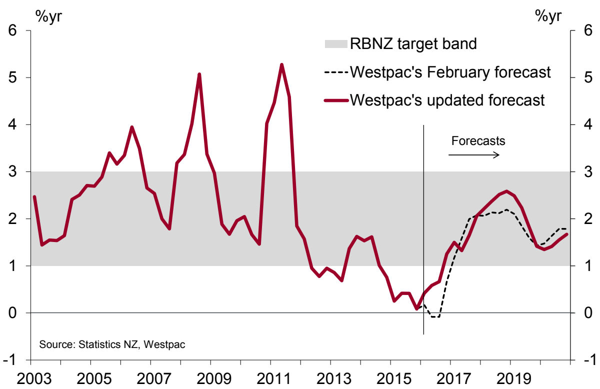
2 June 2016

Down to the wire

RBNZ MPS Preview, June 2016

- On balance, we now consider "on hold" to be the more likely OCR decision next week.
- But the June MPS decision remains a very close call. The odds of a cut are higher than market pricing suggests.
- Our forecast is now for the final OCR cut to occur in August.
- We still believe the OCR low-point for this year will be 2.0%.

CPI inflation forecasts



Just a few weeks ago, the June Monetary Policy Statement seemed a straightforward call. The RBNZ had signalled that it expected, at some point, to reduce the OCR from 2.25% to 2.0%. Given that the inflation outlook remained low, and that the RBNZ has a tendency to adjust the OCR at Monetary Policy Statements rather than OCR Reviews, a cut in June seemed logical.

But over the past few weeks, the available information has changed. There is now less urgency for the Reserve Bank to reduce the OCR, following a range of developments that have pushed inflation forecasts up closer to the Reserve Bank's target. It now looks as though the June MPS decision will go down to the wire.

After running through our analysis, we have come to the conclusion that the RBNZ is slightly more likely to keep the OCR on hold than to cut in June. Thus we are changing our OCR call – we now expect the final cut of the year to occur in August, rather than June.

We hasten to emphasise that this was a close-run decision for us, and will no doubt be a close decision for the RBNZ. Next week's MPS is much more finely balanced than financial market pricing suggests. Financial markets lurched a few weeks ago, and are now factoring in just a 20% chance of an OCR reduction. That is far too low. We would put the odds at more like 45%.

So what has changed?

The exchange rate has persisted higher for longer than the RBNZ anticipated, and was the key argument in favour of a June OCR cut. On its own, the high exchange rate will tend to supress inflation. However, a range of inflation-boosting developments have occurred in recent weeks. Together, these have been more than enough to offset the high exchange rate, and have changed the calculus for monetary policy.

- Rising petrol prices mean that the next inflation print is likely to be 0.6%, rather than the 0.3% the RBNZ was forecasting back in March. The details of the March inflation report were probably also slightly stronger than the RBNZ had anticipated.
- Last week's Government Budget included a lift in tobacco excise that will directly boost inflation over the coming four years. While the RBNZ looks past the direct impact of policy-induced price changes, this will still help to shore up flagging inflation expectations.
- The Budget also included a lot of extra infrastructure spending, which will add to medium-term inflation pressures in the construction industry.
- Global financial markets have calmed since March. Among other things, this has served to reduce bank funding costs. Consequently, retail fixed mortgage rates have been falling relative to swap rates.
- Global prices for key New Zealand export products have lifted.

The RBNZ will also be cognisant of rapidly rising house prices. The housing market itself will be no surprise to the RBNZ – the March MPS already factored in 3.5% per quarter house price inflation. The market is no hotter than that.

But rising house prices have sparked a surprising lift in household credit growth. Mortgage borrowing has surged – April was the strongest month for mortgage lending growth since November 2007. This indicates that monetary policy has gained traction. It also highlights that an all-too-familiar borrow-and-spend dynamic has emerged in the New Zealand economy. These dynamics can develop momentum of their own, and in the past they have led to inflation.

In our recent Quarterly Economic Overview we noted that there is no reason to believe this borrow-and-spend dynamic will end over the coming year. This affected our economic forecasts. We are sure that the RBNZ's thinking is similar.

Indeed, the March MPS included a scenario in which house prices rose for longer and boosted domestic demand by more than the central forecasts. In that scenario, the RBNZ envisaged no OCR cuts below 2.25%. There is at least a risk that this scenario has become reality. The RBNZ may want to pause to assess how inflation is going to respond to this surge in credit growth.

Why wait?

We still expect that the RBNZ will eventually cut the OCR to 2.0%. And the RBNZ is probably thinking the same way, at least on the balance of probabilities. So some might ask why the RBNZ would wait before delivering this final cut.

The answer is option value. By holding off in June, the RBNZ gives itself time to confirm whether the cut to 2.0% is indeed required. Even if there is only a small chance that the final cut will be cancelled, it is still worthwhile retaining the option. After all, the cost to the economy of holding off cutting for a couple of months is negligible.

Conversely, reducing the OCR in June would extinguish the RBNZ's option to end the current OCR cycle at 2.25%. Central banks are allergic to rapid policy reversals, so once the RBNZ has reduced the OCR to 2.0%, it will be stuck with that level for quite some time.

The Reserve Bank itself has expressed the same principle in different words – as the OCR approaches the end of a cycle, it should be adjusted more slowly and more cautiously.

Communication challenges

Whether the RBNZ cuts the OCR next week or keeps it on hold, it is going to face communication challenges. Giving markets the impression that the OCR reduction cycle has ended could cause the exchange rate to rise in an unhelpful way – this is what happened last December. If the RBNZ does cut next week, it will seek to avoid language that suggests it is finished cutting the OCR. More likely, it would opt for non-committal language, such as "further OCR changes will depend on the data."

In the case of an "on hold" decision, the risk is that markets start to doubt the RBNZ's resolve to cut the OCR any further at all. If the RBNZ leaves the OCR on hold as we expect, its 90-day interest rate forecast is likely to remain at 2.1%, firmly indicating that one more OCR cut is expected. The RBNZ's rhetoric would presumably be equally firm. A repeat of the April OCR phraseology would probably suffice:

"Further policy easing may be required to ensure that future average inflation settles near the middle of the target range. We will continue to watch closely the emerging flow of economic data."

While we expect the OCR to remain on hold in June, we do expect that the RBNZ will eventually conclude that an OCR reduction to 2.0% is necessary. Hence, we consider market pricing for an OCR reduction by August – currently 50% – is undercooked.

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