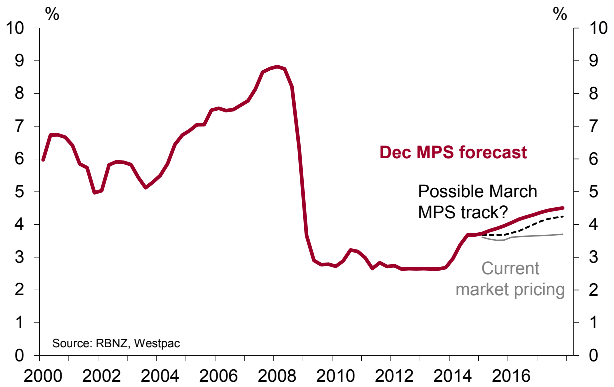
Keep it steady

March 2015 *Monetary Policy Statement* preview

- The RBNZ is expected to keep the OCR on hold next week, and the accompanying press statement is expected to echo the neutral tone of the January OCR review.
- The RBNZ's forecast for the 90-day interest rate is expected to be around 40 bps lower than in December. The forecast is expected to show the 90-day rate remaining flat at least through to early 2016, and then rising slowly further ahead.
- The March *Monetary Policy Statement* is expected to include an extended discussion on the current low level of inflation and how this is affecting the stance of monetary policy.
- On the exchange rate, the RBNZ will reiterate that the level of the NZD is unjustified and unsustainable.

90-day interest rates forecasts



In their first OCR review of 2015, the RBNZ made a marked change to their policy stance. Having previously stated that *"some further increase in the OCR is expected to be required"*, in January the RBNZ noted that they *"expect to keep the OCR on hold for some time"*. They went on to note that *"future interest rate adjustments, either up or down, will depend on the emerging flow of economic data."* January's one-page statement didn't provide much scope to elaborate on the change in stance. However, the RBNZ Governor's February speech outlined many of the considerations that would have been factored into the RBNZ's thinking. And with conditions little changed since then, we can take an educated guess as to the content of next week's *Monetary Policy Statement.*

We expect that the RBNZ will leave the OCR on hold at 3.5%. With a combination of low near-term inflation but a solid outlook for medium-term domestic demand, the neutral tone of the January announcement is likely to be retained. In addition, we expect that the policy paragraph of the press release will again note that the OCR is likely to remain on hold for some time, and that future interest rate adjustments will be dependent on how economic conditions evolve.

Consistent with the considerations noted above, the RBNZ's 90-day interest rate forecast is expected to remain flat at least through to early 2016. While the interest rate track is expected to show some increases in the latter part of the projection, these are likely to be more modest than was anticipated in the RBNZ's December forecasts. We expect the 90-day interest rate forecast to be around 40 bps lower than the RBNZ previously assumed.

Low near-term inflation a concern, but the RBNZ is focused on the medium term

A key focus of the *Monetary Policy Statement* will be how weak near-term inflation is affecting the outlook for monetary policy. Inflation is now expected to remain below RBNZ's 1 to 3% target band through 2015, which is a much weaker outlook than the RBNZ anticipated in December. This has prompted questions about whether the RBNZ will follow the example of many other central banks in recent months and ease policy.

Such concerns have been reinforced by challenging conditions in the external sector, including drought in some parts of the country and a still elevated NZD.

We expect that the *Monetary Policy Statement* will outline in very clear terms that current low inflation is a 'look through' event for monetary policy. In large part, weak near-term inflation is a result of earlier sharp declines in international oil prices. While these declines will dampen annual inflation through 2015, they don't imply a sustained reduction in inflation (in fact, oil prices have already bounced about 25% from their January lows). Consistent with this, Governor Wheeler's February speech signalled that low near-term inflation on its own isn't enough to warrant OCR cuts, especially given the robust outlook for domestic demand. Instead, such a change in stance would require some form of disruption to economic or financial conditions. It wouldn't be surprising to see the March *Monetary Policy Statement* expanding on the RBNZ's thinking on this, perhaps through some form of policy scenario.

The *Statement* is expected to highlight that, although headline inflation is currently low, indicators of domestic demand such as net immigration and business confidence have remained firm. This is helping to offset the impacts of drought on growth, and is likely to contribute to an increase in domestic inflation over the medium term, albeit at a gradual pace. OCR reductions at the current time would reinforce such medium-term inflation pressures, and would risk supercharging already strong conditions in the housing market.

Housing market conditions still a concern

Housing market conditions remain a particular focus for the RBNZ and are likely to receive attention in the *Monetary Policy Statement*. In February they noted that house price inflation was a key concern for financial stability and economic conditions more generally. Since that time, the housing market has remained firm and we've seen falls in mortgage interest rates.

Pressures in the housing market are expected to prompt some tightening in macro prudential policy over the course of this year, and the RBNZ may make some mention of possible changes in capital adequacy requirements at next week's press conference. However, major changes to the RBNZ's macro prudential regulations are not expected to be announced at the time of the March *Monetary Policy Statement*.

Exchange rate

The RBNZ is expected to reiterate its discomfort with the current level of the New Zealand dollar, noting once again that it is "unjustified and unsustainable". Since the RBNZ last used such language in January, the NZD has actually appreciated against a number of currencies. While the impact of these words on currency markets does tend to diminish with the frequency of their use, we are not yet at the point of zero impact and failing to use them again next week would send the wrong signal.

Financial market reaction

While we expect that the RBNZ's 90-day interest rate forecast will indicate some rate increases at longer horizons, at the time of writing financial markets were pricing in around 17 basis points of OCR cuts over 2015. Nevertheless, market reaction to the *Statement* is likely to muted if, as expected, the RBNZ lowers its interest rate forecasts compared to December and maintains a neutral stance.

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