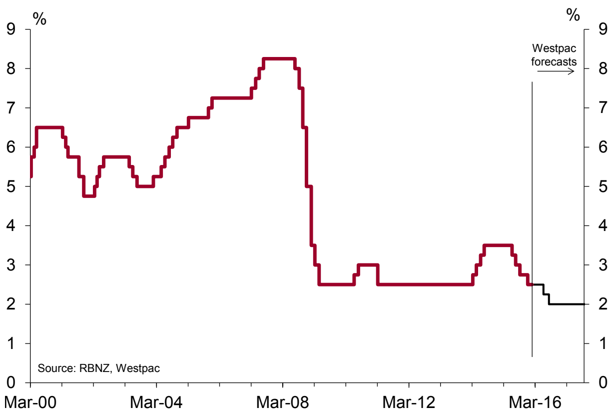
3 March 2016

A step closer

Preview of RBNZ *Monetary Policy Statement*, March 2016

- We expect next week's *Monetary Policy Statement* to project a lower path for interest rates over the coming year.
- The New Zealand economy is ticking over nicely, but inflation pressures are very subdued, and a sustained return to the midpoint of the inflation target is looking increasingly unlikely under current policy settings.
- However, the timing of interest rate cuts remains uncertain. While a case can be made for immediate action, we think the RBNZ's concerns about the housing market and its comfort with the rate of core inflation will stay its hand for now.
- We expect two further cuts to the OCR in June and August, which will take it to a low to 2%.

Westpac OCR forecast



We've been saying for some time that the OCR will need to be cut further this year, in order to return inflation to target and maintain it there over the medium term. Next Thursday's *Monetary Policy Statement (MPS)* should bring our view a step closer to fruition. While we don't expect the Reserve Bank to pull the trigger next week, we expect a strong signal to the market about the likelihood of lower interest rates.

The March *MPS* is likely to present a very different set of forecasts to those in December, where the cash rate had been projected to remain flat at 2.50% for an extended period. Developments since then have generally pointed in the direction of even less inflationary pressure than the RBNZ anticipated. As a result, the *MPS* this time is likely to project a lower path for interest rates over the next year or so. This could be accompanied by a statement along the lines of:

"The Reserve Bank will monitor economic and financial developments closely, but at this stage some further reduction in the OCR seems likely in order to ensure that future average CPI inflation settles near the middle of the target range."

Recent communications suggest that the RBNZ has no intention of being hurried into action though, and there are some genuine concerns, such as the strength of the housing market, that remain unresolved. We're currently forecasting two 25 basis point rate cuts in June and August, but also we've emphasised that the March and April reviews are very much live. Interest rate markets are pricing in a 30% chance of a rate cut next week, and we'd put the odds at least as high as that.

Key developments

The near-term outlook for inflation has weakened substantially since December, in large part due to the renewed plunge in world oil prices. Annual inflation slowed to just 0.1% by the end of last year, compared to the RBNZ's forecast of 0.4%. Our latest forecasts suggest that it will remain near zero, or perhaps even slightly below, for much of this year. The RBNZ had previously expected annual inflation to return back above 1% in early 2016; that now looks to be delayed by at least a year.

What's more, this prolonged period of low headline inflation may be starting to undermine confidence in the RBNZ achieving the inflation target. In a recent speech, RBNZ Governor Wheeler noted that "survey measures of inflation expectations have fallen and are now consistent with inflation settling at 2 percent in the medium term… we would not wish to see inflation expectations become unstable and decline significantly". In fact, inflation expectations have fallen across a range of measures, to levels that are arguably no longer consistent with the 2% midpoint of the target.

The New Zealand dollar has not provided the helping hand in generating inflation that was expected. That is in part due to a weaker US dollar, as doubts have emerged about whether the US Federal Reserve will raise rates further this year in the face of a softening global environment.

Finally, world dairy prices have fallen further since the start of the year, a point underscored by Fonterra lowering its forecast milk price for the current season from $4.60/kg to $4.15/kg in January. The misfortunes of the dairy industry were an important part of what prompted the RBNZ to start cutting interest rates last June, sooner than most in the market had expected.

Lest this seem like a litany of bad news, we should note that the data on economic activity has remained fairly solid. After a slow patch in the first half of 2015, GDP grew by 0.9% in the September quarter, stronger than expected, and we're expecting a 0.7% rise for the December quarter (released later this month).

There was also a surprisingly sharp fall in the unemployment rate at the end of last year, to a seven-year low of 5.3%. It's not clear how much of the fall was genuine and how much will prove to be sampling error, but it was a welcome sign of improvement after a year of rising unemployment.

On the whole, it's likely that the *MPS* will once again feature forecasts of solid GDP growth over the next couple of years. However, it's worth noting a point made by RBNZ Assistant Governor McDermott in a speech last month. These strong growth forecasts don't reflect a view that the economy is doing fine on its own; they are what the RBNZ thinks is needed to generate 2% inflation over the medium term. If actual growth falls short of these strong projections, it's likely that inflation will fall short too.

Moving dates

While we expect the *MPS* to project a lower path for interest rates, the timing of OCR cuts is still finely balanced. Recent statements from the RBNZ suggest two hurdles that may not yet have been cleared: the strength of the housing market, and the underlying trend in inflation.

The Auckland housing market has slowed sharply since October, when new regulations around property investment came into force. However, some of the heat in the market prior to October was due to investors rushing in to beat the new regulations, so it's not surprising that we'd see a post-regulation hangover for at least a few months. The RBNZ has said that it would like to see the housing figures for February and March – that is, beyond the holiday period – before drawing a firm conclusion about whether these regulations will have a sustained dampening effect.

The other factor is that the underlying trend in inflation has been better behaved than the headline measure, which has been dragged down by factors like the plunge in oil prices that are beyond the RBNZ's control. In particular, the RBNZ has recently been drawing attention to its own model-derived estimate of core inflation, which has remained comfortably within the 1-3% target range (albeit below the 2% midpoint for several years).

For these reasons, we've favoured June and August as the most plausible dates for OCR cuts this year. By then, the RBNZ will have more detailed information on the housing market, and an additional read on headline (and core) inflation. However, we acknowledge that the RBNZ may decide that the recent flow of data has been enough to override what was said previously. Hence, both next Thursday's review and the following one on 28 April should be considered live dates for OCR cuts.

Market reaction

Financial markets are pricing in a low point of around 2.1% for the OCR this year – that is, a high probability of two 25 basis point cuts. However, the first of those cuts is not fully priced in until June, while there is only a 30% chance of a cut priced in for next Thursday.

We suspect that an on-hold decision next week, but with a strong signal for rate cuts over the coming months, would be enough to appease the market and prevent an unwanted bounce in market interest rates and the exchange rate.

Alternatively, if the RBNZ does cut the OCR next week, the market is likely to go all the way to pricing in a second rate cut within the next few months. That implies scope for a modest fall in fixed-term interest rates.

If the RBNZ remains on hold and sounds non-committal about future OCR cuts, we would expect a jump in market interest rates and especially the exchange rate. We see this as the least likely scenario.

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