Overtaken by events
December 2014 MPS Review: OCR on hold at 3.50%

- As expected, the Reserve Bank today left the Official Cash Rate (OCR) on hold and pushed out the expected timing of future interest rate hikes.
- The RBNZ has become more optimistic about the economy’s capacity to grow without inflation, and has substantially upgraded its GDP forecasts over coming years.
- We feel that the RBNZ’s forecasts are already being overtaken by events. Lower oil prices and a strong currency could see inflation fall below 1% again over the next year, while the housing market is heating up again.
- In these circumstances, we see interest rate hikes being delayed until 2016, but with macroprudential policy perhaps coming into play again next year.

In terms of the bottom line for interest rates, the message from today’s Monetary Policy Statement was very much what we expected. With the economy expected to keep growing at an above-trend pace for the next couple of years, inflation pressures will eventually re-emerge and higher interest rates will be needed. However, inflation remains low for now, and has continued to surprise on the downside, for reasons that are still being investigated. As a result, those interest rate hikes are likely to be later and less extensive than the Reserve Bank previously thought.

The foreign exchange market seemed to be surprised by this message, sending the New Zealand dollar more than a cent higher this morning. In particular there was some surprise at the reintroduction of the statement that “some further increase in the OCR is expected to be required”. This phrase was removed from the October OCR review statement, leading some in the market to conclude that the RBNZ had dropped its tightening bias. We argued at the time that the tightening bias was still intact if you read between the lines of the statement; today’s MPS makes it explicit again.

While the RBNZ’s published projections themselves don’t raise any concerns for us, we feel that they are already being overtaken by events. In the last few weeks there have been some major developments in terms of oil prices, the exchange rate and the housing market. The first two are clearly downside risks to the RBNZ’s inflation forecasts. In contrast, the risks to house prices are to the upside, although the implications for inflation are not so clear-cut.

As we detailed in yesterday’s bulletin, we now expect annual inflation to fall below the bottom of the RBNZ’s 1-3% target band over the next year, before picking up strongly in later years. We suspect that the RBNZ will want some clear evidence that inflation is returning to within the target band – and staying there – before raising interest rates again, and on our forecasts that evidence won’t be forthcoming until early 2016.

That said, the RBNZ may well spend the next year warning of interest rate hikes – and certainly downplaying the chances of rate cuts – in order to avoid pumping up an already-buoyant housing market. In that sort of environment, macro-prudential tools are likely to form part of the policy debate again.

Forecast details
As we expected, the RBNZ lowered its 90-day interest rate projections by around 30 basis points compared to the September MPS. The new projection effectively implies that only another three OCR hikes will be needed over the next three years, with the December 2015 quarter as the most plausible timing of the next OCR hike.
The RBNZ has continued to be surprised by the economy’s capacity to grow without generating much inflation. Significantly, the RBNZ’s research now suggests that the downside surprises on inflation have been on the non-tradables side, which is more amenable to monetary policy settings (in contrast, tradables inflation has behaved as would be expected, given the usual drivers such as the exchange rate). Consequently, the RBNZ has substantially upgraded its estimates of both potential and actual growth over the next few years – it now expects GDP growth to be running above 3% through to early 2017, a view that we more or less share.

The RBNZ lowered its near-term inflation forecasts to incorporate the softer than expected September quarter outturn. Annual inflation is now expected to reach just 1.3% by June next year, compared to the previous forecast of 1.7%. However, beyond this point there was very little change to the RBNZ’s inflation forecast – the non-tradables inflation forecast was reduced, reflecting the economy’s higher growth potential, but the tradables inflation forecast was increase on the assumption that the exchange rate will continue to fall.

Inflation forecasts, RBNZ versus Westpac

On that note, the RBNZ repeated its now-standard statement that it sees the level of the exchange rate as “unjustified” and “unsustainable”, and that it expects a further significant depreciation.

Risk factors

The RBNZ noted a number of risks to its inflation projections. As it discussed in detail in the September MPS, there are lingering questions about the strength of the linkages between housing, migration, the exchange rate, expectations and inflation. In addition, it cited some specific risks that could affect the outlook: the effects of lower dairy prices on domestic spending, the strength of the housing market, and the impact of lower oil prices.

We feel that some of the RBNZ’s projections already starting to look dated since they were finalised in late November. Firstly, world oil prices have fallen even further than anticipated. The RBNZ’s projections assume that Dubai oil prices will hold at around $80-85 per barrel over the next few years, but the actual price has since dropped well below $70. As we detailed in our bulletin yesterday, this alone makes it likely that inflation will fall below 1% over the next year.

The effect of plunging world oil prices would be compounded if the currency remained stubbornly high. We’re not so convinced that the US dollar is destined to head higher once the Federal Reserve starts to raise interest rates – it’s just as plausible that a stronger US economy will be seen as a positive driver for the rest of the world, which would see funds flow from the US into higher-yielding destinations such as emerging markets and commodities. Moreover, the New Zealand dollar will struggle to weaken on a trade-weighted basis when some of our major trading partners – Europe, Japan and Australia – are either loosening monetary policy or are about to do so.

As for the housing market, figures released by REINZ just yesterday show a dramatic resurgence in the housing market over the last two months, and while the RBNZ took a cautious stance in its comments today, there was a clear sense that housing has quickly become a front-of-brain issue again for the RBNZ. We think that rising population and lower mortgage rates will see house price inflation exceed the RBNZ’s forecasts.

That said, house price growth to date has probably had less impact on inflation than expected, and if that situation persists, it’s not obvious that the RBNZ would need to respond with earlier interest rate hikes. Instead, it’s more likely that the RBNZ would address house prices directly using macroprudential tools, as it did in 2013 when the housing market was booming but inflation was below target.

We note that RBNZ Governor Wheeler said today that they are not contemplating further macroprudential tools at the moment, but we suspect that their thinking will evolve over time. Bear in mind that as late as December 2012 the Governor told Parliament that “as we see the housing market at present on a national basis, and given the credit growth figures that I talked about, we wouldn’t see the need to use LVR ratios at this point in time”. Eight months later the RBNZ introduced a cap on high-LVR lending.

Dominick Stephens
Chief Economist

Michael Gordon
Senior Economist
The Reserve Bank today left the Official Cash Rate unchanged at 3.5 percent.

The global economy continues to grow at a moderate pace, though recent data suggest a softening in major economies other than the United States. Inflation remains below target in most of the advanced economies due to spare capacity and declining commodity prices. Monetary policy is expected to remain very supportive for some time.

New Zealand’s economic growth is running at an annual rate of around 3½ percent. While dairy prices have declined sharply, domestic demand has retained momentum, supported by the ongoing growth in consumption and construction activity. Interest rates are low by historical standards and continue to support domestic demand. The exchange rate does not reflect the decline in export prices this year and remains unjustifiably and unsustainably high. We expect to see a further significant depreciation.

CPI inflation remains modest, at 1 percent in the year to September. Weak global inflation, falls in international oil prices and the high exchange rate are the main influences. Inflation in the non-tradeables sector remains subdued with capacity pressures having less impact than usual.

Growth is expected to remain at or above trend through 2016, with unemployment continuing to decline. Modest inflation pressures suggest the expansion can be sustained for longer than previously expected with a more gradual increase in interest rates. Underpinning this, the economy’s productive capacity is being boosted by high labour force participation, strong net immigration and continued investment growth.

Risks to the growth outlook include dairy prices, which are expected to recover in 2015, the overvalued exchange rate, and the strength of construction activity. Inflation risks include the impact of rising capacity pressures on domestic inflation, the response of house prices to the strong migration inflows, and the impact of lower oil prices.

With output projected to grow at or above capacity, CPI inflation is expected to approach the 2 percent midpoint of the Reserve Bank’s target range in the latter part of the forecast period. Some further increase in the OCR is expected to be required at a later stage. Further policy adjustments will depend on data emerging over the assessment period.
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