Westpac
Institutional Bank

10 March 2016

Lower and lower

March 2016 *MPS* Review: RBNZ cuts OCR to 2.25%, signals another cut this year

- The Reserve Bank reduced the Official Cash Rate by 25bp to 2.25%.
- This fulfils our long-running forecast that the OCR would fall below 2.5%.
- Today's change of stance from the RBNZ was no surprise, given the recent accumulation of evidence suggesting the trajectory of inflation was too low.
- However, that the RBNZ chose today to actually reduce the OCR was slightly more surprising.
- The RBNZ highlighted concerns about weak global demand and a sharp fall in inflation expectations.
- We now expect another cut in June, although April is also "live".
- The risks are now tilted towards the OCR falling below 2.0%.

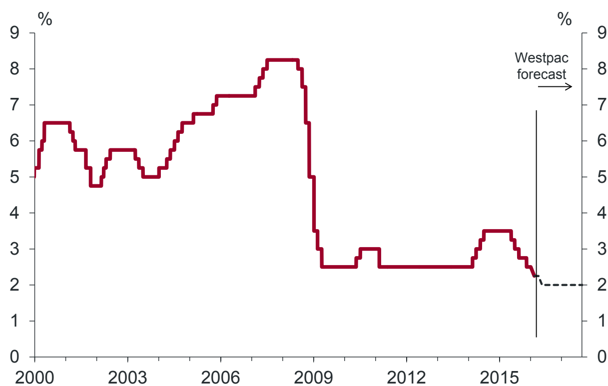
In today's *Monetary Policy Statement* the Reserve Bank reduced the Official Cash Rate to a new record low of 2.25%, and signalled that another cut was likely in coming months. Persistently low inflation outcomes, softening world demand and a sharp drop in inflation expectations meant that inflation was unlikely to settle at the 2% midpoint of the target band without a change in policy settings.

In July last year we identified that the OCR would have to fall to 2.0%, and suggested that the cuts below 2.5% would occur in early 2016. At the time this was a distinctly minority view, but became more accepted as conditions evolved.

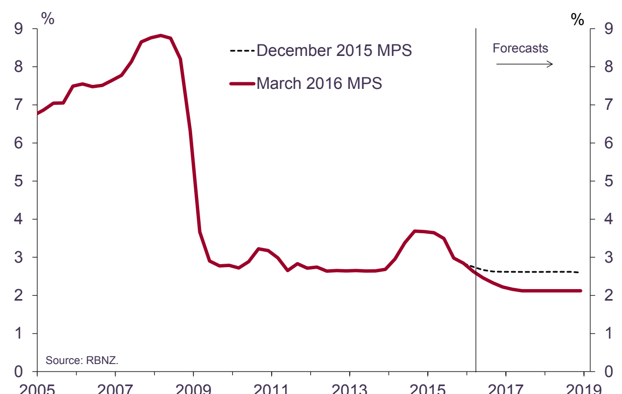
The timing of those rate cuts, however, was always very uncertain, and depended on the RBNZ's judgements. In January we pencilled in a rate cut below 2.5% for March, but we shifted the expected timing of that first cut to June after a speech last month by RBNZ Governor Wheeler that appeared to push back against calls for rate cuts.

So what has changed since that speech to prompt the RBNZ into action? The *MPS* cited two factors in particular: the softening global environment, leading to a lower degree of imported inflation than expected in New Zealand; and a drop in inflation expectations across a range of measures, to levels that are arguably no longer consistent with the 2% midpoint of the inflation target.

Westpac OCR forecast



RBNZ 90-day rate forecasts



The forecasts the RBNZ published today were very much in line with what we were expecting. Indeed, the RBNZ's views are now similar to our own in most respects. On that basis, we have no reason to dispute the suggestion OCR cut will come at the June *MPS*. However, the situation is very much data dependent, and April will be a live review.

We'd also note that 2.0% is no line in the sand for the OCR. Indeed, the balance of risks is now pointed to the downside. In the near term, a persistent rise in the cost of overseas funding could hamper the RBNZ's efforts to bring borrowing rates down. And over the longer term, it's possible that more stimulus will be needed once the Christchurch rebuild hits the wind-down phase.

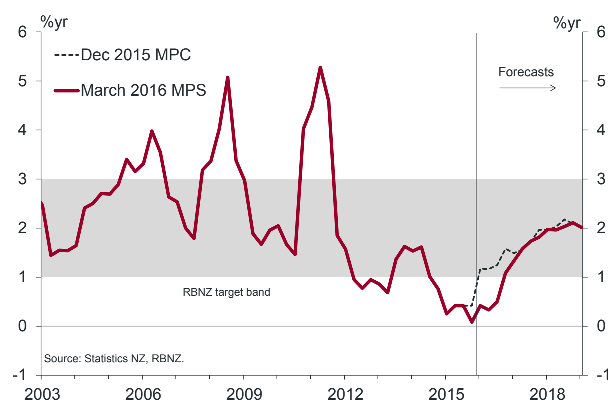
Forecast details

As in the RBNZ's previous statements, the *MPS* painted a reasonably robust picture of the New Zealand economy. Annual GDP growth is expected to pick up to around 3% over the next couple of years, with high population growth, a strong pipeline of construction work and a lift in tourist spending helping to offset the drop in income from dairy exports.

There is, however, an important caveat to these forecasts, as was pointed out by the RBNZ Assistant Governor in a recent speech. These strong growth forecasts do not reflect a belief that the economy is doing fine on its own; rather, they are what the RBNZ believes is needed to generate 2% inflation over the medium term. If growth were to fall short of these forecasts, then in the absence of a monetary policy response, it's likely that inflation would fall short too.

And on the inflation front, the RBNZ once again has little room for error. Annual inflation is forecast to remain below 1% until the end of this year, largely due to the renewed plunge in world oil prices this year. But even once this effect washes out, the return to the 2% target midpoint is expected to be gradual, only reaching that mark in early 2018.

RBNZ inflation forecasts



The RBNZ cited weaker global inflation pressures as a key reason for a lower OCR. In one sense, this is not a new development: forecasts of trading partner growth have been steadily creeping lower for some time. So there seems to have been a judgement call involved as well. The *MPS* acknowledges that weak tradables inflation has been about much more than just oil prices, and that weak world demand is weighing on prices for a wide range of commodities, both imported and exported.

The other major concern raised in today's *MPS* was the fall in inflation expectations. Expectations have been drifting lower over time, but until recently the RBNZ has maintained that they were consistent with the 2% target midpoint. But in the early part of this year there was a sharp drop across a range of measures, particularly "over the time horizon relevant for monetary policy" as the *MPS* notes.

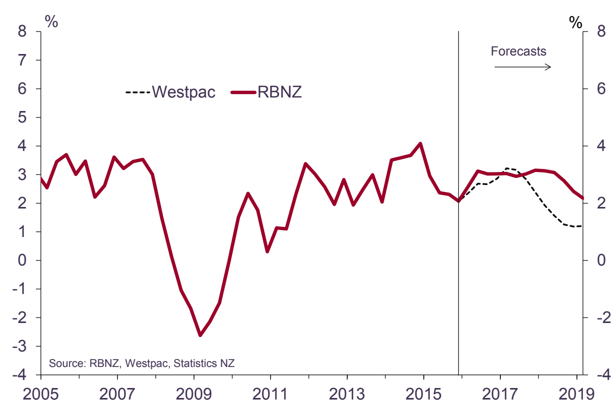
As in December, the RBNZ provided a range of risk scenarios around its central view. Two in particular are worth noting. The first involved persistently higher overseas funding costs for New Zealand banks. In this instance, the RBNZ would be prepared to take the OCR below 2% in order to get borrowing rates down to the desired levels. We regard this as a genuine risk, but it's highly uncertain how it will play out over the coming months.

The second scenario involved a stronger than expected housing market, in turn leading to stronger domestic demand, which might mean that further interest rate cuts are unnecessary. We're certainly aware of the risk of a resurgence in the housing market once last year's regulations have been absorbed. But the RBNZ's already very bullish view on house prices leaves a high hurdle for upside surprises – the RBNZ expects the national average house price to rise 12% this year, compared to our forecast of 5%.

Overall, we're comfortable with our view that the RBNZ will cut the OCR again to 2% in the coming months. But 2% is by no means a lower bound, and we're considering at least two factors that could cause it to go even lower than that. The first is in the near term: higher finding costs, as described above, could require offsetting reductions in the OCR.

The second factor is more long-term, and is where our forecasts diverge more substantially from the RBNZ. The level of earthquake rebuild activity in Canterbury appears to have plateaued, and we expect it to gradually decline from 2017 onward as more projects are completed. As the rebuild slows, nationwide GDP growth is likely to slow to a below-trend pace and domestic inflation pressures will start to ease. At this stage, it's quite plausible that more stimulus will be needed in order to anchor inflation around the 2% target. In contrast, the RBNZ's growth forecasts remain fairly perky well into 2018.

RBNZ GDP growth forecasts



Market implications

The reaction to today's decision was considerable, given that market pricing for a cut today was only about 20% (and had been edging down in recent days). The New Zealand dollar fell by 1.35 cents against the US dollar, and the two-year swap rate fell from 2.45% to 2.25%, a record low. We would expect swap rates to continue declining over the day or two ahead, as markets come to absorb the RBNZ's new stance.

Dominick Stephens
Chief Economist

Michael Gordon
Senior Economist

RBNZ media release

The Reserve Bank today reduced the Official Cash Rate (OCR) by 25 basis points to 2.25 percent.

The outlook for global growth has deteriorated since the December *Monetary Policy Statement,* due to weaker growth in China and other emerging markets, and slower growth in Europe. This is despite extraordinary monetary accommodation, and further declines in interest rates in several countries. Financial market volatility has increased, reflected in higher credit spreads. Commodity prices remain low.

Domestically, the dairy sector faces difficult challenges, but domestic growth is expected to be supported by strong inward migration, tourism, a pipeline of construction activity and accommodative monetary policy.

The trade-weighted exchange rate is more than 4 percent higher than projected in December, and a decline would be appropriate given the weakness in export prices.

House price inflation in Auckland has moderated in recent months, but house prices remain at high levels and additional housing supply is needed. Housing market pressures have been building in some other regions.

There are many risks to the outlook. Internationally, these are to the downside and relate to the prospects for global growth, particularly around China, and the outlook for global financial markets. The main domestic risks relate to weakness in the dairy sector, the decline in inflation expectations, the possibility of continued high net immigration, and pressures in the housing market.

Headline inflation remains low, mostly due to continued falls in prices for fuel and other imports. Annual core inflation, which excludes the effects of transitory price movements, is higher, at 1.6 percent.

While long-run inflation expectations are well-anchored at 2 percent, there has been a material decline in a range of inflation expectations measures. This is a concern because it increases the risk that the decline in expectations becomes self-fulfilling and subdues future inflation outcomes.

Headline inflation is expected to move higher over 2016, but take longer to reach the target range. 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.

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