Westpac
Institutional Bank

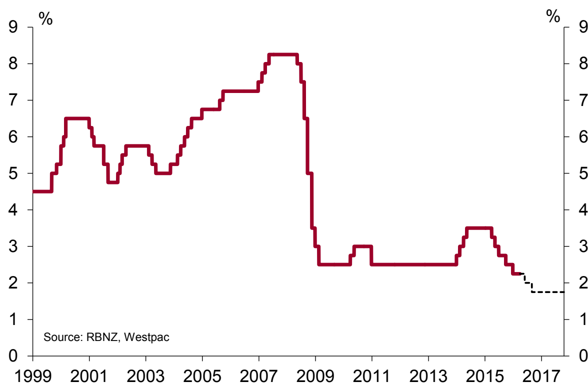
4 August 2016

It’s in the bag

Preview of RBNZ *Monetary Policy Statement*, August 2016

- We expect the Reserve Bank to cut the OCR by 25 basis points to 2% next week.
- The RBNZ took the unusual step of correcting market pricing by releasing a brief but strongly-worded statement last month, noting that further easing is “likely”.
- The sharp rise in the New Zealand dollar since June will be the RBNZ’s main concern. Lower tradables inflation suggests that looser monetary policy is needed to keep overall inflation on track to return to the target.
- We now expect a further OCR cut in November, to a low of 1.75%.

Westpac OCR forecast



The Reserve Bank removed much of the mystery around next Thursday’s *Monetary Policy Statement* by releasing an unscheduled economic update two weeks ago. The update observed that the high New Zealand dollar implied a weaker outlook for inflation than in the June *MPS*, and that it was “likely” that further policy easing will be needed.

The strength of the language in that statement makes it all but certain that the RBNZ will cut the OCR by another 25 basis points next week, and that it will signal a willingness to go further. We expect the 90-day rate projections to imply a low point for the OCR of 1.75%, compared to 2% in the June *MPS*, paving the way for another rate cut in November.

Interest rate markets are already fully pricing in a 25 basis point cut next week, an unusually high degree of certainty. We think that a 25 basis point cut, with a lower interest rate projection and guidance that “further easing may be required”, would be a broadly neutral result for the market.

It’s worth bearing in mind that the RBNZ’s June forecasts already included one further rate cut this year, if the economy panned out as expected. And since then, there haven’t been any dramatic changes on the domestic front. Near-term growth looks to be tracking a little stronger than expected, while inflation pressures are a little weaker. House prices have continued to rise rapidly, exceeding the RBNZ’s already-strong forecasts.

The big change over the last two months has been the steep rise in the New Zealand dollar. On a trade-weighted basis, the currency is about 6% higher than the RBNZ had assumed for this quarter, and had been even higher than that before the RBNZ issued its economic update. A ‘miss’ of that size is fairly extreme, though not unprecedented, and it will put a severe dent in the RBNZ’s tradables inflation forecasts. Consequently, a lower interest rate path is needed to keep overall inflation on track to return to the target over the medium term.

Admittedly, there's some wiggle room around how much impact the stronger New Zealand dollar will have on the RBNZ's forecasts. It will depend on the RBNZ's judgements around (1) how much of the currency's recent rise will be sustained over time, and (2) the extent to which it reflects improved fundamentals. We suspect that the RBNZ will treat most of the currency's rise as a genuine shock, since domestic conditions haven't changed much and commodity prices have been fairly flat for the most part. The jump in prices at yesterday's GlobalDairyTrade auction will be welcomed, but it came too late to be incorporated in the *MPS* forecasts.

Our judgement is that the stronger exchange rate, along with other developments since June, is probably worth closer to a 25-point than a 50-point reduction in the RBNZ's interest rate projections. However, we acknowledge that the risks are towards a larger reduction in the interest rate track.

Beyond August: another OCR cut this year

Like the RBNZ, we've adjusted our forecasts to reflect the reality of a stronger NZ dollar. We now expect a further OCR cut this year, most likely in the November *MPS*, to a low of 1.75%.

We admit that's not a very controversial call. Some analysts have already been saying the same thing, interest rate markets have fully priced in a second rate cut, and the RBNZ's most recent statement suggests that it's willing to go there.

So why have we only now come to that view? Our guiding principle is that OCR forecasts should be based around the outlook for inflation. Markets have gone astray at times by presuming that the RBNZ would use interest rates to influence house prices, or to generate a particular reaction in the exchange rate. The fact is that neither of those aims falls within the RBNZ's mandate. House prices and the exchange rate certainly matter, but only to the extent that they affect the RBNZ's inflation forecasts. We suspect that the RBNZ's recent economic update was aimed at reaffirming this point.

Our own inflation forecasts suggest that some additional easing, beyond what was already expected, would be appropriate – but the message is far from decisive. The stronger than expected starting point for the NZ dollar will certainly depress inflation over the near term. But like the RBNZ, we still expect the exchange rate to decline over the next year, on the back of Fed rate hikes and a stronger US dollar.

In addition, the inflation rate is currently being held back by some temporary factors: the sharp drop in fuel prices, and the cuts to ACC levies for vehicle registrations. Both of those factors will drop out by the second half of next year, which will see the annual inflation rate pop up to something much more consistent with the 2% target midpoint.

So the risk that the RBNZ faces seems to be one of an uncomfortably slow return to the inflation target, rather than a sustained undershoot. The danger here, as the RBNZ has noted in the past, is that persistently low inflation becomes embedded in wage- and price-setting behaviour, making it that much harder to dislodge. On that note, the RBNZ may take some comfort from the fact that inflation expectations were steady in the latest survey, though they remain below what would be consistent with achieving 2% inflation over the medium term.

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