

Kicking the can down the road

RBNZ OCR Review, October 2015

- The RBNZ left the OCR on hold, but signalled that it expects to reduce the OCR again.
- Today’s Review left the December OCR decision open.
- The easing bias was watered down by the RBNZ saying “It is appropriate at present to watch and wait.”
- But the RBNZ warned that if the exchange rate stays high, interest rates will be lower than otherwise.
- We expect that the recent rise in the exchange rate will indeed be sustained until December.
- Therefore, we conclude that a December OCR cut is more likely than not.

There were no major surprises in today’s RBNZ OCR Review – the OCR remained on hold at 2.75%, the RBNZ reiterated that “*some further reduction in the OCR seems likely*”, and the easing bias was more tentative than the previous communique in September – all very much as anticipated. However, the Review did contain intriguing turns of phrase that added nuance to the outlook and created a little more uncertainty about the December OCR decision.

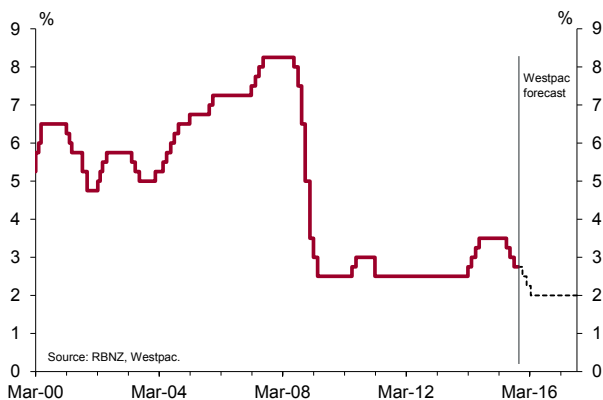
The overall effect was to kick the can down the road. The RBNZ may expect to reduce the OCR, but it is committed to nothing. The language in today’s Review leaves the RBNZ open to either cutting the OCR or leaving it on hold at the December *Monetary Policy Statement*.

Our view remains that a December cut is the more likely decision - mainly because we expect the exchange rate will be uncomfortably high when the RBNZ comes to make the call.

The key policy guidance sentence of the Review was almost a word-for-word repeat of previous policy guidance – “*some further reduction in the OCR seems likely*” depending on the data. But that was followed by a new phrase: “*It is appropriate at present to watch and wait.*” It is not clear exactly what that meant – it could simply be a justification for today’s on-hold decision. More likely, it was meant as a subtle indication that the RBNZ is currently in pause mode, and is committed to no particular timing of OCR reductions.

Commentary on the economy was a little more upbeat than the September MPS – especially “*Continued economic expansion is expected to result in some pick-up in non-tradables inflation*”. However, the laundry-list of reasons to be cautious about cutting the OCR that appeared in a recent speech was absent from today’s Review.

Westpac OCR forecast



Instead, the detail of Review read like a list of the factors the RBNZ would be watching between now and December:

- Uncertainty about interest rates in the United States was mentioned.
- The RBNZ said it was too early to tell whether the recent rise in dairy prices would be sustained – if it is, presumably the OCR is less likely to be cut.
- High Auckland house prices were mentioned.
- The RBNZ explicitly linked the exchange rate and interest rate decisions, saying that if the exchange rate sustained its recent rise “*a lower interest rate path than otherwise*” would be required.

The last of these particularly caught our eye. The lower exchange rate was the cornerstone of the RBNZ’s argument that inflation would quickly rebound to two percent – clearly, that view has been eroded. Furthermore, this comment was genuinely new. There was no significant mention of the exchange rate in the Governor’s speech on monetary policy a couple of weeks ago.

Our views on developments between now and December are that dairy prices will stay high and so will the exchange rate. We expect the Auckland housing market to have showed signs of slowing, while markets in other parts of NZ continue to pick up. And we expect the Federal Reserve to hike rates in December, although that decision will be made a week after the RBNZ’s December decision.

If we are right about the way conditions are going to develop, the RBNZ would most likely cut the OCR in December, because of the high exchange rate.

But there is much water to flow under the bridge between now and December. So we must repeat our caution from last week – a December cut is no done deal. The RBNZ is probably undecided at present, and the final decision will depend on the data.

Financial markets reacted by sending swap rates four basis points higher, moving to price only a 40% chance of a cut in December, and sending the exchange rate higher by about a third of a cent against the USD. To some extent, interest rates and the exchange rate had to rise simply because the RBNZ didn’t cut on the day (markets had factored in some residual risk of a cut). But we think the market reaction was a bit overblown – we would put the odds of a December cut at above 50%.

Full RBNZ statement:

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.75 percent.

Global economic growth is below average and global inflation is low despite highly stimulatory monetary policy. Financial market volatility has eased in recent weeks, but concerns remain about the prospects for slower growth in China and East Asia especially. Financial markets are also uncertain about the timing and effects of monetary policy tightening in the United States and possible easings elsewhere.

The sharp fall in dairy prices since early 2014 continues to weigh on domestic farm incomes. However, growth in the services sector and construction remains robust, driven by net immigration, tourism, and low interest rates. Global dairy prices have risen in recent weeks, contributing to improved household and business sentiment. However, it is too early to say whether these recent improvements will be sustained.

House price inflation in Auckland remains strong, posing a financial stability risk. While residential building is accelerating, it will take some time to correct the supply shortfall. The Government has introduced new tax requirements and the Reserve Bank’s new LVR restrictions on investor lending come into effect on 1 November.

CPI inflation remains below the 1 to 3 percent target range, largely reflecting a combination of earlier strength in the New Zealand dollar and the 60 percent fall in world oil prices since mid-2014.

Annual CPI inflation is expected to return well within the target range by early 2016, as the effects of earlier petrol price falls drop out of the CPI calculation and in response to the fall in the exchange rate since April. However, the exchange rate has been moving higher since September, which could, if sustained, dampen tradables sector activity and medium-term inflation. This would require a lower interest rate path than would otherwise be the case.

Continued economic expansion is expected to result in some pick-up in non-tradables inflation, despite the moderating effects of strong labour supply growth.

To ensure that future average CPI inflation settles near the middle of the target range, some further reduction in the OCR seems likely. This will continue to depend on the emerging flow of economic data. It is appropriate at present to watch and wait.

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

Disclaimer

Things you should know: Each time someone visits our site, data is captured so that we can accurately evaluate the quality of our content and make improvements for you. We may at times use technology to capture data about you to help us to better understand you and your needs, including potentially for the purposes of assessing your individual reading habits and interests to allow us to provide suggestions regarding other reading material which may be suitable for you.

If you are located in Australia, this material and access to this website is provided to you solely for your own use and in your own capacity as a wholesale client of Westpac Institutional Bank being a division of Westpac Banking Corporation ABN 33 007 457 141 AFSL 233714 ('Westpac'). If you are located outside of Australia, this material and access to this website is provided to you as outlined below.

This material and this website contain general commentary only and does not constitute investment advice. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. This material and this website may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material and this website does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. The forecasts given in this material and this website are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Transactions involving carbon give rise to substantial risk (including regulatory risk) and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. Statements setting out a concise description of the characteristics of carbon units, Australian carbon credit units and eligible international emissions units (respectively) are available at www.cleanenergyregulator.gov.au as mentioned in section 202 of the Clean Energy Act 2011, section 162 of the Carbon Credits (Carbon Farming Initiative) Act 2011 and section 61 of the Australian National Registry of Emissions Units Act 2011. You should consider each such statement in deciding whether to acquire, or to continue to hold, any carbon unit, Australian carbon credit unit or eligible international emissions unit.

Additional information if you are located outside of Australia

New Zealand: The current disclosure statement for the New Zealand division of Westpac Banking Corporation ABN 33 007 457 141 or Westpac New Zealand Limited can be obtained at the internet address www.westpac.co.nz. Westpac Institutional Bank products and services are provided by either Westpac Banking Corporation ABN 33 007 457 141 incorporated in Australia (New Zealand division) or Westpac New Zealand Limited. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement at www.westpac.co.nz.

China, Hong Kong, Singapore and India: Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activity.

Disclaimer continued overleaf.

Disclaimer continued

Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking Regulatory Commission (CBRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

U.K.: Westpac Banking Corporation is registered in England as a branch (branch number BR000106), and is authorised and regulated by the Australian Prudential Regulatory Authority in Australia. WBC is authorised in the United Kingdom by the Prudential Regulation Authority. WBC is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority in the United Kingdom. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. This material and this website and any information contained therein is directed at a) persons who have professional experience in matters relating to investments falling within Article 19(1) of the Financial Services Act 2000 (Financial Promotion) Order 2005 or (b) high net worth entities, and other persons to whom it may otherwise be lawfully communicated, falling within Article 49(1) of the Order (all such persons together being referred to as “relevant persons”). The investments to which this material and this website relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this material and this website or any of its contents. In the same way, the information contained in this material and this website is intended for “eligible counterparties” and “professional clients” as defined by the rules of the Financial Services Authority and is not intended for “retail clients”. With this in mind, Westpac expressly prohibits you from passing on the information in this material and this website to any third party. In particular this material and this website, website content and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction.

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission (“CFTC”) as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC (“WCM”), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 (‘the Exchange Act’) and member of the Financial Industry Regulatory Authority (‘FINRA’). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not be subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.

For the purposes of Regulation AC only: Each analyst whose name appears in this report certifies that (1) the views expressed in this report accurately reflect the personal views of the analyst about any and all of the subject companies and their securities and (2) no part of the compensation of the analyst was, is, or will be, directly or indirectly related to the specific views or recommendations in this report.