

The cat is out of the bag

RBNZ OCR preview, April 2015

- In a speech this week the RBNZ shifted to a slightly more dovish monetary policy stance.
- The OCR outlook is still “on hold”. But the RBNZ would consider cutting if inflation pressures fell any further.
- The cat is already out of the bag. Next week’s OCR Review can only serve to affirm this change of stance.
- There is still scope for a small market reaction next week, depending on the RBNZ’s exact words.
- We agree with the RBNZ’s new assessment. We ascribe a 40% chance to OCR cuts this year.

This week’s speech by RBNZ Assistant Governor John McDermott essentially “let the cat out of the bag” ahead of next week’s OCR Review. While the outlook for the OCR is still “on hold”, the speech indicated that if domestic inflation pressures fell any further the RBNZ would consider cutting the OCR. This clearly represents a shift from the key policy sentence of the RBNZ’s March *Monetary Policy Statement*, which struck a firmly neutral tone:

“...future interest rate adjustments, either up or down, will depend on the emerging flow of economic data.”

It is unlikely that next week’s OCR Review will contradict the Assistant Governor’s speech after only one week. It seems obvious that next week’s OCR Review will be more dovish than the press release that accompanied the March *MPS* press release. Although the central OCR outlook is still “on hold”, we suspect that the RBNZ will find some way to introduce more asymmetry into its language than it has used in previous missives. At the very least, any reference to the OCR going “up” will be purged. Market reaction on the day will hinge on whether the RBNZ explicitly mentions the possibility of the OCR going down, or leaves that possibility implicit.

Between a rock and a hard place

Monetary policy has been stuck between a rock and a hard place for some time. Near-zero inflation, dimming prospects for primary exporters, and an extremely high trade-weighted exchange rate all argue for OCR cuts. But cutting the OCR would risk turbo-charging the already-hot domestic economy, thus generating a future inflation issue. Auckland house prices are roaring higher, construction activity is booming, net immigration is running at all-time highs, and consumers are on a spending spree.

Since last September the Reserve Bank’s monetary policy strategy has focussed on “domestic price-setting behaviour”, which is a broad term for inflation expectations. The low inflation rate that prevails at present will only become a medium-term problem if businesses and consumers take on a low inflation mind set and lose faith in inflation returning to two percent on

average. So the Reserve Bank is closely watching surveys of inflation expectations, pricing intentions, and costs. The RBNZ is also drawing inferences about inflation expectations from financial markets and from its economic models.

At the time of the March *MPS*, the Reserve Bank's interest rate projection was dead-pan flat, and the press release referred to the possibility of rates moving "either up or down". However, an alternative scenario within the *MPS* did indicate that the RBNZ would cut the OCR should inflation expectations fall much further, and the Governor's subsequent comments portrayed more worry about the downside than the upside.

Since March, the balance of economic developments has been to the downside. We estimate that the RBNZ's internal interest rate forecast is now 20 basis points lower over two years than it was. This is mainly because the exchange rate is trading 3% to 4% higher than the RBNZ previously assumed. (And the strong exchange rate will outweigh upside surprises on net immigration and house prices).

There has not been much new information about domestic price setting behaviour since the March *MPS*. However, judging by Dr McDermott's speech, RBNZ thinking in this area has evolved in a dovish direction. The RBNZ's model-based and market-based measures of inflation expectations are now below the inflation target, while only the survey-based measures are in line with target.

Furthermore, Dr McDermott's speech expressed more scepticism about the strong economy boosting inflation via the output gap than in past communications.

We agree that there is a chance of cuts later this year

So along three dimensions the RBNZ's thinking has evolved more in the direction of interest rate cuts. We tend to agree with the RBNZ's assessment, and have ourselves become more ready to countenance OCR cuts this year. On our forecasts, inflation will remain at or below half a percent until the end of this year. That is an awfully long period over which low inflation could influence expectations. So despite our resolutely bullish views on the housing market and economic growth, we ascribe roughly a 40% chance to OCR cuts occurring this year.

If the Reserve Bank were to cut the OCR, it would most likely occur late in the year, for two reasons. First, compelling evidence of falling inflation expectations won't really be available until at least the middle of this year. Second, macroprudential tightening is one possible resolution to the monetary policy conundrum. The RBNZ has indicated that it will restrict mortgage lending to landlords. However, implementing such restrictions is infeasible until later in the year. The RBNZ may be loath to cut the OCR until it is comfortable that the housing market can be contained another way.

Generally, OCR cuts do not come as singletons. The 40% odds we are ascribing are to *at least two* OCR cuts. Therefore, we have no disagreement with current financial market pricing,

which implies around 25 basis points worth of OCR cuts over the coming year. This could be interpreted as 50/50 odds on two or more cuts ahead.

The shape of next week's statement and market reaction

Given that the cat is already out of the bag, the scope for a market reaction next week is now limited. Markets reacted vigorously to the speech, sending swap rates five basis points lower, and the New Zealand dollar down by three-quarters of a cent. One struggles to imagine how a one-page press release could contain new information over and above a nine-page speech delivered only one week earlier. However, the reality of financial markets is such that the exact words that the RBNZ chooses next week could cause some degree of price action.

There were a couple of sentences in Dr McDermott's speech that read awfully like typical policy guidance sentences, were presumably vetted by the Governors' Committee before they were uttered, and could be used as a template for next week:

"The outlook for inflation is ... subdued, and suggests that monetary policy should remain stimulatory for some time. ... The timing of future adjustments in interest rates will depend on the evolution of inflationary pressures in both the traded and non-traded sectors."

Should the policy paragraph of the OCR Review read along these lines, we suspect that interest rates and the exchange rate would rise, if only slightly. Markets are probably primed for a clearer shift in the articulation of the balance of risks.

Another option, which we judge less likely, is for the Reserve Bank to be more emphatic about the possibility of reducing interest rates, albeit in conditional and cautious fashion. Perhaps the RBNZ will insert somewhere in the press release language along the lines of this sentence that appeared in the speech:

"Evidence of weakening demand and domestic inflationary pressures would prompt us to consider lowering interest rates."

Any such reference to a lower OCR, even if stated in conditional terms, would be significant to markets. Interest rates and the exchange rate could fall.

The other possibility for generating a market reaction on the day is any hint of intervening in the New Zealand dollar (or lack thereof). Intervention was not really elaborated on in Dr McDermott's speech. Our view is that the RBNZ will adopt strident language concerning the exchange rate, but it remains to be seen whether the market will deem such language strident enough.

Aside from the exchange rate and inflation, next week's Review will probably feature a downgraded assessment of the global economy, mention of weak export commodity prices, and substantial reference to the housing market and net immigration which have both surprised the RBNZ on the upside.

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