Westpac

Institutional Bank

10 December 2014

Oil is still king

Cheaper oil will have a profound effect on New Zealand

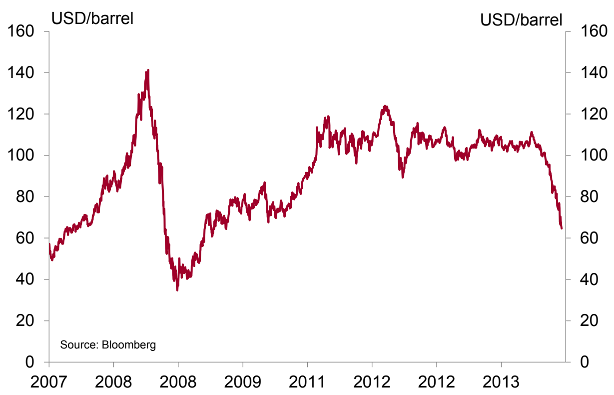
- Global crude oil prices have plunged to a five-year low. The impact on inflation, financial markets, and the economy will be profound.
- We now expect inflation to drop below one percent, and to remain there until December 2015.
- We now expect no change in the OCR until 2016.
- Lower fixed mortgage rates will "spike the punch" at the housing market party. We now expect 7% house price inflation in 2015.
- The Reserve Bank is more likely to tighten macroprudential policy than loosen it over the year ahead.
- We have upgraded our GDP forecast for 2015, to 3.4%.
- The New Zealand dollar may fall further against the US dollar, but will remain strong against other currencies including the Australian dollar.

Global oil prices have plunged to a five-year low. This may prove to be a large but temporary dip in global oil prices – next year we would expect a supply response to kick in, while at the same time accelerating global economic growth will shore up demand for oil. Nevertheless, the sheer scale of the drop in oil prices will have a profound effect on inflation and the economy.

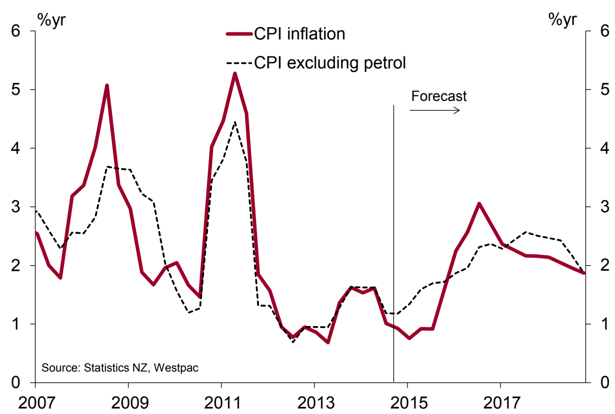
Lower global oil prices will reduce New Zealand inflation directly via petrol prices, and indirectly by reducing costs for many businesses (think couriers and taxis). It now looks likely that inflation will drop below one percent in the December quarter of 2014, and will remain below one percent for a whole year. Before the dramatic plunge in oil prices, we were forecasting 1.8% inflation for September 2015. We are now forecasting just 0.9% inflation.

If our call for a v-shaped recovery in oil prices is correct, then New Zealand inflation will rise sharply from December 2015 onwards. Hence we are forecasting a temporary spike in inflation during 2016.

Dubai oil price

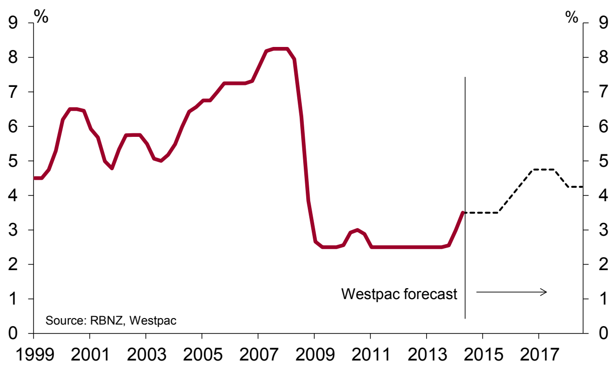


Westpac inflation forecast



So long as inflation is below one percent, it is highly unlikely that the Reserve Bank will hike the OCR. We now expect the OCR to remain on hold at 3.5% for the whole of 2015. (Before the plunge in oil prices, we anticipated a September OCR hike.) We are forecasting four OCR hikes over 2016, and one in 2017, taking the OCR to a stunted peak of just 4.75%.

Westpac OCR forecast



Despite low inflation, the odds of the Reserve Bank cutting the OCR in 2015 are low. A dip in inflation associated with falling global oil prices is a classic "look through" event. The RBNZ is required to focus on the medium-term outlook for inflation, rather than adjusting the OCR in response to every bump and dip in inflation. New Zealand is experiencing strong economic growth and a resurgent housing market which could lead to rising inflation over the longer term. The RBNZ would be unwise to reduce the OCR in such an economic environment.

But financial markets may take a different view. The spectacle of inflation dropping below the bottom of the Reserve Bank's target range, and staying there for a year, could cause markets to price in at least some risk of OCR cuts. Two-year swap rates could fall to 3.7% or below. If they do, fixed mortgage rates will fall in sympathy.

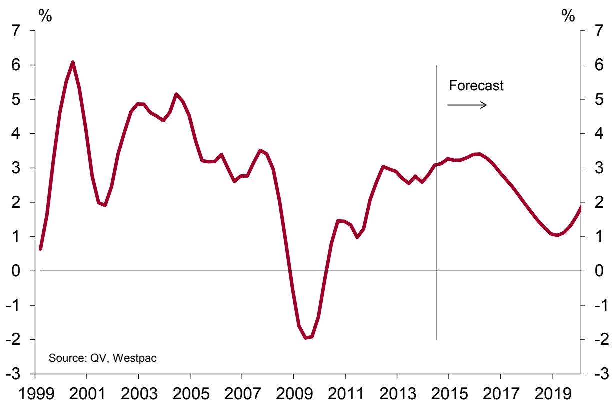
For the housing market, a further reduction in fixed mortgage rates will be like spiking the punch at a neighbourhood barbeque. The current friendly hubbub will quickly morph into something more raucous. The latest data already suggests that housing market activity has picked up substantially since September's election. The combination of booming population growth, improved consumer confidence, and low fixed mortgage rates is sure to stimulate the market further. We suspect that house price inflation is going to accelerate in the months ahead, and we are now forecasting 7% house price inflation for 2015 (previously 3.5%).

With the OCR pinned down at 3.5%, the RBNZ will be left with only one option for dealing with financial stability concerns associated with rising house prices – macroprudential policy.

The prospect of the RBNZ removing or reducing its restrictions on high loan-to-value ratio mortgage lending is now very distant indeed. Over the next year, some form of tightening in macroprudential policy is more likely.

Rising house prices, cheaper petrol and low interest rates will obviously boost consumer spending and GDP growth. We have upgraded our GDP growth forecast for 2015 to 3.4% (previously 3.2%). That said, we continue to expect something of a "two-speed economy" next year. Some rural regions will struggle under the pressure of a low dairy payout, while urban areas benefit from strong consumer demand.

Westpac GDP forecast



If financial markets do start talking about the possibility of OCR cuts, the New Zealand dollar would fall against the US dollar. We now expect the NZD/USD exchange rate to reach a trough of 74 cents on average over the June quarter of 2015.

However, we anticipate little change in the New Zealand dollar on a trade-weighted basis.

In Australia, the interest rate outlook has changed by even more than in New Zealand. Recent national accounts data was weak, and Australia is experiencing a sharper decline in global prices for its key commodity exports than New Zealand. We now expect the Reserve Bank of Australia to reduce the Australian cash rate by 25 basis points in each of February and March next year. Consequently, we expect the New Zealand dollar will *strengthen* slightly against the Australian dollar in early 2015.

Similarly, the New Zealand dollar has been strengthening against the Japanese yen, and may strengthen further in early 2015.

As we have argued elsewhere, big trade-weighted declines in the New Zealand dollar tend to occur during recessions or periods of rapid decline in the terms of trade – neither of which is anticipated for 2015.

A word on the Reserve Bank's *Monetary Policy Statement* tomorrow

The bulk of the recent plunge in oil prices will have happened too late to be fully incorporated in the forecasts the Reserve Bank will issue tomorrow. However, the Reserve Bank will be aware of the revised inflation outlook. The fact that inflation could fall below one percent may make it into Chapter One of the *Monetary Policy Statement* (which also forms the press release and is drafted later than other chapters), and will certainly be a topic of discussion at the press conference.

The Reserve Bank will probably note that falling oil prices will stimulate economic growth, and will reduce inflation only temporarily. We suspect that the Reserve Bank will strongly reiterate that it is currently in a period of "monitoring and assessment" of inflation, and that the OCR is unlikely to change for some time.

Dominick Stephens
Chief Economist

Westpac forecasts

	2014q3	2014q4	2015q1	2015q2	2015q3	2015q4	2016q1	2016q2	2016q3	2016q4
GDP (ann ave % change)	3.1	3.3	3.2	3.2	3.3	3.4	3.4	3.3	3.1	2.9
Inflation (% annual)	1.0	0.9	0.8	0.9	0.9	1.6	2.2	2.6	3.1	2.7
Unemployment rate (% s.a. end of period)	5.4	5.4	5.1	5.0	4.7	4.6	4.5	4.3	4.3	4.3
House prices (% annual)	5.2	5.5	6.7	6.8	7.1	7.0	6.0	4.5	2.9	1.5
90 day bank bill (end of period)	3.69	3.70	3.70	3.70	3.70	3.75	4.00	4.25	4.50	4.70
2 year swap (end of period)	4.09	3.90	3.70	3.70	3.90	4.20	4.50	4.70	4.70	4.70
TWI (end of period)	79.5	77.7	77.5	76.7	78.7	79.7	81.0	80.2	78.9	77.5
NZD/USD (end of period)	0.84	0.77	0.76	0.74	0.77	0.79	0.81	0.81	0.80	0.79
NZD/AUD (end of period)	0.91	0.93	0.93	0.93	0.93	0.93	0.93	0.91	0.89	0.87
NZD/EUR (end of period)	0.64	0.63	0.63	0.62	0.64	0.64	0.65	0.64	0.63	0.62
NZD/JPY (end of period)	87.6	91.6	92.0	91.4	96.3	98.8	101.3	102.1	101.6	101.1

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