the plunging exchange rate – the trade weighted index is down 7.4% since 21 April, and it could fall further if the US Federal Reserve remains on track to hike interest rates in September. Whether the OCR actually falls this year or not remains a close call – we will reassess our OCR forecast after next week’s *Monetary Policy Statement*.

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