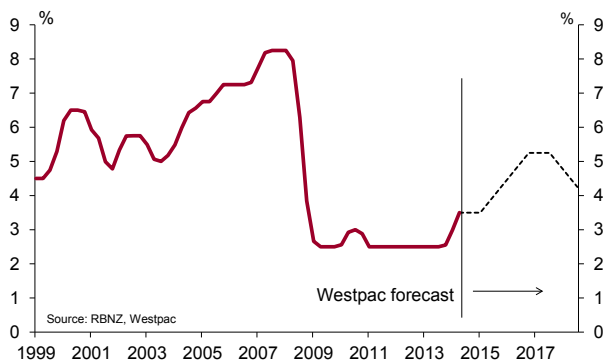


# Stand down

## RBNZ OCR preview, October 2014

- In September, the RBNZ said it would wait and watch inflation.
- Inflation has fallen to 1.0%, and looks likely to remain below 1.5% for another six months.
- We conclude that the RBNZ will not hike the OCR until September 2015 (previously June).
- Next week's RBNZ OCR Review will express a similar sentiment – the OCR is not likely to change any time soon.

### Westpac OCR forecast



### Westpac OCR forecasts

2014	Dec	3.50%
2015	Mar	3.50%
	Jun	3.50%
	Sep	3.75%
	Dec	4.00%
2016	Mar	4.25%
	Jun	4.50%
	Sep	4.75%
	Dec	5.00%

Between March and July 2014 the RBNZ increased the Official Cash Rate from 2.5% to 3.5% because it feared that strong economic growth could eventually provoke unacceptably high inflation. But over the course of this year inflation has been surprisingly tame. By the time of the September *Monetary Policy Statement* the RBNZ had changed its tune. In that document the RBNZ expressed uncertainty about just how much inflation the strong economy would generate, and announced that the OCR would be kept on hold at 3.5% for a period of “monitoring and assessment” of inflation.

In effect, the RBNZ ruled out hiking the OCR until it sees the “whites of the eyes” of inflation itself, rather than lifting the OCR in anticipation of possible future inflation.

When we cross-referenced the RBNZ’s revised stance against our own forecasts, which indicated that inflation would remain low until mid-2015, we immediately reached the conclusion that the RBNZ would leave the OCR at 3.5% for quite some time.

Since the September *MPS* was published, developments on the inflation front have been even weaker than we expected. Annual inflation dropped to just 1.0% in September 2014 (weaker even than our bottom-of-market forecast, and substantially below the RBNZ’s forecast of 1.3%). Global commodity prices have plunged recently, raising the possibility of lower food and petrol prices in the months ahead. The Quarterly Survey of Business Opinion for September showed little evidence that businesses were experiencing undue cost increases. And the ANZ Business Outlook survey registered a decline in inflation expectations. Our latest forecasts have inflation remaining at 1.0% in December 2014, and 1.3% in March 2015.

With this type of inflation outlook in the offing, it seems unlikely that the RBNZ will entertain the idea of hiking the OCR any time soon. We now expect that the OCR will remain unchanged at 3.5% until September next year, before another tranche of hikes take place (we were previously forecasting a June 2015 hike).

Next week's RBNZ OCR Review will surely reflect a similar sentiment: the RBNZ is watching inflation closely, and is currently low. Back in September the RBNZ's policy guidance phrases were:

*"...it is prudent to undertake a period of monitoring and assessment before considering further policy adjustment. Nevertheless, we expect some further policy tightening will be necessary..."*

Recent developments have probably been compelling enough for the RBNZ to alter that guidance to something along the lines of:

*"The current period of monitoring and assessment is likely to continue for some time. While we expect some further policy tightening will be necessary, the timing and extent will depend on how inflation responds to economic and financial developments."*

Phraseology along these lines would rule out hikes in the near term, while retaining a suitably unspecific notion that the next change in the OCR is more likely to be up than down.

The RBNZ's press release will no-doubt discuss the very low level of inflation currently, and will acknowledge that inflation could stay low for some time yet. But the RBNZ will also have to explain why it is not *reducing* the OCR in light of below-target inflation. This will be achieved by explaining that inflation is forecast to gradually increase towards the 2% target in response to the robust state of New Zealand's economy, booming net immigration, and booming construction activity.

The press release will probably also discuss emerging worries about slower global economic growth, and will note that global prices for New Zealand export commodities are falling. The RBNZ will probably acknowledge that the exchange rate has fallen in response to lower export prices. But it will contend that the depreciation has not been sufficient, and that the exchange rate remains "unjustified and unsustainable" – code for possible exchange rate intervention.

We will be interested to see how the Reserve Bank handles the fact that fixed mortgage rates have declined sharply in recent weeks. We rather suspect that the RBNZ will be quietly pleased by this proxy monetary easing, and may let it slide without a mention in this OCR Review.

## Market reaction

Whatever the nuances of next week's OCR Review, it is unlikely that interest rate markets will shift much. Market pricing has already shifted to price no OCR hike from the RBNZ for the coming year, and the RBNZ is highly unlikely to dispel that notion.

The New Zealand dollar might experience a small knee-jerk drop if the RBNZ uses its intervention code words "unjustified and unsustainable", or engages in other forms of rhetorical warfare against the high New Zealand dollar.

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