Westpac

Institutional Bank

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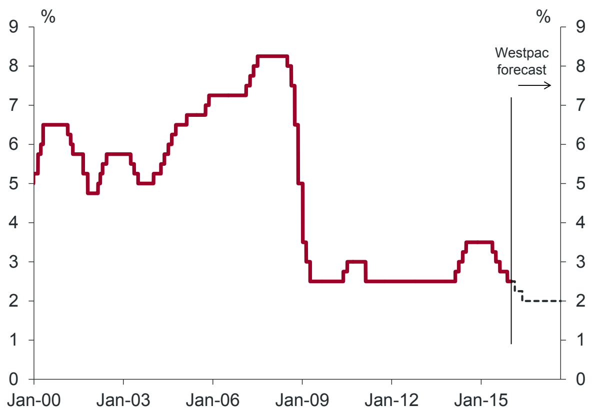
A clearer case

RBNZ OCR Review, January 2016

- The OCR remained on hold at 2.5% at today's OCR Review.
- The RBNZ warned that it may reduce the OCR further this year.
- This was encouraging for our long-held forecast that the OCR will drop to 2.0% this year.
- But the timing of OCR cuts remains uncertain.
- We now regard March as the slightly more likely start date for OCR cuts (previously June).
- Further clarity on the March MPS may emerge on Wednesday next week, following labour market data and a key RBNZ speech.

Westpac OCR forecast



Today's RBNZ OCR Review was straightforward, and in line with our expectation. The RBNZ has shifted its stance, and is now warning that it may reduce the OCR below 2.5% at some point this year. The key policy guidance sentences were:

"Some further policy easing may be required over the coming year 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."

The RBNZ sounded nervous about global financial market developments, noting that uncertainty about global growth had increased. But this was balanced by an ongoing positive assessment of New Zealand's GDP growth prospects and ongoing concern about high Auckland house prices.

The real driver of the RBNZ's change of tune was inflation.

The RBNZ acknowledged that inflation *"will take longer to reach the target band than previously expected."* That was putting it diplomatically. In December the RBNZ forecast that inflation would rise above 1% in March 2016. Our updated forecasts now suggest that inflation will fall to zero by September 2016, and will not get above 1% until 2017. This is not just because of plunging global oil prices. It has also become clearer that tradables inflation is not rising very much in response to the large decline in the exchange rate last year. On top of this, domestic sources of inflation have been subdued.

As an inflation targeting central bank, there was no way the RBNZ could ignore such a monumental change in the inflation outlook. The RBNZ did defend its record by noting that its favoured measure of core inflation is currently around 1.6%, and that inflation expectations are stable. But the RBNZ evidently also recognises the risk that inflation expectations and core inflation could fall, given that headline inflation is now expected to remain below 1% for over two years. Hence, the RBNZ concluded that further OCR cuts may be required.

Westpac's OCR call

The Westpac Economics Team has, since July last year, been forecasting that the OCR would fall from 2.5% to 2.0% during 2016. This was predicated on inflation falling short of the RBNZ's expectation. Obviously, today's OCR Review was very encouraging for our view.

But we have long been uncertain as to the exact timing of cuts. The best we have been able to offer is that cuts would begin in either March or June, depending on sentiment at the RBNZ and the details of the data. When forced to choose between those two dates, until today we sided with June being slightly more likely start date than March.

But after digesting last week's low inflation data, and considering the clarity of the easing bias the RBNZ articulated today, we would now suggest that March is the slightly more likely start date for OCR cuts – but only by a slim margin. Hence we are now forecasting OCR cuts in March and June this year.

True, today's OCR Review did not sound like a central bank that plans to cut the OCR at its next meeting. But neither was a March cut ruled out. The RBNZ runs only a cut-down analysis ahead of January OCR Reviews. Ahead of the March *Monetary Policy Statement*, the RBNZ will complete its full analysis. When it does, we suspect it will find that:

- Global financial market stress is translating to a weaker global growth outlook, lower prices for key New Zealand export products, and higher funding costs for New Zealand banks;
- Inflation is not likely to rise above 1% until 2017; and
- The Auckland housing market has indeed cooled.

We must stress that the timing of OCR cuts remains a difficult call, and will be heavily influenced by the flow of data. We get further clarity regarding the March MPS next Wednesday. On that day a fortnightly GlobalDairyTrade auction is due, the December 2015 labour market data is due, and the RBNZ Governor will give a speech to the Canterbury Employers' Chamber of Commerce. We will continue to fine-tune our OCR forecasts as developments occur.

Market reaction

While today's Review was in line with our expectation, the signal that the RBNZ may reduce the OCR was more forthright than markets anticipated. Consequently, the two-year swap rate fell about 5 basis points as markets moved further toward accepting the inevitability of OCR cuts this year. However, markets appear to be struggling with the March / June choice in exactly the same way as we are. Markets are now pricing in a 50% chance of an OCR cut by March, and almost a full OCR cut by June.

Full RBNZ Statement

The Reserve Bank today left the Official Cash Rate unchanged at 2.5 percent.

Uncertainty about the strength of the global economy has increased due to weaker growth in the developing world and concerns about China and other emerging markets. Prices for a range of commodities, particularly oil, remain weak. Financial market volatility has increased, and global inflation remains low.

The domestic economy softened during the first half of 2015 driven by the lower terms of trade. However, growth is expected to increase in 2016 as a result of continued strong net immigration, tourism, a solid pipeline of construction activity, and the lift in business and consumer confidence.

In recent weeks there has been some easing in financial conditions, as the New Zealand dollar exchange rate and market interest rates have declined. A further depreciation in the exchange rate is appropriate given the ongoing weakness in export prices.

House price inflation in Auckland remains a financial stability risk. There are signs that the rate of increase may be moderating, but it is too early to tell. House price pressures have been building in some other regions.

There are many risks around the outlook. These relate to the prospects for global growth, particularly around China, global financial market conditions, dairy prices, net immigration, and pressures in the housing market.

Headline CPI inflation remains low, mainly due to falling fuel prices. However, annual core inflation, which excludes temporary price movements, is consistent with the target range at 1.6 percent. Inflation expectations remain stable.

Headline inflation is expected to increase over 2016, but take longer to reach the target range than previously expected. Monetary policy will continue to be accommodative. Some further policy easing may be required over the coming year 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.

Dominick Stephens
Chief Economist

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Anne Boniface, Senior Economist
+64 9 336 5669

David Norman, Industry Economist
+64 9 336 5656

Any questions email:
economics@westpac.co.nz

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