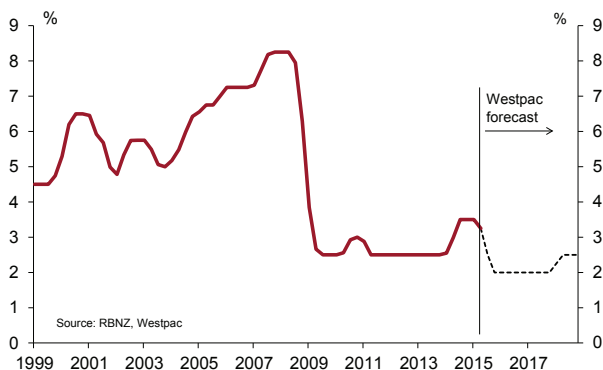


How low will it go?

RBNZ OCR Preview, July 2015

- New Zealand's economic situation has changed rapidly.
- We now expect the OCR to fall to 2.0% by December.
- There are better than even odds of a 50bps OCR cut at some point this year.
- Our base case is that the RBNZ will cut 25bps on Thursday, but it is a close call.
- There is a clear risk of the RBNZ instead cutting by 50 basis points.
- Either way, the accompanying press release will forthrightly proclaim the need for further OCR cuts.
- We expect two-year swap rates and the exchange rate to fall after the RBNZ's announcement.

Westpac OCR forecast



In June the RBNZ reduced the OCR by 25 basis points and signalled that a follow-up cut would come at some point later in the year. The RBNZ was concerned that underlying inflation had drifted too low. Because the economy's capacity to supply goods and services was greater than previously thought, there was little upward pressure on inflation in the pipeline. And with dairy export prices falling fast, the RBNZ saw a risk of an economic slowdown that could further reduce inflation pressures. The RBNZ was dismissive of the possibility that rapidly rising house prices could stoke future inflation.

The June cut surprised financial markets. We suspect that the RBNZ chose to surprise financial markets in order to put downward pressure on the exchange rate, which is a rapid way of provoking higher inflation.

Since the June *MPS* New Zealand has experienced a shocking run of economic data:

- GDP growth was just 0.2% in the March quarter, and only part of the weakness was due to drought.
- Business and consumer confidence has fallen sharply.
- Global dairy prices have fallen 17% from an already-low level. We are now forecasting a farmgate milk payment of \$4.30 per kg of milksolids, compared to \$4.40 last season and \$8.40 in 2013/14.
- June quarter inflation data portrayed ongoing soft non-tradables inflation.
- It appears that rebuilding activity in Canterbury has reached its peak nine months earlier than anticipated. Rebuilding activity looks likely to plateau for a year or so, and then to start declining.

The housing market and net immigration have remained very strong, but not much more so than the RBNZ had already anticipated.

The one development that genuinely does argue against interest rate cuts is the plunging exchange rate. However, we suspect the exchange rate has not fallen far enough – the RBNZ still has a lot of work to do to return inflation to two percent on average over the medium term.

The final significant piece of context for the OCR outlook is comments that were made by the Minister of Finance about a week after the June MPS. The Minister had this to say about inflation relative to the inflation target:

“He’s been out of the zone for years now, below the midpoint for quite a long time. He’s meant to be following the Policy Targets Agreement, that’s the bit I look at, and one day somebody will start asking the minister of finance questions about whether he’s actually following the agreement or not.”

With all of the above in mind, it now seems abundantly clear that the RBNZ will reduce the OCR further and faster than it signalled in the June *Monetary Policy Statement*. We now expect the OCR to fall to 2.0% by the end of this year. There are better than even odds of a 50bps cut at some point during the year.

For Thursday, an OCR cut of some description is a slam dunk. Our base case is that the RBNZ will cut 25bps and will use strong language to describe the likelihood of further OCR cuts – our pick for the policy guidance sentence would be something like:

“It is likely that significant further reductions in the OCR will be required in the months ahead.”

The RBNZ will certainly acknowledge the fall in the exchange rate, but we suspect it will stick to its description of the exchange rate as “unjustified and unsustainable,” on the basis that the exchange rate has not fallen far enough to adequately cushion the economy given the sharp decline in export commodity prices.

An OCR Review along these lines would cause markets to price some risk of a 50bps OCR cut in September, and to price a risk of the OCR eventually falling below 2.5%. These market changes would manifest as a drop in the two-year swap rate on the day. Lower swap rates, combined with language aimed directly at the exchange rate, would also see the exchange rate fall on the day.

There is a clear risk that instead of waiting, the RBNZ will cut 50bps on Thursday. We see valid arguments in favour of either 25bps or 50bps, and there is little way of telling which way the Bank will leap on the day. On balance we opted to call only a 25 basis point reduction, but it was a close call. Certainly, we think the risk of a 50 basis point reduction is greater than the 15% chance or so that markets are currently pricing

The arguments for an immediate 50bps cut are:

- Why wait? Virtually everybody agrees that the OCR needs to fall by another 75 basis points, and some are saying 125. 50bps now is unlikely to be a policy mistake.
- This consensus lowers the risk for the RBNZ – if inflation does pop higher in a year’s time, the RBNZ can refer back to today’s private sector and political commentary.
- A sharp OCR reduction now would get the exchange rate down faster.
- The recent dramatic change in New Zealand’s economic situation justifies bold action now.

The arguments against an immediate 50bps cut are:

- 50bps now may smack of panic and could actually worsen economic confidence.
- The RBNZ may want to keep its powder dry and retain the ability to cut rapidly if the situation gets even worse.
- The housing market is still very strong – the RBNZ may prefer to wait until house price inflation cools before cutting the OCR aggressively.
- The July OCR Review involves a truncated forecasting process at the RBNZ, and only a one-page press release. The RBNZ may prefer to await the full forecasting process and the superior communication opportunity of the September Monetary Policy Statement before taking such bold action.

Dominick Stephens
Chief Economist

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Satish Ranchhod, 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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