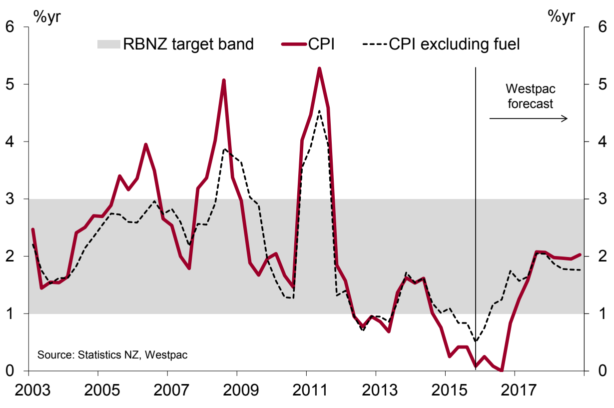
25 January 2016

Clear cut

RBNZ OCR Preview, January 2016

- The Reserve Bank is unlikely to change the Official Cash Rate at this Thursday's review.
- However, we expect a shift in policy guidance to an explicit easing bias.
- The RBNZ will express its willingness to reduce the OCR, without making any commitment or indication of timing.
- The New Zealand economy is ticking over nicely, but inflation is far too low, global financial markets are stressed, and the Auckland housing market has cooled.
- Our current forecast is for OCR cuts in June and August.
- But the risk is that the RBNZ cuts in March.

CPI inflation forecasts



The RBNZ is highly likely to leave the OCR unchanged at this Thursday's OCR review, given the 'on hold' guidance it gave last month. However, we anticipate a significant shift in policy guidance, with the RBNZ adopting an easing bias.

When the Reserve Bank cut the OCR to 2.5% in December, it indicated that it expected not to cut the OCR again this cycle. That was on the basis that GDP growth would run at a solid pace, house prices would continue rising sharply, and that the exchange rate would gradually fall. Most importantly, the RBNZ's 'on hold' stance was predicated on inflation jumping above 1% in March 2016 and rising steadily thereafter, on the basis that the lower exchange rate would feed through to higher prices for tradable goods and services.

However, the December Monetary Policy Statement also indicated that the Reserve Bank stood ready to *"reduce rates further if circumstances warrant."* The RBNZ was acknowledging that things might evolve differently to forecast – and if they did, the RBNZ explicitly reserved the right to reduce the OCR. We would call that a conditional easing bias.

Circumstances have indeed changed, and in our view it is now clear that further OCR reductions are warranted. We expect the Reserve Bank will indicate a greater likelihood of OCR reductions when it issues its OCR review on Thursday. Examples of possible policy guidance sentences might be:

"The OCR is expected to remain low for some time, and could even move lower."

Or:

"The OCR is expected to remain at or below the current level for some time."

Either phrase would convey the RBNZ's readiness to reduce the OCR, without actually committing the RBNZ to any particular course of action.

If we are wrong, and the Reserve Bank instead issues unchanged policy guidance on Thursday, we certainly wouldn't give up on the idea of OCR cuts this year. There is another opportunity for the RBNZ to change its stance on February 3, when the Governor will deliver his annual speech to the Canterbury Employers' Chamber of Commerce. This speech is traditionally focused on monetary policy, and has in the past been used as an opportunity to signal a change to the OCR outlook.

Outlook is for zero inflation

Recent data has more or less vindicated the RBNZ's upbeat GDP growth forecasts, showing that the New Zealand economy was ticking along nicely at the end of 2015. But in almost any other area one cares to investigate, there has been a decisive shift down in the outlook for inflation.

The December quarter Consumer Price Index showed that inflation had undershot the RBNZ's expectation by a significant margin – and not just because of falling petrol prices. Prices remained muted across a wide range of tradable goods and services, suggesting that passthrough from the lower exchange rate to inflation remains elusive. Inflation excluding petrol has been running below 1% since June 2015, and is likely to stay below 1% until June 2016.

Including petrol, the inflation outlook looks even worse. Following the recent plunge in global oil prices, our own inflation forecast has shifted to zero for the year to September 2016. That implies a good chance that annual inflation will drop below zero this year. Inflation is unlikely to return above the 1% lower limit of the RBNZ's target band until March 2017.

Meanwhile, global equity markets have weakened considerably since the start of the year, and markets generally are showing signs of risk aversion. The jury is out on whether this is simply market jitters or reflects genuine weakness in China's economy. Either way, this market turmoil will have a direct influence on New Zealand's inflation outlook, via confidence, bank funding costs, weaker global commodity prices (dairy auctions have been down) and weaker Asian exchange rates.

Despite the market turmoil, the trade-weighted exchange rate has held up at a higher level than the RBNZ forecast in the December *Monetary Policy Statement*. This will further supress the inflation outlook.

Finally, the housing market has turned out significantly weaker than the RBNZ expected. In December the RBNZ forecast 17% house price inflation for the year to June 2016. But the Real Estate Institute's House Price Index suggests that house prices in Auckland have fallen almost 6% since September, probably in response to regulatory changes. Even accounting for housing market upturns across many other parts of the country, this will still leave nationwide annual house price inflation below 10% for the year to June 2016.

The OCR outlook

It now seems clear that the most prudent course for the RBNZ is to reduce the OCR at some point. There is a clear and present risk that persistently low rates of headline inflation will cause an unhelpful drop in inflation expectations. Conversely, the risk that OCR reductions would imperil financial stability has receded a bit with the recent fall in Auckland house prices. The only remaining question, to our minds, is the timetable for action.

For some time our forecast has been that the RBNZ will reduce the OCR twice in 2016, with June and August pencilled in as the most likely dates. But recent developments have made us more mindful of the risk of the RBNZ moving even earlier. The March Monetary Policy Statement is most certainly live, with the outcome depending on forthcoming data. Factors that will help us to firm up our forecast of the timing of OCR cuts this year include:

- Any evidence of inflation expectations falling materially below 2%
- Whether or not the current stress in global financial markets persists
- The evolution of the exchange rate and the housing market
- Labour market data, due on 3 February
- Developments in New Zealand export commodity markets – we fear weaker export prices following the lead that global financial markets have set
- The tone of the Reserve Bank's OCR guidance on Thursday and at the 3 February speech

Market reaction

Financial markets have shifted in recent weeks to pricing in a 50% chance of an OCR cut by March, with 25 basis points of OCR reductions priced by September. Given that pricing, markets will be looking for a shift to an explicit OCR easing bias along the lines we have posited above. If the RBNZ prevaricates at all, the exchange rate and interest rates will rise. Equally, if the RBNZ goes further and indicates that it intends to reduce the OCR in March, financial markets would respond by marking the NZD and interest rates lower.

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