Westpac
Institutional Bank

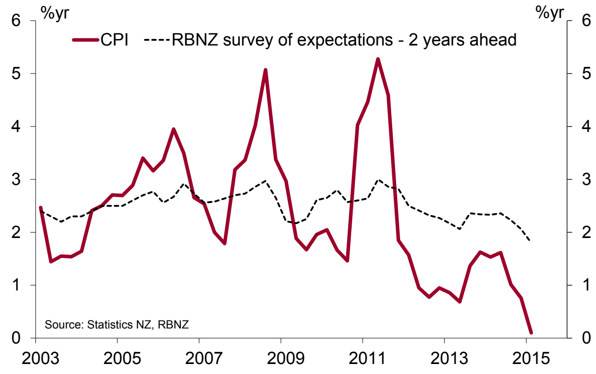
30 April 2015

Stamp of approval

April 2015 OCR Review: OCR on hold at 3.50%

- Today's OCR Review gave the official stamp of approval to last week's speech. The RBNZ has adopted a conditional easing bias.
- The OCR will remain on hold unless domestic demand weakens and wage and price-setting behaviour settles below the inflation target.
- We suspect wage and price-setting will indeed drop, but we doubt that demand will weaken.
- There were no material surprises in the Review, but markets still reacted to confirmation of the conditional easing bias.
- We remain comfortable with the OCR outlook we issued last week.
- The OCR is most likely to remain on hold, but there is a 40% chance of two or more cuts over the coming year.
- If cuts do occur, they would most likely occur late in the year.

CPI inflation and inflation expectations



Source: Statistics NZ, RBNZ

Today's Reserve Bank April OCR Review gave the official stamp of approval to the sentiments Assistant Governor John McDermott delivered in a speech last week. As the speech explained, the RBNZ has stepped away from its previous neutral stance on the OCR outlook. Instead, the RBNZ has adopted a conditional easing bias. This means that the OCR will remain on hold unless certain conditions are met, in which case it could be cut.

Given the "heads up" we got in last week's speech, we felt there were no material surprises today. Nevertheless, financial markets reacted to confirmation of the conditional easing bias by sending swap rates approximately four basis points lower, and the New Zealand dollar half a cent lower. We suspect that interest rates will continue to drift lower over the coming days. Interest rate market pricing now implies 30 basis points of OCR reductions by April next year. That is not wildly inconsistent with our view that there is approximately a 40% chance of two or more OCR cuts over the coming year (and a 60% chance of no change).

The key policy guidance paragraph in today's OCR Review was:

"The timing of future adjustments in the OCR will depend on how inflationary pressures evolve in both the non-traded and traded sectors. It would be appropriate to lower the OCR if demand weakens, and wage and price-setting outcomes settle at levels lower than is consistent with the inflation target."

We interpret this to mean that the central OCR outlook is still "on hold" - the words "It would be appropriate to lower the OCR" imply that it is not currently appropriate to lower the OCR.

The conditions the RBNZ has laid out for cutting the OCR amount to quite high hurdles. The OCR will be cut only **if** demand weakens **and** wage and price-setting behaviour **settle** below the inflation target. The word "and" is very important here – both conditions have to be met. That is a tough ask. If both conditions are met, it would not be until late this year.

The first condition, that demand weakens, will be the toughest to meet. The key drivers of today's strong demand are the Canterbury rebuild, construction activity in Auckland, low interest rates, booming net immigration, and rising house prices. None of these is about to start fading. True, export conditions have weakened, but business and consumer confidence appears to have been resilient, even in export-focussed regions. We would point to the RBNZ's proposed restrictions on mortgage lending to landlords as the most plausible catalyst for weaker domestic demand – but our understanding is that such restrictions cannot be introduced until late in the year.

The second condition, that wage and price-setting behaviour settles below the inflation target, will be easier to meet, but not until later in the year. "Wage and price-setting behaviour" basically means inflation expectations. The Reserve Bank has adopted this alternative term in order to steer us away from a narrow focus on a few surveys of inflation expectations, and towards a wider appreciation of the data. Whatever the semantics, there is indeed a significant risk of wage and price-setting outcomes dropping below the inflation target. Surveys of inflation expectations have already dropped to about 2%, and in our view they could yet drop further. The RBNZ has pointed out that its market-based and model-based measures of inflation expectations are below the target, and its "factor model" of core inflation is currently 1.3%. Wage growth is currently low and isn't about to change. And surveys are telling us that few firms intend to raise their prices. However, the RBNZ has said that it requires wage- and price-setting outcomes to **settle** below the target. Verifying where anything has settled necessarily requires time.

Given all of this, we remain comfortable with the OCR outlook we issued last week. The most likely scenario is that the OCR will remain on hold for some time. However, we believe there is roughly a 40% chance of at least two OCR cuts, depending on what happens with inflation expectations. If cuts do occur, they will occur very late in the year, because only then can the RBNZ verify that inflation expectations have fallen, and only then will the RBNZ have new mortgage restrictions in place to help slow the housing market.

As anticipated, the OCR Review weighed in heavily against the high exchange rate, given the environment of falling export commodity prices. The exchange rate was described as unjustifiable, unsustainable, and unhelpful. This is a warning that exchange rate intervention remains an option open to the RBNZ. However, the RBNZ has not chosen to exercise that option much over the past year. Markets are growing weary of the RBNZ crying wolf on this topic.

The details of the OCR Review were a little more downbeat on both the global economy and the NZ economy outlook, compared to the March MPS. The RBNZ described house price inflation in Auckland as "elevated" today, compared to "showing signs of picking up" in the March *MPS*. That is an upgrade, but rather a mild one given what has happened over the past month or two.

RBNZ press release

The Reserve Bank today left the Official Cash Rate unchanged at 3.5 percent.

Trading partner growth continues at around its long-term average, but remains dependent on highly accommodative monetary settings. Policy interest rates are at record lows and many European government bonds are trading at negative yields. Looking ahead, considerable uncertainties exist in Europe, China and Australia, and on the timing of US monetary policy adjustment, although global growth should be boosted by the decline in world oil prices. Crude oil prices are almost 50 percent below their July 2014 level, with increasing supply mostly contributing to this fall.

The New Zealand economy continues to grow at an annual rate of around 3 percent, supported by low interest rates, high net immigration and construction activity, and the fall in fuel prices. House price inflation is elevated in Auckland. However, lower dairy incomes, lingering effects of drought, fiscal consolidation, and the high exchange rate are weighing on the outlook for growth.

Lower fuel prices, coming on top of the high exchange rate and low global inflation, lowered annual CPI inflation to 0.1 percent in the March quarter. Underlying inflation remains low and is expected to pick up gradually. Monetary policy will focus on the medium-term trend in inflation. The Bank expects to keep monetary policy stimulatory, and is not currently considering any increase in interest rates.

We are watching closely the ongoing impact on tradables inflation from global forces and the high New Zealand dollar. On a trade-weighted basis, the New Zealand dollar continues to be unjustifiably high and unsustainable in terms of New Zealand's long-term economic fundamentals. The appreciation in the exchange rate, while our key export prices have been falling, is unwelcome.

The timing of future adjustments in the OCR will depend on how inflationary pressures evolve in both the non-traded and traded sectors. It would be appropriate to lower the OCR if demand weakens, and wage and price-setting outcomes settle at levels lower than is consistent with the inflation target.

The Bank will continue to monitor and carefully assess the emerging flow of economic data.

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