![Westpac Institutional Bank]

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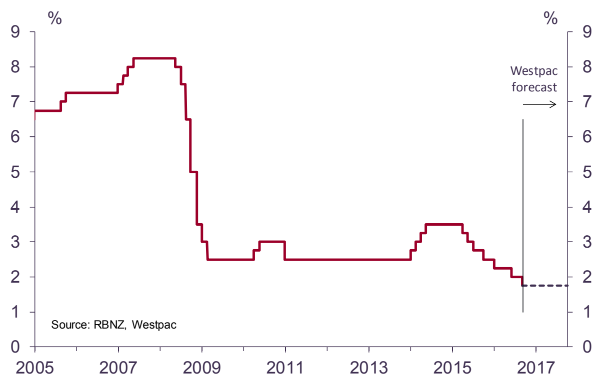
It's all part of the plan

November 2016 MPS Review: RBNZ cuts OCR to 1.75%, shifts to more neutral stance

- The Reserve Bank reduced the Official Cash Rate by 25bps to a record low of 1.75%, and shifted to a more neutral stance.
- Further cuts have not completely been ruled out, especially given the continuing uncertainty around the global environment and lingering softness in inflation. However, developments over the past few months have been positive for the New Zealand economy, and the downside risks to the RBNZ's view have diminished.
- We expect that the OCR will remain on hold for an extended period. However, longer term rates look set to rise from here.

Westpac OCR forecast



A record low

At today's *Monetary Policy Statement*, the Reserve Bank cut the Official Cash Rate by 25bps, taking it to a new record low of 1.75%. And it looks like it will remain there for some time. The RBNZ noted that "current projections and assumptions indicate that policy settings, including today's easing, will see growth strong enough to have inflation settle near the middle of the target range". That marks a shift to a much more neutral stance by the RBNZ, after the last few months when they had strongly signalled that "further policy easing will be required".

This doesn't mean that the door is completely closed with regards to further cuts. The RBNZ noted that "numerous uncertainties remain, particularly in respect of the international outlook, and policy may need to adjust accordingly" – a comment that implicitly acknowledges the uncertainty around the global outlook following the unexpected result of the US election. Reflecting such uncertainties, the RBNZ's projections show the OCR at 1.7%. The RBNZ only publishes OCR forecasts to one decimal place, but this suggests that they still see some small possibility of a further easing. However, it doesn't indicate any strong commitment to doing so. (Note: this is the first time the RBNZ has published an explicit forecast for the OCR, giving us a clearer view of their thinking on policy, unobscured by changes in funding spreads).

With economic activity humming along, we expect the OCR to remain on hold at the current level for an extended period. Inflation is expected to rise as some temporary factors drop out and as the economy strengthens. But the return to the target midpoint is still likely to be very slow, and the risk of overshooting is low.

It's all part of the plan

Today's cut comes in the face of signs that the New Zealand economy is on increasingly solid footing, with positive signs in the household and business sectors, continued strong population growth, and gains in commodity prices. Against this positive backdrop, there was some question about whether a cut was even needed today.

However, the strength in activity that we're seeing is at least in part due to the current record low levels of interest rates. The RBNZ needs the economy to continue running at a solid pace to generate a pick-up in domestic pricing pressures in the face of continued softness in global inflation.

In addition, today's decision was very well signalled in recent policy statements and a recent speech, and market pricing had adjusted accordingly. Failure to deliver would have risked sharp moves higher in both the New Zealand dollar and wholesale interest rates – effectively resulting in an unwanted tightening of monetary conditions.

Slow and steady wins the race

To ensure the economy continues trucking along, the OCR will need to remain low for some time. However, the downside risks to the domestic economic outlook have been dissipating. Furthermore, the RBNZ remains conscious of the risks of over-stimulating the economy and housing market, as well as the associated risks for the exchange rate. Consequently, rather than cutting the OCR further over the coming year to spur a rapid increase in prices, they can take their foot off the accelerator for the time being.

Consistent with this, the RBNZ is targeting a gradual return of inflation to the 2% midpoint of the target band. The RBNZ's updated forecasts have inflation returning to 2% in Q4 of 2018 (just slightly later than their previous forecast).

This gradualism also reflects that much of the softness in inflation that we're seeing is due to offshore factors, including softness in global trade and inflation. These factors are continuing to weigh on import prices in New Zealand, and are beyond the control of domestic monetary policy. That's a judgement that seems very appropriate to us.

The RBNZ's forecasts show a degree of caution around some of the positive factors boosting economic activity. In the case of dairy prices, the RBNZ noted the risk that some of the strong gains in recent months could reverse. And in the case of the household sector, the RBNZ noted that the boosts from migration and house prices are expected to have a more muted impact on consumption than in the past.

One of the key concerns for the RBNZ continues to be inflation expectations. While the decline seen in recent years has been arrested, shorter-term expectations remain lower than desired. In addition, with inflation low, there is still some risk that expectations decline further. That would be a major concern for the RBNZ, affecting wage a price setting decisions, and potentially eroding the effectiveness of interest rate reductions. This will be an area that the RBNZ continues to monitor closely.

The other key concern that will be keeping the RBNZ's staff up at night is the health of the global economy. Global demand remains subdued, and the related softness in global inflation has had a large impact on the RBNZ's thinking. On top of this, the risk of volatility in global financial conditions remains omnipresent, with events such as the ongoing Brexit negotiations and last night's unexpected US election result adding a further layer of uncertainty. Although such concerns have been trumped by the strength of domestic activity in recent months, the RBNZ will no doubt be keeping an eye on developments offshore over the coming months.

Where to from here?

Our stance has been that after today's cut the OCR would be on hold for an extended period. Financial markets and other forecasters have been coming around to that view in recent weeks, and the RBNZ is now also signalling, barring future shocks, 1.75% is most likely to mark the low point for the OCR.

However, that doesn't mean we'll see the same stability in the interest rates faced by borrowers and savers. Term interest rates are facing upward pressure from several sources. First, global interest rates have already been trending higher in recent weeks, with New Zealand carried along for the ride. And after an initial panic move lower, the market's verdict now seems to be that a Trump presidency will mean higher long-term borrowing rates.

Second, banks are facing a higher mix of funding costs relative to the level of the OCR. Until recently, growth in deposits had broadly matched lending growth. But in recent months, there has been a marked shortfall in deposit growth, which may be a sign that people are seeking out higher-return investments. The gap can be filled with wholesale funding, but this is both costly and increasingly constrained by regulatory requirements. So we may see lending and deposit rates creep higher independently of the OCR.

Finally, in the near term at least, there's a risk that the market goes overboard in trying to anticipate the timing of OCR hikes. Interest rate markets are already factoring in more than a 50% chance of a 25bp hike by the end of 2017. That seems far too early to us. The RBNZ is still likely to be looking at inflation in the lower half of its target range by that point; the risk of overshooting the target seems low.

If the above points hold true, the RBNZ will be facing an implicit tightening of monetary conditions over the next couple of years anyway. We don't think that the RBNZ would go as far as cutting the OCR further to try to offset this trend. But we wouldn't be surprised if future RBNZ statements move away from signalling a bias for future OCR moves, and place more emphasis on the "monetary policy will continue to be accommodative" clause.

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RBNZ Statement

The Reserve Bank today reduced the Official Cash Rate (OCR) by 25 basis points to 1.75 percent.

Significant surplus capacity exists across the global economy despite improved economic indicators in some countries. Global inflation remains weak even though commodity prices have come off their lows. Political uncertainty remains heightened and market volatility is elevated.

Weak global conditions and low interest rates relative to New Zealand are keeping upward pressure on the New Zealand dollar exchange rate. The exchange rate remains higher than is sustainable for balanced economic growth and, together with low global inflation, continues to generate negative inflation in the tradables sector. A decline in the exchange rate is needed.

Domestic growth is being supported by strong population growth, construction activity, tourism, and accommodative monetary policy. Recent dairy auctions have been positive, but uncertainty remains around future outcomes. High net immigration is supporting growth in labour supply and limiting wage pressure.

House price inflation remains excessive and is posing concerns for financial stability. Although house price inflation has moderated in Auckland, it is uncertain whether this will be sustained given the continuing imbalance between supply and demand.

Headline inflation continues to be held below the target range by ongoing negative tradables inflation. Annual CPI inflation was weak in the September quarter, in part due to lower fuel prices and cuts in ACC levies. Annual inflation is expected to rise from the December quarter, reflecting the policy stimulus to date, the strength of the domestic economy, and reduced drag from tradables inflation.

Monetary policy will continue to be accommodative. Our current projections and assumptions indicate that policy settings, including today's easing, will see growth strong enough to have inflation settle near the middle of the target range. Numerous uncertainties remain, particularly in respect of the international outlook, and policy may need to adjust accordingly.

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