Westpac

Institutional Bank

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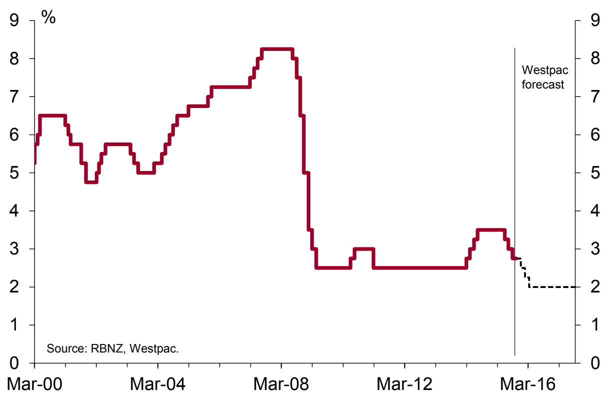
Cat out of the bag, again

RBNZ OCR Preview, October 2015

- Next week's OCR Review will contain few surprises, because the RBNZ let the cat out of the bag in a speech last week.
- We expect the OCR will remain on hold at 2.75%.
- The RBNZ will reiterate that it expects to cut the OCR further.
- But the easing bias will be more qualified and tempered than the September MPS.
- For December we are pencilling in a cut, but it is no done deal.
- The RBNZ currently plans to deliver only one more cut this cycle.
- By contrast, we are forecasting three cuts: in December, March and June.

Westpac OCR forecast



The build-up to next week's October OCR Review reminds us of April 2015, when the Reserve Bank last gave an on-the-record speech a couple of weeks before an OCR Review. That speech announced that the ground was shifting for monetary policy, and the RBNZ's policy stance was changing. It included a "dress rehearsal" OCR guidance paragraph that was faithfully repeated on the day of the actual OCR Review a week later.

The dress-rehearsal approach obviously worked for the RBNZ, because they appear to have done the same thing this month.

Last week the RBNZ Governor gave a speech about central banking in the modern era. The speech reinstated house prices as an issue of direct concern for monetary policy, and mentioned the risk of low interest rates inflaming the housing market. That's quite a turnaround – the RBNZ downplayed the housing market when it decided to cut the OCR in June, to our surprise at the time. And the September *Monetary Policy Statement* pointedly omitted any forecast of house prices. Clearly, the RBNZ has been rattled by the broadening beyond Auckland of the house price boom.

The speech also referred to the improvement in local economic data and higher dairy prices. If these inclusions were hawkish, so was the key omission – there was no significant reference to the recent rise in the exchange rate.

The Governor repeated the line from previous monetary policy communications that *"Some further easing in the OCR seems likely but this will continue to depend on the emerging flow of economic data"*. But this was in the context of a swathe of sentences all expressing caution about cutting the OCR too rapidly or too far. The whole policy guidance paragraph from the speech was:

Recent economic indicators have been more encouraging. Some further easing in the OCR seems likely but this will continue to depend on the emerging flow of economic data. At the same time however, we remain conscious of the impact that low interest rates can have on housing demand and its potential to feed into higher price inflation. It is important also to consider whether borrowing costs are constraining investment, and the need to have sufficient capacity to cut interest rates if the global economy slows significantly.

We have drawn a number of key conclusions following that speech:

- It is unlikely that the RBNZ will cut the OCR at next week's Review, having just delivered such a hawkish speech.
- *"Some further easing…"* etc is likely to be repeated word for word, and will be the key sentence of the OCR Review.
- However, the RBNZ's easing bias will be softened via a more upbeat description of economic conditions, and probably also via qualifying sentences within the crucial policy guidance paragraph, per the speech.
- The RBNZ is aiming for an OCR low-point of 2.5%, meaning it expects to deliver one more cut this cycle.
- Consequently we are forecasting a cut in December – but that is no done deal. The RBNZ's current thinking may lean in favour of cutting in December, but that could easily change. Next week's OCR Review will leave the RBNZ enough wriggle room to keep the OCR on hold in December if required.

One thing that doesn't seem so clear is how the RBNZ will treat the exchange rate. The speech barely mentioned the exchange rate, but that doesn't seem like a credible option for an OCR Review – especially as the NZD has risen 7% since the last *MPS*. We suspect that, like the All Blacks, the RBNZ kept a little something in reserve during the preliminaries. The RBNZ is likely to deviate from the speech by expressing discomfort at the rising exchange rate, perhaps labelling it "unwelcome".

Westpac's OCR forecast

The RBNZ's stance is moving in a more hawkish direction at present, but we believe the situation will change early next year.

We have long disputed the RBNZ's view that a 2.5% OCR will be sufficient to return inflation to two percent on a sustained basis. Our latest analysis is suggesting that inflation will be closer to one percent in early-2016 than two. In fact, we doubt that inflation will reach two percent before 2017, which is right around the time that the waning Canterbury rebuild will put renewed downward pressure on the economy and inflation. We conclude that the OCR will have to fall to 2.0%, and we remain steadfast in that view.

But after the speech we were forced to rethink the *timing* of OCR reductions in 2016. Last week we altered our OCR forecasts slightly, and now anticipate cuts in March and June next year (in addition to the aforementioned cut in December 2015). Our forecast assumes three key developments will have taken place by March: (1) An El Nino drought will have impacted agricultural production; (2) The Auckland housing market will have slowed; and (3) Data will increasingly be suggesting that inflation will undershoot the RBNZ's forecasts.

Market reaction

An OCR Review along the lines we anticipate would not move interest rate markets, which have been well primed by the speech. If the RBNZ did take aim at the exchange rate, the NZD would remain steady, or perhaps fall slightly. If the RBNZ omitted any mention of the exchange rate, then the NZD would be sure to rise.

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

Satish Ranchhod, Senior Economist
+64 9 336 5668

Anne Boniface, 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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