Westpac Institutional Bank

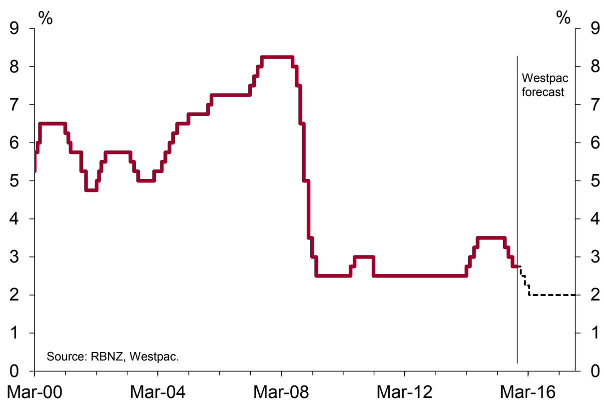
29 October 2015

Kicking the can down the road

RBNZ OCR Review, October 2015

- The RBNZ left the OCR on hold, but signalled that it expects to reduce the OCR again.
- Today's Review left the December OCR decision open.
- The easing bias was watered down by the RBNZ saying "It is appropriate at present to watch and wait."
- But the RBNZ warned that if the exchange rate stays high, interest rates will be lower than otherwise.
- We expect that the recent rise in the exchange rate will indeed be sustained until December.
- Therefore, we conclude that a December OCR cut is more likely than not.

Westpac OCR forecast



There were no major surprises in today's RBNZ OCR Review – the OCR remained on hold at 2.75%, the RBNZ reiterated that *"some further reduction in the OCR seems likely"*, and the easing bias was more tentative than the previous communique in September – all very much as anticipated. However, the Review did contain intriguing turns of phrase that added nuance to the outlook and created a little more uncertainty about the December OCR decision.

The overall effect was to kick the can down the road. The RBNZ may expect to reduce the OCR, but it is committed to nothing. The language in today's Review leaves the RBNZ open to either cutting the OCR or leaving it on hold at the December *Monetary Policy Statement.*

Our view remains that a December cut is the more likely decision - mainly because we expect the exchange rate will be uncomfortably high when the RBNZ comes to make the call.

The key policy guidance sentence of the Review was almost a word-for-word repeat of previous policy guidance – *"some further reduction in the OCR seems likely"* depending on the data. But that was followed by a new phrase: *"It is appropriate at present to watch and wait."* It is not clear exactly what that meant – it could simply be a justification for today's on-hold decision. More likely, it was meant as a subtle indication that the RBNZ is currently in pause mode, and is committed to no particular timing of OCR reductions.

Commentary on the economy was a little more upbeat than the September MPS – especially *"Continued economic expansion is expected to result in some pick-up in non-tradables inflation"*. However, the laundry-list of reasons to be cautious about cutting the OCR that appeared in a recent speech was absent from today's Review.

Instead, the detail of Review read like a list of the factors the RBNZ would be watching between now and December:

- Uncertainty about interest rates in the United States was mentioned.
- The RBNZ said it was too early to tell whether the recent rise in dairy prices would be sustained – if it is, presumably the OCR is less likely to be cut.
- High Auckland house prices were mentioned.
- The RBNZ explicitly linked the exchange rate and interest rate decisions, saying that if the exchange rate sustained its recent rise *"a lower interest rate path than otherwise"* would be required.

The last of these particularly caught our eye. The lower exchange rate was the cornerstone of the RBNZ's argument that inflation would quickly rebound to two percent – clearly, that view has been eroded. Furthermore, this comment was genuinely new. There was no significant mention of the exchange rate in the Governor's speech on monetary policy a couple of weeks ago.

Our views on developments between now and December are that dairy prices will stay high and so will the exchange rate. We expect the Auckland housing market to have showed signs of slowing, while markets in other parts of NZ continue to pick up. And we expect the Federal Reserve to hike rates in December, although that decision will be made a week after the RBNZ's December decision.

If we are right about the way conditions are going to develop, the RBNZ would most likely cut the OCR in December, because of the high exchange rate.

But there is much water to flow under the bridge between now and December. So we must repeat our caution from last week - a December cut is no done deal. The RBNZ is probably undecided at present, and the final decision will depend on the data.

Financial markets reacted by sending swap rates four basis points higher, moving to price only a 40% chance of a cut in December, and sending the exchange rate higher by about a third of a cent against the USD. To some extent, interest rates and the exchange rate had to rise simply because the RBNZ didn't cut on the day (markets had factored in some residual risk of a cut). But we think the market reaction was a bit overblown – we would put the odds of a December cut at above 50%.

Full RBNZ statement:

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.75 percent.

Global economic growth is below average and global inflation is low despite highly stimulatory monetary policy. Financial market volatility has eased in recent weeks, but concerns remain about the prospects for slower growth in China and East Asia especially. Financial markets are also uncertain about the timing and effects of monetary policy tightening in the United States and possible easings elsewhere.

The sharp fall in dairy prices since early 2014 continues to weigh on domestic farm incomes. However, growth in the services sector and construction remains robust, driven by net immigration, tourism, and low interest rates. Global dairy prices have risen in recent weeks, contributing to improved household and business sentiment. However, it is too early to say whether these recent improvements will be sustained.

House price inflation in Auckland remains strong, posing a financial stability risk. While residential building is accelerating, it will take some time to correct the supply shortfall. The Government has introduced new tax requirements and the Reserve Bank's new LVR restrictions on investor lending come into effect on 1 November.

CPI inflation remains below the 1 to 3 percent target range, largely reflecting a combination of earlier strength in the New Zealand dollar and the 60 percent fall in world oil prices since mid-2014.

Annual CPI inflation is expected to return well within the target range by early 2016, as the effects of earlier petrol price falls drop out of the CPI calculation and in response to the fall in the exchange rate since April. However, the exchange rate has been moving higher since September, which could, if sustained, dampen tradables sector activity and medium-term inflation. This would require a lower interest rate path than would otherwise be the case.

Continued economic expansion is expected to result in some pick-up in non-tradables inflation, despite the moderating effects of strong labour supply growth.

To ensure that future average CPI inflation settles near the middle of the target range, some further reduction in the OCR seems likely. This will continue to depend on the emerging flow of economic data. It is appropriate at present to watch and wait.

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