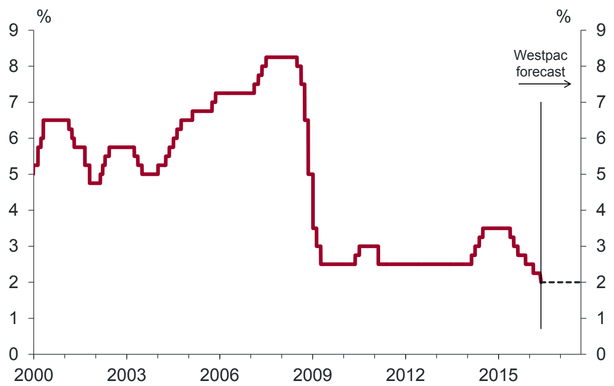
Westpac Institutional Bank

Softly, softly

RBNZ OCR Review, April 2016

- As expected, the OCR remained unchanged at 2.25% at today's OCR Review.
- The RBNZ retained its easing bias, but guidance on further interest rate cuts was less emphatic than we were expecting.
- Instead, the RBNZ's statement brought inflation-positive developments in the domestic economy to the fore. And they sounded less worried about the downside risks to the inflation outlook than in the March MPS.
- We continue to expect another rate cut from the RBNZ, most likely in June. Today's statement suggests that, for now, the RBNZ sees 2% as the low in the OCR.

Westpac OCR forecast



The RBNZ left interest rates on hold at 2.25% in today's OCR Review. It reiterated its easing bias saying *"Further policy easing may be required to ensure average inflation settles near the middle of the target band"*. However, it gave no sense that the need to cut rates further was any more pressing than it was seven weeks ago.

Markets reacted with some surprise. They had been increasingly pricing in the chance of a sub-2% OCR this year and had priced in a decent chance of a rate cut as soon as today. In contrast, today's statement conveyed a more upbeat view from the RBNZ on the inflation front than in March. This led to a sizable market reaction; the NZD jumped almost a cent against the US dollar while interest rates rose 7 basis points.

Judging from today's comments, the RBNZ's economic outlook is little changed from the March *Monetary Policy Statement (MPS)*. And today's one pager gave more weight to the inflation-positive developments in the real economy, arguably at the expense of the inflation-negative financial market developments.

The global outlook remains soft, but no more so than before. And along with other commodity prices, dairy prices have improved (though they remain below break-even levels for most farmers). On the domestic front, strong inward migration, construction activity and the tourism sector all got a nod. House prices rated a mention, but the RBNZ sounded like it was treating the recent pickup in house price inflation in Auckland with some caution.

All this was very much in line with our expectations. The real surprise was that these inflation-positive developments weren't balanced to a greater degree against the inflation-negative changes in financial markets over the last six weeks. In particular, we expected the much stronger NZ dollar and the incomplete pass through from the March OCR cut to mortgage rates would get a mention.

On the former, the RBNZ certainly acknowledged the strong currency. However, they sounded no more concerned than they were back in March. That's despite the currency tracking about 3% higher than the RBNZ's projection at that time. The exchange rate was labelled as *"higher than appropriate"* and a lower NZ dollar was described as *"desirable"*. This expressed some discomfort, but was quite some way from the much sterner language used at times in the past, likely reflecting the more positive signs the RBNZ is seeing for inflation.

And while the currency rated a mention, that's more than can be said for pressures on bank funding costs. Commentary around the widening spread between wholesale interest rates and mortgage rates since the March *MPS* was conspicuously absent.

An explanation for the omission might be that today's statement was only a one page press release, prepared without the more comprehensive analysis conducted prior to a full *MPS*. This may have made communications tricky. Alternatively, the RBNZ may have shifted the issue down the "to do" list, only to pull it out again further down the track. Or perhaps with financial market volatility easing in recent weeks, they may be waiting for the situation to resolve itself further down the track, without the need for any action from the RBNZ. Whatever the case, we will continue to closely monitor developments on this front ahead of the June *MPS*.

Overall, the RBNZ remains concerned about the inflation outlook, but the heightened risk of inflation expectations falling to unacceptably low levels (which saw the RBNZ hurrying to cut rates in March) has eased. The outlook now is for headline inflation to *"strengthen as the effects of low oil prices drop out and as capacity pressures gradually build"*.

Implications

We continue to expect the RBNZ to deliver one more rate cut, most likely in June this year. That's consistent with the projections in the March *MPS*. The RBNZ has shown a preference for moving at *Monetary Policy Statements*. And if they are planning on delivering only one more cut (as we suspect) this would give them a chance to fully explain their thinking. It will probably take fresh bad news on the inflation front to knock them off this path, and encourage them to cut rates below 2%. A rejig of the monetary policy timeline means there is also an *MPS* in August, however to us this looks like a very long time to wait.

Market reaction

Like us, the market regarded today's OCR Review as more hawkish than expected. The NZD/USD jumped from 0.6840 to 0.6940 shortly after the statement. NZD/AUD rose from 0.9020 to 0.9130 and could run further, particularly given the surprisingly weak Australian CPI result yesterday. Interest rates were also up. The two-year swap rate has risen from 2.19% to 2.26%.The market has also moved to reduce the likelihood of the OCR moving below 2% in the near term and are pricing almost 60% chance of an OCR cut in June.

RBNZ Statement

The Reserve Bank today left the Official Cash Rate unchanged at 2.25 percent.

The outlook for global growth has deteriorated over recent months due to weaker growth in China and other emerging markets. Prices for some commodities, including oil, have picked up but remain weak.

Monetary conditions are extremely accommodative internationally, with considerable quantitative easing and negative policy rates in some countries. Financial market volatility has eased in recent weeks, but markets continue to watch closely the policy settings of major central banks.

Domestically, the economy is being supported by strong inward migration, construction activity, tourism, and accommodative monetary policy. Dairy export prices have improved slightly, but are below break-even levels for most farmers.

The exchange rate remains higher than appropriate given New Zealand's low commodity export prices. A lower New Zealand dollar is desirable to boost tradables inflation and assist the tradables sector.

There are some indications that house price inflation in Auckland may be picking up. House prices remain at very high levels and additional housing supply is needed. Housing market pressures are building in some other regions.

There are many uncertainties around the outlook. Internationally, these 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 low fuel and other import prices. Annual core inflation remains within the target range. Long-term inflation expectations are well-anchored at 2 percent. However, as we have previously noted, there has been a material decline in shorter-term expectations.

We expect inflation to strengthen as the effects of low oil prices drop out and as capacity pressures gradually build. 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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