Westpac

Institutional Bank

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Down to the waterline

July 2015 OCR Review: OCR cut to 3.0%

- As expected, the RBNZ cut the OCR 25 basis points and signalled further cuts to come.
- The economic outlook has deteriorated materially according to the RBNZ.
- However, the RBNZ argued that the falling exchange rate will help to return inflation to 2%.
- This rendered the overall tone of the OCR Review more moderate than expected.
- A 25bps OCR cut in September looks likely.
- The RBNZ may well adopt a more dovish stance in September, following the full MPS forecasting process.

Today the Reserve Bank reduced the OCR by 25 basis points, noted that the economic outlook had deteriorated since June, and indicated that further OCR reductions were coming. The RBNZ's policy guidance sentence today was:

"At this point some further easing seems likely."

This was less conditional than June's "We expect further easing may be appropriate. This will depend on the data." We take this to mean that the RBNZ will cut the OCR again in September. But beyond that there is no way to be sure what the RBNZ intends to do.

The RBNZ stated that the "growth outlook is now softer than at the time of the June Statement. Rebuild activity in Canterbury appears to have peaked, and the world price for New Zealand's dairy exports has fallen sharply." The RBNZ remained dismissive of the housing market, saying that "House prices in Auckland continue to increase rapidly, but, outside Auckland, house price inflation generally remains low." These comments were no surprise. They indicate that the RBNZ has become more pessimistic on the economic outlook – a sentiment with which we concur.

But offsetting these downbeat comments, the RBNZ pointed out that the plunging exchange rate will cause inflation to rise back to 2% in early-2016. In a separate paragraph the RBNZ described the falling exchange rate as helpful. Although the RBNZ did say that "further depreciation is necessary given the weakness in export commodity prices," we still judge the RBNZ's commentary on the exchange rate to be more moderate than expected.

These surprisingly moderate comments contributed to the half-cent increase in the exchange rate that followed the OCR Review. Markets were braced for a 25 basis point OCR cut, but were also pricing some risk of a 50 basis point reduction. Furthermore, the RBNZ's policy guidance was probably a tad more moderate than markets anticipated. Consequently, two-year swap rates rose around five basis points after the announcement.

With underlying inflation continuing to prove very soft, global dairy prices plunging, the Canterbury rebuild peaking early, and business confidence falling, we believe the RBNZ has its work cut out to return inflation to two percent, beyond a short-term exchange-rate induced inflation spike next year. We are forecasting the OCR to fall to a record low of 2.0%.

There was little in today's Statement to indicate that the RBNZ has reached a similar conclusion. That said, we must bear in mind that today was a one-page OCR Review, underpinned by a truncated forecasting process at the RBNZ. When the RBNZ conducts its full Monetary Policy Statement process in September, it may well see fit to signal OCR cuts more vigorously. We see no reason to change our forecast of the terminal OCR.

The RBNZ's slightly more cautious mood does, however, argue against the risk of a 50 basis point OCR cut, which we had been flagging. Accordingly, we will shift to forecasting 25 basis point OCR cuts at each RBNZ meeting between now and next January.

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