Westpac

Institutional Bank

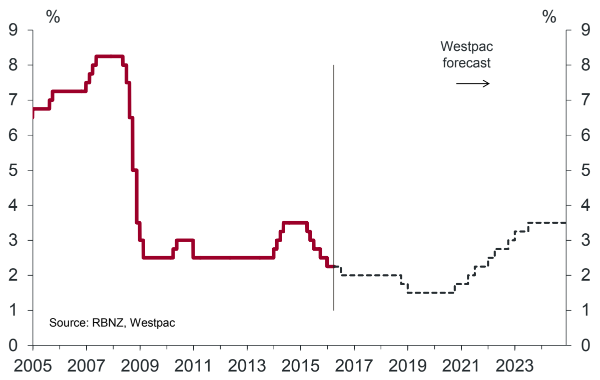
9 June 2016

Hold fire

June 2016 MPS Review: RBNZ on hold at 2.25%

- The Reserve Bank left the Official Cash Rate unchanged at 2.25% today.
- The RBNZ still believes that another rate cut is more likely than not in the coming months.
- But with economic conditions improving recently, the RBNZ shared our assessment that it was worth waiting a bit longer to make that call.
- We continue to expect one more OCR cut this year, at the August Monetary Policy Statement.
- The strength of the New Zealand dollar is a downside risk for the RBNZ's inflation forecasts, while strong credit growth is an upside risk.

Westpac OCR forecast



The Reserve Bank left the Official Cash Rate unchanged at 2.25% in today's *Monetary Policy Statement*. Both the decision and the tone of the statement were much in line with what we proposed in our preview last week. The RBNZ still seems inclined to cut the cash rate again this year, taking it to a new low of 2%. But with the recent evidence on the economy proving to be a bit more inflation-positive, the Reserve Bank felt it was worthwhile awaiting more evidence to verify that the final rate cut is needed.

We don't have any reason to quibble with the RBNZ's assessment, as our economic forecasts are very similar to theirs over the near term. We continue to expect one further OCR cut this year, most likely at the next *MPS* in August. But the risks around that forecast are skewed to the upside – that is, the OCR is more likely to remain at 2.25% than to fall below 2% this year. The data between now and August – which will include June quarter inflation and employment – will be critical to the case for or against further easing.

Financial markets reacted as we would have expected, given that they were factoring in around a one-in-four chance of a rate cut today. Interest rate markets are now pricing only around an 80% chance of a further rate cut this year, while the New Zealand dollar rose a cent to 0.7110. The strength of the exchange rate – which is already a good 5% ahead of the starting point of the RBNZ's projections – will certainly bolster the case for a further rate cut in August, if it is sustained.

As we expected, the RBNZ appears to have upgraded its assessment of the economy since March, but not quite enough to warrant a change in its published forecasts or its signal on future monetary policy moves. The bottom line of the media release was identical to the last two statements:

"Monetary policy will continue to be accommodative. 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."

Similarly, the 90-day interest rate projection was identical to March, flattening out at 2.1%. This was consistent with one more OCR cut in this cycle, but with no hints about the timing.

However, the statement was sprinkled with more upbeat observations compared to March and April. In particular, the RBNZ is clearly more comfortable about the outlook for inflation over the near term. Inflation is still expected to remain subdued for a while longer, not reaching 2% until the end of 2017. But with oil and other commodity prices now heading higher, inflation is forecast to be more comfortably back within the 1-3% inflation target range next year.

That in turn reduces the risk that low inflation becomes embedded in people's expectations. Surveyed inflation expectations fell sharply earlier in the year – a key motivation for the OCR cut in March – and were steady in the latest quarter. The RBNZ believes these expectations will rise again as headline inflation returns to the target range.

The RBNZ even went as far as warning of the risks of forcing a faster return to the inflation target:

"In the Bank's judgement, more monetary stimulus than projected, to return inflation to target a little sooner, would generate more volatility in non-tradables inflation and output than is necessary. In addition, the PTA directs the Bank to also have regard to financial stability. The high level of house prices relative to incomes in Auckland, and the recent increase in house price inflation in many parts of the country, is a concern from this perspective, and will continue to warrant close attention."

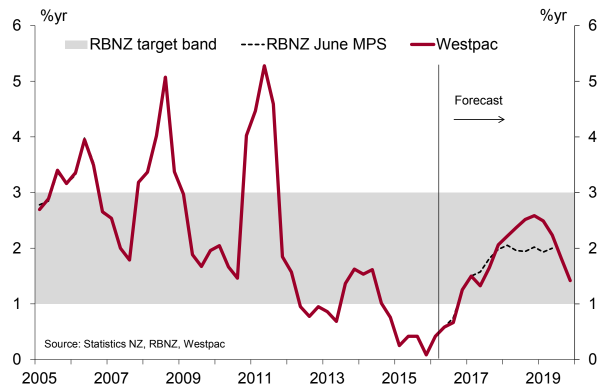
The RBNZ also appears more comfortable with the international environment, in particular the extent to which it feeds through into market volatility and the cost of funding from overseas. The RBNZ notes that even though the March OCR cut wasn't fully passed on, mortgage rates have fallen in outright terms, and *"are providing significant impetus to the outlook for domestic demand"*.

Alternative scenarios

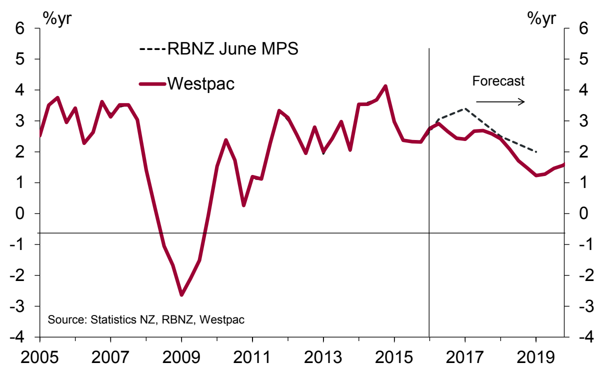
As in recent *Monetary Policy Statements*, the RBNZ included two alternative scenarios for monetary policy. In the first, the NZD trade-weighted index remains steady for years, rather than gradually falling as in the central forecast. In the second, house price inflation is significantly stronger than in the central forecast, prompting a surge in growth in household spending. In the exchange rate scenario, the RBNZ proposes that the OCR would fall to 0.75%. And in the house price scenario the RBNZ proposes reversing course and hiking the OCR above 3%.

A casual observer might regard the RBNZ's proposed responses to these scenarios as surprisingly large. But these large policy responses may be due to a technical issue – the RBNZ seems to have effectively switched off any feedback effects in its modelling. For example, the exchange rate scenario involves the TWI flat-lining above 72 *despite the OCR falling to 0.75% for an extended period*. Such a combination would be an extraordinary turn of events – little wonder that it would warrant a large monetary policy response. The same applies to the house price scenario, which involves a red-hot housing market despite rising interest rates.

CPI inflation forecasts



GDP growth



These alternative scenarios do not imply that the RBNZ would slash the cash rate dramatically if the TWI lingers above 72 over the next few months. The sensitivity of the RBNZ's OCR forecast to short-term exchange rate surprises is much more modest. And as we've witnessed in the last two OCR reviews, the reasons for the exchange rate's strength matter – the RBNZ would be more prepared to tolerate a strong exchange rate if local economic conditions have genuinely improved.

That said, the level of the TWI today, should it persist, is one argument in favour of an August OCR cut.

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