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A question of tactics

RBNZ OCR Preview, April 2016

- The RBNZ is most likely to keep the OCR on hold next week, but to signal an OCR cut ahead.
- Compared to the March MPS, recent developments lean further towards the need for OCR cuts.
- But the RBNZ prefers to move at MPS dates, not OCR Reviews.
- And cutting next week would present tactical and communication challenges.
- The only reason to cut next week is if the RBNZ has already decided that the OCR is going below 2%.
- That would be a very significant development, but we assign only a 25% chance to it happening.
- Markets should prepare for very forthright commentary on the high exchange rate.

Westpac OCR forecast

In March the RBNZ cut the OCR and indicated that *"further policy easing may be required."* Based on its forecasts and communications at the time, the RBNZ expected to deliver one more OCR reduction, probably in June.

As we head into next week's April OCR Review, the trick will be to assess whether conditions have changed sufficiently for the RBNZ to deviate from its previous plan and deliver an early OCR cut.

Since March, economic data developments have been mostly inflation-positive, while financial market developments have been inflation-negative. The balance between the two does lean in favour of further OCR reductions. However, tactical considerations make the hurdle for an April OCR cut quite high. We are not convinced that this hurdle has been cleared, particularly considering that the financial market developments driving the need to cut could prove fickle. We therefore conclude that although the April OCR Review is live, the RBNZ is more likely to remain on hold – we assign roughly 25% odds to a cut.

That said, we certainly expect the RBNZ's commentary to acknowledge the balance of recent developments, and to provide a firmer easing signal – perhaps the RBNZ will describe further easing as *"likely in the coming months"*, to keep markets focussed on falling interest rates.

We continue to regard June as the more likely date for the next OCR reduction. While we are forecasting only one more OCR reduction, we must admit that the risk of the OCR eventually falling below 2% is mounting.

Tactical nuances

We think the RBNZ will favour June over April for tactical reasons. April is an OCR Review, not a *Monetary Policy Statement (MPS)*. The Reserve Bank has demonstrated a preference for changing the OCR at MPS dates while eschewing OCR Reviews. Of the five OCR reductions in the current cycle, four have occurred on MPS dates and only one has occurred at an OCR Review.

The reasons the RBNZ prefers MPSs are twofold. First, the RBNZ conducts a more comprehensive analysis prior to MPSs. And second, MPSs come with plenty of opportunity to communicate subtleties in the outlook, via 40-odd pages of supporting explanation and a press conference. In contrast, OCR Reviews consist of only a one-page press release.

In this instance, cutting at next week's OCR Review would require the RBNZ to give signals about the future of the OCR that it may not be ready to commit to. Cutting next week would take the OCR down to the previously-forecast low point of 2%. Thus the Reserve Bank's policy guidance sentence will reveal whether or not the RBNZ now expects the OCR to fall below 2%. If the RBNZ signals no further OCR reduction, financial market pricing may gravitate toward a flat rather than falling OCR. In turn, that could cause the exchange rate to rise. Such is the fate the RBA suffered last year when it delivered its so-called "hawkish cut."

Conversely, cutting the OCR to 2% and retaining the phrase that *"further policy easing may be required"* would effectively nail the RBNZ's colours to the mast, signalling that it now intends to cut the OCR below 2%. This would be a very big step, and not one we believe that the RBNZ is ready to take just yet.

The much simpler tactic would be to keep the OCR on hold, and firmly signal future policy easing. The language could be stepped up to something like *"further policy easing is likely in the months ahead"*. This would keep the prospect of further OCR reductions on markets' minds, while deferring the question of how low the OCR is expected to go until the full MPS in June.

Economic versus financial market developments

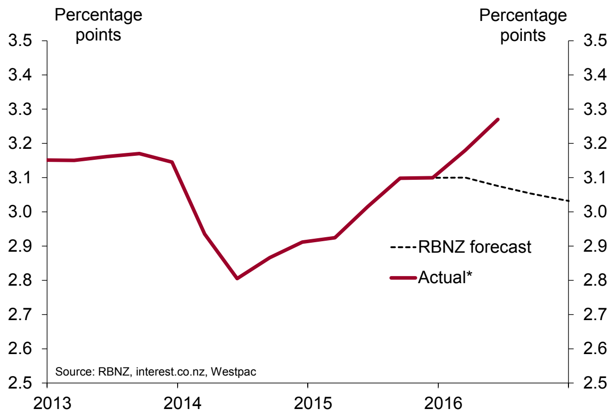
Recent economic data developments have mainly tended to lean against the need for OCR reductions:

- March quarter inflation was in line with the RBNZ's forecast, but the details were a little stronger than the RBNZ anticipated.
- December 2015 GDP growth was stronger than the RBNZ anticipated.
- Housing market data for March was very strong, and an economy-wide borrow-and-spend dynamic appears to be developing. This indicates that monetary policy is (finally) gaining some traction.
- Global financial markets have calmed and commodity prices are rising, although the dairy downturn is now impacting economic confidence more obviously.

But these mainly inflation-positive developments have been offset by the high exchange rate, which will tend to suppress inflation. Back in March the RBNZ forecast that the Trade Weighted Index (TWI) would average 70.9 in the June quarter. We are only a quarter of the way through the quarter, but so far the TWI has averaged 72.7, and it isn't looking likely to fall in the near term.

The most important recent development arguing in favour of OCR cuts is mortgage rates. Following the March OCR reduction, wholesale interest rates fell sharply while mortgage rates fell only modestly. The gap between mortgage rates and the corresponding bank bill or swap rates has widened by 20 basis points. The details of the March MPS reveal that the RBNZ did not foresee this. In other words, the RBNZ has not achieved the reduction in mortgage rates that it sought.

Margin between floating mortgage rates and 90-day interest rates, main banks



One might argue that the RBNZ will offset the widening of mortgage margins by lowering the OCR further. But it would seem mechanistic and simplistic for the RBNZ to take such action immediately. Mortgage margins over swap rates are fickle, and could yet drop away. After all, global credit markets are currently calming, meaning bank funding costs may soon fall. And the recent heat in the housing market raises the question of how much lower mortgage rates actually need to go.

Given this mix of developments, we suspect that the RBNZ will want to observe how the exchange rate, mortgage rates, and the housing market evolve before deciding on whether the OCR is likely to fall below 2%.

RBNZ press release

Although we are not convinced that the RBNZ will cut the OCR next week, we do expect acknowledgement of recent developments in the press release. Very firm language on the exchange rate is a certainty – the RBNZ may even bring back a phrase it used last year, along the lines of *"continued strength* *in the exchange rate would require a lower interest rate path than would otherwise be the case."* In other words, the OCR will fall below 2% if the exchange rate stays high.

Communication about mortgage rates will have to be more subtle, as the RBNZ will want to avoid the impression that it is giving banks licence to expand margins. However, we would still expect some reference to mortgage rates not falling as far as the OCR.

And finally, we would expect the RBNZ to acknowledge the strong housing market, possibly even referring to the fact that expanding household debt indicates that monetary policy is having an impact on the economy.

Market reaction

If the RBNZ does keep the OCR on hold while issuing some signal of cuts ahead, there would be little market reaction. Financial markets are currently pricing some risk that the OCR will fall below 2%, and would continue to do so in the scenario we regard as most likely.

As described above, we believe that the RBNZ would only cut the OCR next week if it has already decided that it is going to have to drop the OCR below 2%. That would be a very important development, and financial markets would react vigorously. In this scenario, we would most likely conclude that a follow-up cut in June is likely.

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