Westpac

Institutional Bank

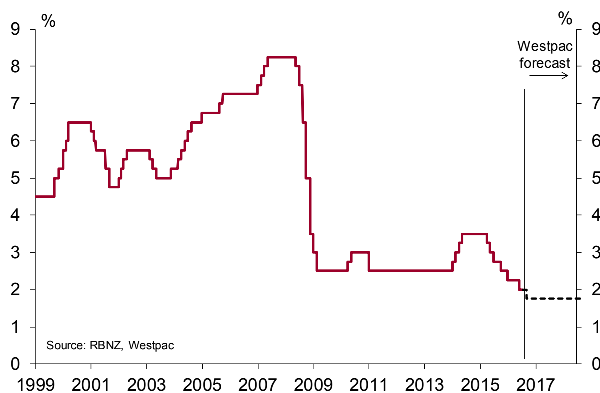
3 November 2016

One last time

Preview of RBNZ Monetary Policy Statement, 10 November

- We expect the Reserve Bank to reduce the OCR to 1.75% next week.
- The RBNZ has strongly signalled a further easing, and failing to deliver could lead to an unwanted and self-defeating market response.
- Beyond next week's decision, the RBNZ is likely to retain a mild bias towards further easing. But we expect the OCR to remain on hold through 2017.
- Developments over the last few months have been positive for the New Zealand economy. Inflation remains very low, but the downside risks to the RBNZ's view have diminished.

Westpac OCR forecast



In the August and September OCR decisions, and again in a speech in October, the Reserve Bank gave a strongly-worded signal of its intentions: *"further policy easing will be required to ensure that future inflation settles near the middle of the target range"*. Its most recent interest rate projection roughly split the difference between one and two further OCR cuts over the coming months. And given the RBNZ's apparent preference for taking action at its quarterly *Monetary Policy Statements* (and given that the next scheduled OCR review isn't for another three months), next Thursday's decision has long been the obvious candidate for another OCR cut.

However, next week's decision comes against the backdrop of a strong run of developments for the New Zealand economy. It's not that the RBNZ has been surprised in terms of activity, which was already forecast to be quite strong, and inflation has been as subdued as expected. But the downside risks that the RBNZ has highlighted in the past – particularly around dairy prices and inflation expectations – have clearly diminished.

We expect the RBNZ to deliver another 25 basis point cut next week, to a new low of 1.75%. But we have to admit that the economic case for doing so is largely around keeping financial markets in check. A 25 basis point cut is almost fully priced into currency and interest rate markets. Failing to deliver what's been signalled would risk a sharp move higher in the New Zealand dollar and wholesale interest rates, which would flow through into retail lending rates – effectively an unwanted tightening of monetary conditions.

The risk of an adverse market reaction is particularly high right now. Interest rates around the world have been heading higher in recent weeks, with the US Federal Reserve on the verge of a rate hike and markets sensing that other central banks are shying away from further easing measures. The challenge for the RBNZ is that if it gives too strong an impression that interest rates have bottomed, longer-term rates could rise sharply as traders scramble to predict when OCR hikes will begin.

Consequently, we expect that the RBNZ will retain at least a mild bias towards further OCR cuts. The language of the statement is likely to be softened from *"easing will be required"* to *"may be required"*, perhaps with more emphasis on data-dependency. We think that such a signal would be neutral to slightly positive for the NZ dollar and interest rates. However, if the market response is more dramatic than that, there's every chance that we'll see another 'Economic Update' from the RBNZ before Christmas, like the one that was hastily scheduled in July to correct market perceptions.

Economic conditions

The near-term picture of the local economy has panned out much in line with the RBNZ's expectations. GDP growth over the first half of the year was a little stronger than forecast, and while the RBNZ hasn't published a quarterly forecast for the unemployment rate, the drop to 4.9% in the September quarter was probably close to expectations. Indicators such as business confidence suggest that the underlying momentum in the economy remains strong, although some of the 'hard' data on activity over the September quarter has been more subdued.

Annual inflation remains very soft, dropping to just 0.2% in the September quarter. However, this was partly due to some temporary and well-anticipated factors, and the outturn was actually slightly higher than the RBNZ had forecast. The RBNZ's prediction that annual inflation will reach the lower edge of the 1-3% target range next quarter looks to be on track. However, it's not time to declare victory just yet – much of the increase will come from a jump in fuel prices, a temporary factor that should be looked through on the way up just as it has been on the way down.

More importantly, inflation expectations have been well-behaved in the face of very low headline inflation. The RBNZ had highlighted a further drop in inflation expectations as a major downside risk to its interest rate projections, especially in light of research which suggested that expectations have become more backwards-looking. If low inflation were to become embedded in wage- and price-setting decisions, it would be that much harder to engineer a return to the inflation target.

Instead, the latest survey saw a slight uptick in inflation expectations, and with headline inflation set to head higher from here, the risk of a further slide in expectations has diminished. Even so, with two-year ahead expectations holding at around 1.7%, that still suggests some scepticism about the RBNZ meeting its medium-term inflation target. It's likely that a long period of low interest rates will be necessary to keep both actual and expected inflation on track.

By far the biggest surprise for the RBNZ will have been the whopping 44% rise in world dairy prices since July (including the 11% jump in this week's auction). Higher dairy prices in themselves are not hugely inflationary in the near term, but they remove a key risk to activity, and financial stability, over the medium term. The bounce in dairy prices also provides some justification for the recent strength of the NZ dollar. While the RBNZ is likely to repeat its comment that *"a decline in the exchange rate is needed"*, it's no longer obvious that the strong NZ dollar requires an interest rate response.

On the negative side of the ledger, the tightening of the loan-to-value ratio limits in July will have an impact on the RBNZ's forecasts of house prices, household spending, output and ultimately inflation. This isn't news as such, but it wasn't factored into the RBNZ's published forecasts in August.

Policy statement

One small wrinkle to note is that, from next week's *MPS*, the RBNZ's published interest rates projections will be based on the OCR instead of the 90-day bank bill rate. The reason is due to changes in the spread between the two rates, which have muddied the policy signal that the 90-day rate projection was meant to convey. However, the change won't make a lot of difference to our analysis going forward.

The balance of developments over the last three months suggests to us that the RBNZ's forecasts today would favour a single OCR cut, down to 1.75%. Even so, the RBNZ may want to retain a mild easing bias, to discourage market speculation about the next move being up. So we suspect that it will pitch its published OCR track slightly below 1.75%, implying a small probability of another cut next year.

Such a forecast would probably be neutral or slightly positive for the NZ dollar and interest rates. However, in making any predictions about how markets will act on the day, we should bear in mind that the RBNZ has the dubious honour of being the first central bank to make a policy decision right after the US election. Depending on the result, global market movements could trump whatever the RBNZ has to say.

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