Westpac

Institutional Bank

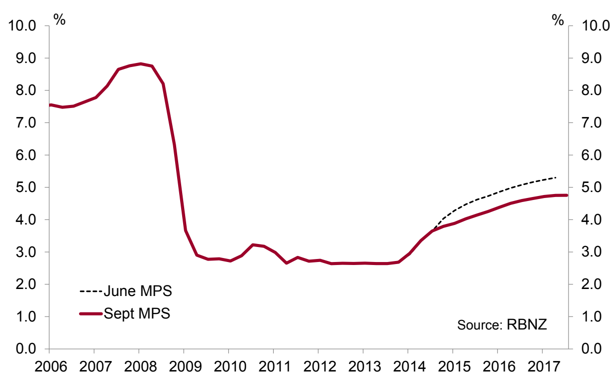
11 September 2014

A change of mood

September 2014 MPS Review: OCR on hold at 3.50%

- The Reserve Bank left the Official Cash Rate (OCR) on hold as expected, but substantially lowered its projections for the OCR over coming years.
- The RBNZ has not been rattled by the economic environment; it still anticipates continued strong growth.
- Rather, the RBNZ has altered its judgement around how economic growth affects inflation, in light of recent weak inflation outturns.
- We now expect the next OCR hike to be delayed until June next year.

RBNZ forecasts, Jun vs Sep: 90 day interest rates



In today's *Monetary Policy Statement* the RBNZ left the Official Cash Rate unchanged as expected, but markedly changed the outlook for interest rate hikes. The bottom line remains that rates will need to rise from here in order to keep inflation near the 2% target over the medium term. But the RBNZ now expect those rate hikes to occur much later, and to be more gradual, than it signalled three months ago.

We were surprised at the extent to which the RBNZ lowered its interest rate projections, given that the recent economic news could only be described as 'mixed' compared to what the RBNZ had forecast in the June *MPS*. And while financial markets were already braced for a downgrade to the outlook, the RBNZ's latest interest rate projections were pitched even lower than what the market was pricing in. Swap rates have fallen 5 basis points so far today, while the New Zealand dollar has fell 0.4 cents in the immediate aftermath.

Significantly, it wasn't the economic environment that motivated the RBNZ's change of heart. Export prices and house price inflation have fallen, but only slightly more than the RBNZ assumed in June. Domestic activity has carried on much as expected. And net immigration, which the RBNZ made quite a song a dance about in June, has been much stronger than the RBNZ previously forecast. The RBNZ has actually revised up its GDP forecasts for the next year or so.

Rather, the big change has come from within. The run of low – and lower than expected – inflation outturns over the last couple of years has prompted the RBNZ to reassess some crucial economic relationships: between migration and house prices, between housing and the wider economy, and between growth and inflation.

This distinction is crucial for understanding where interest rates go from here. Forecasts will always ebb and flow as new information arrives. But when the RBNZ makes a judgement about the relationships inherent in the economy, it tends to stick with that judgement for some time. Unless the RBNZ now gets hit by a string of stronger than expected inflation figures – which is not our forecast – the message will remain one of low interest rates for longer.

Consequently, we now expect the RBNZ to wait until next June to resume interest rate hikes, with a follow-up hike in July and one more hike later in the year. Previously we expected the next OCR hike to come in January, with four hikes in total over 2015.

The statement blow-by-blow

The media release accompanying the *MPS* was quite clear about what message the RBNZ wants the public to take away. The "period of assessment before interest rates adjust further" in the July OCR review has become "a period of monitoring and assessment before considering further policy adjustment". In other words, the burden of proof for further rate hikes is now greater, and will take longer to accumulate.

Meanwhile, the RBNZ delivered an even stronger broadside against the high New Zealand dollar than in July. It repeated that the level of the currency is "unjustified" and "unsustainable" – two words associated with the RBNZ's criteria for intervention – and noted that it expects a "further" significant deprecation, indicating that the RBNZ has not been satisfied with the fall in the dollar to date. The strident language of the media release stands in contrast to the analysis in the *MPS* itself, which barely dwelt on the currency. In fact, the RBNZ has actually lowered its exchange rate projections and consequently lifted its forecast of tradable goods inflation since June.

For the most part, the RBNZ's economic forecasts were not dramatically different from the June *MPS*, and largely reflected the flow of news since then. The ongoing fall in world dairy prices has meant that the terms of trade is expect to bottom out at a level 4% lower than before, but with a stronger recovery over 2015 that sees it return to more or less the same level in the longer term.

Similarly, the RBNZ has adjusted down its forecast for 2014 house price inflation (from 5.5% to 4.8%). But it still expects a substantial bounce in house prices over the second half of this year, as the sharp upturn in met migration adds to housing demand. On that subject, net migration flows have continued to surprise on the upside in recent months, and the RBNZ has again revised up its forecast to around 43,000 working-age people this year (previously 37,000).

The most telling aspect of the RBNZ's forecasts is that its outlook for GDP growth is actually stronger over 2015 than the June forecast. We suspect that financial markets were expecting a lower interest rate track in today's statement based on a gloomier assessment of the economy. But clearly that wasn't the motivation for the RBNZ's change in tack.

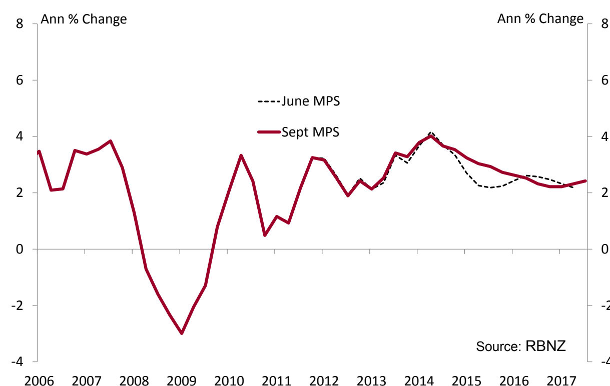
Instead, the RBNZ has taken a second look at some of the key links in its economic forecasts, in light of the subdued inflation outcomes to date. The economy is growing strongly, and the RBNZ remains of the view that GDP is now running more than 1% above its non-inflationary potential level. An output gap of that size would imply a noticeable degree of inflation pressure, particularly in non-tradable goods and services. Yet non-tradables inflation has been persistently lower than expected.

As a result, the RBNZ has substantially lowered its forecasts for non-tradables inflation, despite making little change to its assessment of the output gap.

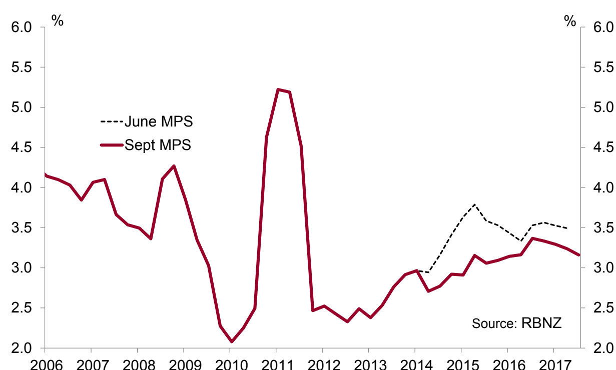
Another example is in the housing market. Having strenuously argued the case for a strong link between net immigration and house price inflation earlier this year, the RBNZ is now taking the view that "net immigration is having a more muted and more lagged effect on house prices than in past cycles". Our own analysis agrees with this to some extent: we have long argued that the mid-2000s housing boom was mainly about low interest rates, tax changes, and rising inflation, rather than an imbalance between physical supply and demand. Consequently, we have long argued that booming net migration will have only a relatively small effect on house prices this year. Nevertheless, we were very surprised to see the Reserve Bank alter its judgement so soon.

These kinds of changes in judgement are always difficult to anticipate. But now that the RBNZ has adopted them, they are likely to stay in place for some time. Consequently, we don't think the RBNZ will decide to hike the OCR until June next year.

RBNZ forecasts, Jun vs Sep: GDP growth



RBNZ forecasts, Jun vs Sep: Non-tradables inflation



RBNZ media release

The Reserve Bank today left the Official Cash Rate unchanged at 3.5 percent.

New Zealand's economy is expected to grow at an annual pace of 3.7 percent over 2014. Global financial conditions remain very accommodative and are reflected in low interest rates, narrow risk spreads, and low volatility across a range of asset markets. Accommodative financial conditions are supporting a moderate rate of global growth, albeit uneven across regions.

New Zealand's economic growth continues to be supported by increasing construction activity and ongoing strength in consumption and business investment. A high level of net immigration is adding to domestic demand as well as productive capacity. Economic growth is projected to moderate in response to recent commodity price declines and the impact of policy tightening. The high exchange rate continues to restrain growth in the traded sectors.

The exchange rate has yet to adjust materially to the lower commodity prices. Its current level remains unjustified and unsustainable. We expect a further significant depreciation, which should be reinforced as monetary policy in the US begins to normalise.

The economy appears to be adjusting to the policy measures taken by the Bank over the past year. House price inflation continues to ease, despite strong net immigration. CPI inflation remains moderate, reflecting subdued wage increases, well-anchored inflation expectations, weak global inflation, and the high New Zealand dollar. However, spare capacity is being absorbed, and annual non-tradables inflation is expected to increase. Risks also remain around how strongly net immigration will affect housing demand, and the extent to which pressures in the construction sector will impact broader inflation.

In light of these uncertainties, and in order to better assess the moderating effects of the recent policy tightening and export price reductions, 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 to keep future average inflation near the 2 percent target mid-point and ensure that the economic expansion can be sustained.

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