Westpac

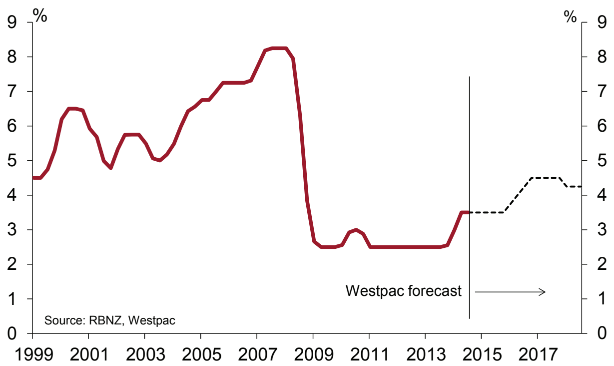
Institutional Bank

A new tack

RBNZ OCR preview, January 2015

- We now expect inflation to remain below 1% until late-2015, and the Reserve Bank to leave the OCR on hold until June 2016.
- The prospect of OCR hikes is now so distant that debating the exact timing is a red herring.
- Instead, the debate should turn to whether the RBNZ will cut the OCR this year. We regard cuts as unlikely, but not unthinkable.
- We expect the RBNZ to remove any mention of hiking the OCR at next week's OCR review.
- Equally, we expect the RBNZ to argue firmly against cutting the OCR.
- Above all, the RBNZ will seek to leave its options open.
- We predict a tightening of macroprudential policy later this year, as falling fixed mortgage rates stimulate the housing market.

Westpac OCR forecast



The dramatic plunge in the global price of oil has all and sundry rethinking the outlook for inflation, interest rates and the economy. Before detailing how the Reserve Bank of New Zealand may react, we should first detail how our own thinking has evolved.

In early December the falling price of oil prompted us to reduce our inflation forecast, cancel any forecast of OCR hikes in 2015, and to increase our house price and GDP forecasts. Yesterday we issued a further tweak to those forecasts. The main points were:

- It now looks as though annual inflation will fall to 0.1% in the March 2015 quarter, and will remain below 1% until December 2015.
- Yesterday's CPI data showed that the underlying trend in inflation remains subdued (rising construction costs are an isolated exception).
- The recent rise in the New Zealand dollar against the Euro and the Australian dollar will further suppress inflation over the year ahead.
- Such a benign inflation outlook has scotched any idea of the RBNZ hiking the OCR in the near term. We now expect no OCR hike until June 2016 (by which time we expect inflation to have risen back above 2%). We are now forecasting a peak OCR of just 4.5%.

The prospect of OCR hikes has become so distant that debating the exact timing is a bit of a red herring. The main point is that we don't expect the OCR to move for some time. The only remaining discussion of interest is whether or not the Reserve Bank will cut the OCR this year.

We don't think the RBNZ will cut rates, or even entertain the idea, under current conditions. After all, New Zealand is experiencing above-trend GDP growth, an unprecedented net migration boom, and a construction boom. Not to mention that the past three months of housing market data have been the strongest in a decade.

The odds of an OCR cut may be low, but they are not zero. There is a plausible set of circumstances under which the RBNZ could cut rates this year – perhaps involving some combination of financial turmoil offshore, falling commodity prices, local drought, or a global exchange rate war that causes the NZD to rise.

Westpac OCR and inflation forecasts

		CPI		OCR
		Qtr %	Yr %	
2014	Dec (Actual)	-0.2	0.8	3.50
2015	Mar	-0.3	0.1	3.50
	Jun	0.5	0.3	3.50
	Sep	0.5	0.5	3.50
	Dec	0.5	1.2	3.50
2016	Mar	0.7	2.3	3.50
	Jun	0.8	2.6	3.75
	Sep	0.8	2.9	4.00
	Dec	0.5	2.9	4.25
2017	Mar	0.6	2.7	4.50
	Jun	0.7	2.6	4.50
	Sep	0.8	2.6	4.50
	Dec	0.5	2.6	4.50

Financial markets have been moving to price in some risk of an OCR cut, but we think they are undercooking the odds. The Overnight Index Swaps market currently has four basis points of OCR cuts priced in – implying a 16% chance of a single OCR cut, or an 8% chance of two OCR cuts. We think that pricing is still too light. We would place roughly 20% odds on two OCR cuts occurring this year.

Next week's OCR Review – all options open

The RBNZ's thinking is likely to be evolving along similar lines to our own. The need to hike the OCR has receded for the time being. But equally, cutting the OCR at this juncture would be a mistake because it would fuel the housing market fire. The Reserve Bank will soon find that it is asserting the latter point in the face of fierce arguments to the contrary, especially since the Bank of Canada's surprise decision to reduce its cash rate.

Next week's OCR Review will need to communicate both the no-hike and the no-cut sentiments, all the while leaving the RBNZ's options open to deal with the inherent uncertainty of the current environment.

The idea that OCR hikes have become a more distant prospect will be easy to convey. The RBNZ can simply remove the phrase from the December MPS that *"Some further increase in the OCR is expected to be required at a later stage,"* in favour of "on-hold" language such as:

"For now it is appropriate to leave the OCR at its current level of 3.5%."

Such language would also help with conveying the "no cut" message, while remaining non-committal about the future and thus leaving the Reserve Bank's options open.

The most fruitful place for the RBNZ to set out its arguments against cutting the OCR would be in the discussion of inflation. The RBNZ could explain that although inflation is expected to drop to a very low level, this is a temporary phenomenon due to falling global oil prices, and as such is not the proper focus on monetary policy. Rather, monetary policy should focus on medium-term inflation. And with a booming housing market, strong construction activity, and rapid population growth, the RBNZ would be justified in repeating the phrase from December that:

"Inflation is expected to approach the 2 percent midpoint of the Reserve Bank's target range in the latter part of the forecast period".

The Reserve Bank will surely express its chagrin at the recent rise in the New Zealand dollar on a trade-weighted basis. Perhaps the Reserve Bank will go as far as to say that future moves in the OCR depend on the evolution of the exchange rate. Such a comment could be taken to mean that the Reserve Bank will hike only if other central banks are hiking and the New Zealand dollar is falling. Alternatively, it could be taken as a threat that an unexpected rise in the New Zealand dollar would remove the barrier to OCR cuts.

We certainly expect the Reserve Bank to repeat its much-used phrase that the exchange rate is *"unjustified and unsustainable"*, thereby hinting that currency intervention remains a possibility.

A word on macroprudential policy

While it won't get a mention at next week's OCR Review, it is worth reminding readers of our forecast that the Reserve Bank will tighten macroprudential policy later this year. As swap rates fall in the weeks ahead, fixed mortgage rates will continue to come down. And lower interest rates will surely provide further stimulus to the housing market, raising concerns about financial stability at the central bank. Late last year the Reserve Bank itself said it wasn't considering macroprudential tightening, but we think that tune will change once the Reserve Bank acknowledges that the housing market is indeed heating up.

Market reaction

Late last year financial markets developed an unhealthy obsession with the exact wording of the final paragraph in the Reserve Bank's press releases. The absence of the words *"increase in the OCR"* from the October press release produced a large market reaction, as did the presence of those words in the December press release. Both market reactions were excessive compared to the actual changes in the Reserve Bank's thinking at the time.

In any case, if the Reserve Bank once again removes any explicit reference to tightening, markets will once again react strongly. The New Zealand dollar could fall sharply, and swap rates could fall to a lesser extent. The difference between now and late-2014, however, is that the Reserve Bank is more likely to approve of a strong exchange rate reaction. (The caveat to this analysis is that markets could move between publication of this document and the release of the OCR Review, obviating the need for much on-the-day reaction).

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