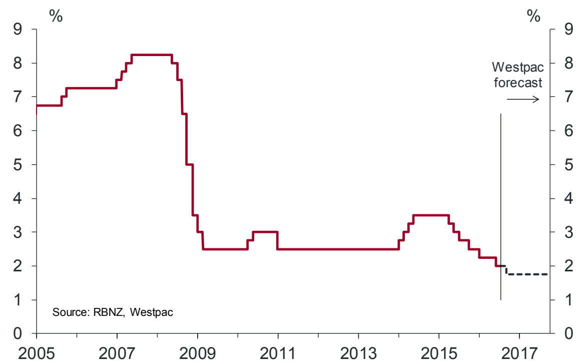
22 September 2016

Second verse, same as the first

RBNZ OCR review, September 2016

- The RBNZ left the OCR unchanged at 2% as was widely expected.
- Much of the language in today's statement was repeated from August, indicating that the RBNZ remains on track for an OCR cut at the November review.
- Despite solid economic growth, the RBNZ faces an uncomfortably slow return to the inflation target, with the risk that this could drag inflation expectations even lower.

Westpac OCR forecast



As we anticipated, today's OCR review was a fairly low-key affair. The Reserve Bank had previously signalled that it expects to cut rates once or twice more in the coming months, with the first move more likely to come at the next *Monetary Policy Statement* in November than at an interim OCR review. Economic conditions have evolved a little in recent weeks, but not enough to diminish the case for more easing. And even subtle changes in the language of today's statement could have given the false impression that the RBNZ was wavering on its plans.

The OCR was left unchanged at 2.00% today, having been reduced by 25 basis points in August. The last lines of the media release were identical to August: *"Our current projections and assumptions indicate that further policy easing will be required to ensure that future inflation settles near the middle of the target range. We will continue to watch closely the emerging economic data."*

"Will be required" is about as strong as the RBNZ's language gets, and is a clear signal that, barring major developments, the RBNZ intends to cut the OCR again in November. Whether there will be a need for more rate cuts beyond that is still up in the air. But there was no need for the RBNZ to make that call at this point, without having collected additional information and run through its full forecasting process.

The statement was updated to reflect the developments since August, but with no apparent change in the RBNZ's overall assessment. Firstly, dairy prices have risen sharply in the last two months, although the RBNZ noted that "the outlook for the full season remains very uncertain". We share this caution – our forecast of a $5/kg milk price for this season is at the lower end of the market range. But there's upside risk to this view if current prices can be sustained over the coming months.

Secondly, the exchange rate has once again risen above what the RBNZ assumed. The statement acknowledged that this is partly justified by the bounce in dairy export prices. And the language on the currency was softened to the extent that it dropped the previous reference to the high exchange rate "making it difficult for the Bank to meet its inflation objective". However, it repeated that a decline in the exchange rate is "needed" – again, quite strong as far as the RBNZ's choice of words goes.

The statement noted that the latest GDP figures, showing 0.9% growth in each of the last two quarters, were consistent with the RBNZ's view. We've noted before that the RBNZ's forecasts already incorporate fairly strong GDP growth – but not because it thinks that the economy is doing fine on its own merits. Rather, it recognises that strong growth is needed in order to generate enough domestic inflation pressure to meet the overall inflation target. If lower interest rates are needed to generate that growth, then the RBNZ will act accordingly.

Finally, it noted that there are early signs that the housing market has cooled after the latest round of loan-to-value ratio (LVR) restrictions on mortgage lending. These were announced in July, but their impact wasn't incorporated in the August *MPS* forecasts as the details were not finalised at that point. The November *MPS* is likely to reveal that the RBNZ has revised down its previous very strong forecast of house price inflation.

The bottom line for the RBNZ is inflation, and here the wording of today's statement was identical to August. Annual inflation is expected to be weak in the September quarter, but to rise from the December quarter onwards, as some temporary factors such as lower fuel prices drop out. So the challenge that the RBNZ faces is one of an uncomfortably slow return to the inflation target rather than a continued undershoot. The RBNZ's concern is that persistently low inflation could see a further decline in wage and price expectations, which would make it that much harder to meet the inflation target over the medium term.

Overall, today's statement supports our forecast that the OCR will be cut to 1.75% in November. The tricky part for the RBNZ will be how to signal its intentions beyond that. If local economic conditions remain favourable then we don't see the need for a further rate cut at this point. But the RBNZ will be wary of shutting the door on future rate cuts, which would risk sending the New Zealand dollar even higher.

Financial markets were prepared for today's on-hold decision, but were concerned about the risk that the RBNZ might soften its language to something like "further easing may be required". In part that was due to NZ-specific developments such as the rebound in dairy prices. But markets could have also been influenced by the growing sense offshore that central banks are reaching an exhaustion point with their unconventional easing measures. Whether that's true in the likes of Europe and Japan, we doubt that it has much relevance here. The RBNZ has plenty of scope to ease through conventional means, and will do so if a return to the inflation target looks in doubt.

Following today's statement, the NZD/USD exchange rate has fallen about 20 points to 0.7340, while the two-year swap rate fell 4bp to 2.04%. Markets are pricing about a 70% chance of an OCR cut in November, which we think is a little on the light side given the forceful language in today's statement.

RBNZ Statement

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.0 percent.

Global growth is below trend despite being supported by unprecedented levels of monetary stimulus. Significant surplus capacity remains across many economies and, along with low commodity prices, is suppressing global inflation. Volatility in global markets has increased in recent weeks, with government bond yields rising and equities coming off their highs. The prospects for global growth and commodity prices remain uncertain. Political uncertainty remains.

Weak global conditions and low interest rates relative to New Zealand are placing upward pressure on the New Zealand dollar exchange rate. The trade-weighted exchange rate is higher than assumed in the August Statement. Although this may partly reflect improved export prices, the high exchange rate continues to place pressure on the export and import-competing sectors and, together with low global inflation, is causing negative inflation in the tradables sector. A decline in the exchange rate is needed.

Second quarter GDP results were consistent with the Bank's growth expectations. Domestic growth is expected to remain supported by strong net immigration, construction activity, tourism, and accommodative monetary policy. While dairy prices have firmed since early August, the outlook for the full season remains very uncertain. High net immigration is supporting strong growth in labour supply and limiting wage pressure.

House price inflation remains excessive, posing concerns for financial stability. There are indications that recent macro-prudential measures and tighter credit conditions in recent weeks are having a moderating influence.

Headline inflation is being held below the target band by continuing negative tradables inflation. Annual CPI inflation is expected to weaken in the September quarter, reflecting 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, reduced drag from tradables inflation, and rising non-tradables inflation. Although long-term inflation expectations are well-anchored at 2 percent, the sustained weakness in headline inflation risks further declines in inflation expectations.

Monetary policy will continue to be accommodative. Our current projections and assumptions indicate that further policy easing will be required to ensure that future inflation settles near the middle of the target range. We will continue to watch closely the emerging economic data.

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