Westpac Institutional Bank

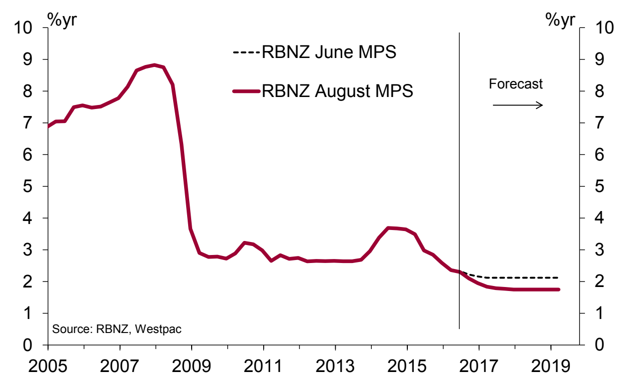
11 August 2016

How low can you go?

August 2016 MPS Review: RBNZ cuts OCR to 2%, signals at least one more

- The Reserve Bank reduced the Official Cash Rate by 25bps to a record low of 2%. They also signalled that further easing is likely.
- We expect that the RBNZ will cut rates again in November, and there is the risk of additional cuts further ahead.
- The strength of the NZ dollar will be a key factor affecting the stance of monetary policy.

Figure 1: 90-day interest rate



A record low cash rate, more to come

At today's *Monetary Policy Statement*, the Reserve Bank reduced the Official Cash Rate to a new record low of 2%. Nevertheless, the RBNZ is still facing an uncomfortably slow return of inflation to target. Consequently, they noted that "that further policy easing *will be required* to ensure that future inflation settles near the middle of the target range" (our emphasis).

Today's decision was a dovish shift from the RBNZ compared to their previous policy statement in June (though they had signalled such a change a few weeks back). In June, the RBNZ's 90-day interest rate track bottomed at 2.1%, and their rhetoric was consistent with a 2% low in the cash rate. Their updated 90-date projection released today was markedly lower, showing the 90-day rate settling at 1.75%.

We expect a further 25bp cut in the OCR in November, which will take it to a low of 1.75%. While there is the possibility of an earlier cut at the 22 September OCR review, we think this is less likely given continued relatively firm GDP growth and only limited new information before the September meeting.

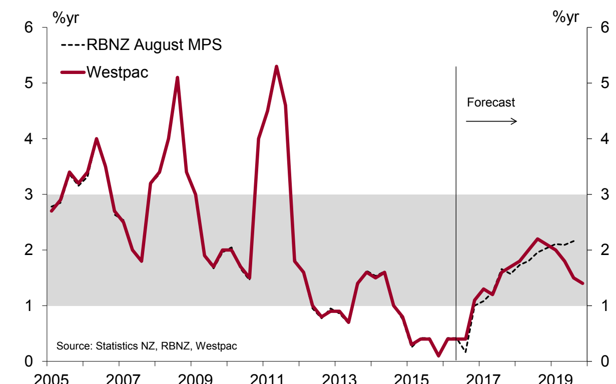
Further ahead, much of the need for additional cuts comes down to the NZ dollar – we expect that it will ease by year's end, but the risk is that it remains high.

An uncomfortably slow return to target

Underlying the RBNZ's dovish shift today are signs that the pick-up in inflation over the coming years will be uncomfortably slow. Inflation is only expected to be back in the RBNZ's target band by the end of this year, and not back to 2% until September 2018.

This very gradual return to target means that inflation expectations will remain under downward pressure for some time. And that's a big concern for the RBNZ. Expectations are a key influence on how businesses adjust wages and prices, and low inflation in recent years has already seen them dropping to low levels. That makes it harder for the RBNZ to generate a lift in inflation.

Figure 2: Inflation forecasts



The RBNZ went to great pains today to highlight that much of the reason for the lingering softness in inflation rests at the feet of the NZ dollar and import prices. In previous cycles such influences were transitory, meaning the RBNZ could look through them. However, the RBNZ now expects that these conditions will be an ongoing challenge for the policy outlook. That's something we'd certainly agree with. Global inflation has remained low for an extended period, and it is set to climb only gradually. Combined with downward pressure on global interest rates and the resulting upward pressure on the NZ dollar, it's likely that imported inflation will remain subdued for some time yet.

This lingering weakness in imported inflation has clearly got the RBNZ's hackles up. And while much of this may be due to factors beyond their control, today's *Statement* emphasised that the RBNZ wants the strength in the NZ dollar kept in check. That was evident in the policy statement itself. It was also evident in a scenario included in the *MPS* which showed that, should the exchange rate remain around current levels over the next few years, the RBNZ would cut the OCR to extremely low levels.

Given the concerns around inflation and inflation expectations, the RBNZ now intends to keep the OCR at lower levels than it had previously factored in. This aims to limit the pressure on the NZ dollar, and stimulate a pick up in domestic activity and inflation. In fact, the RBNZ has made a chunky upwards revision to its growth outlook for the next few years, and is forecasting growth of 3.4% in 2017 and 3.6% in 2018.

The RBNZ's activity forecasts do appear optimistic to us. Population growth has started to slow. In addition, household spending hasn't been responding to house prices gains or low interest rates with as much vigour as it has in the past. On top of this, the RBNZ's strong investment forecasts will be challenged by the wind down in the Canterbury rebuild over the coming years.

Where to next?

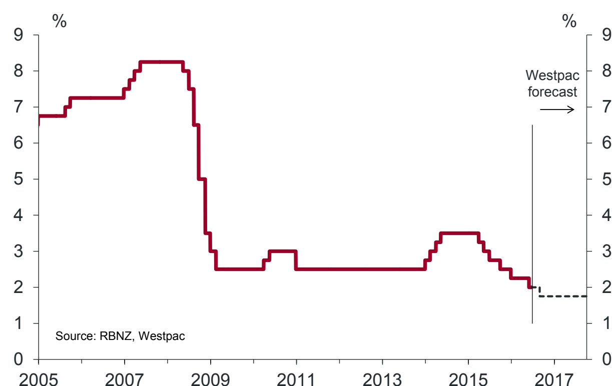
The RBNZ gave a pretty clear signal that the OCR is going lower. So why wait? Alternatively, why not cut by more today?

The challenge the RBNZ now faces is more of a slow return to target (in contrast to the past few years when we were looking at inflation remaining outside target band for an extended period). Inflation is set to pop higher over the coming year as the temporary factors that had held it down drop out of annual figures. In addition, even on our less optimistic growth forecasts, the economy is set to grow at a solid pace which will gradually boost domestic inflation. This means the RBNZ has some breathing room in terms of how and when it adjusts the OCR. Exactly how the next OCR cut occurs will be strongly influenced by what happens with the NZ dollar. But at this stage, we don't see the urgency for rapid cuts. Consequently, we expect the next cut to occur at the November decision, rather than in September.

We still expect that 1.75% will be the low point for the OCR. Growth is looking firm and inflation is expected to lift. Consequently, it's not clear that the OCR will need to go lower than that level. However, the risks are to the downside and we'll be watching economic conditions (especially indicators of inflation expectations and the NZ dollar) closely over the coming months.

On a last point, as we've emphasised for some time, it's the inflation outlook that remains the focal point for the OCR, not the housing market. And today's statement emphasised that point. The RBNZ is conscious that low rates will intensify pressures in the housing market, with house price inflation forecast to rise to an eye-watering rate of 18.5%year. However, it went on to note that changes to macro-prudential policy will help to limit the risks for financial stability.

Figure 3: OCR forecast



Market implications

Today's cut had been well signalled by the RBNZ, following an interim update in July. However, some in financial markets had speculated that the RBNZ would ease by more. As a result, NZD/USD rose from 0.7210 to 0.7270 following the *Statement*. Two-year swap rates initially rose 6 basis points, but this was later unwound.

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