Westpac

Institutional Bank

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Stay the course

RBNZ OCR preview, 22 September 2016

- We expect the Reserve Bank to hold the OCR at 2% next week.
- In August the RBNZ signalled that another cut in November was highly likely, with the possibility of a further cut beyond this.
- Developments since August have been more or less balanced for the inflation outlook. GDP and dairy prices have risen more than expected, but the exchange rate is stronger and the housing market has cooled a little.
- Consequently, we expect next week's one-page statement to deliver the same bottom line as in August.

At the August *Monetary Policy Statement* the Reserve Bank was quite clear about where its intentions lay. Its projections for the 90-day interest rate settled at 1.8%, neatly splitting the difference between one and two more OCR cuts in this cycle. And officials noted that the next move in the OCR was most likely to come at the November review.

In that light, next Thursday's interim OCR review seems like a fairly low-stakes affair. The RBNZ hasn't committed itself to any particular action this time around, and developments since August have been broadly balanced in terms of their implications for inflation. So we see no need for the RBNZ to rattle markets by altering its language. We expect next week's one-pager to repeat the August line that "further policy easing will be required to ensure that future inflation settles near the middle of the target range".

The most significant development since August has been the sharp rise in world dairy prices – up nearly 30% in the last three GlobalDairyTrade auctions, with the futures market suggesting further gains at next Wednesday's auction. The rise in export prices goes some way towards justifying the recent strength of the New Zealand dollar, although the RBNZ will probably still consider some of the currency's gains to be unjustified by fundamentals.

The other positive factor is that the economy grew faster than the RBNZ expected over the first half of this year, with GDP up by 0.9% in both quarters. This is somewhat dated information now, but it will influence the RBNZ's judgement about how much spare capacity remains in the economy.

As for inflation itself, there hasn't been much new information on this front. In the August MPS the RBNZ forecast a very soft September quarter outturn, which would see the annual inflation rate drop back to 0.2%. Since then, food prices have been on the soft side, while fuel prices have risen; the net impact on the RBNZ's inflation forecast is probably a wash.

One factor that will weigh on the RBNZ's thinking is the latest round of loan-to-value ratio (LVR) restrictions, which were signalled in July but weren't incorporated in the August MPS forecasts. The details of the new rules have now been finalised, and the August house sales figures have confirmed that the restrictions have had a dampening effect on house prices (though one that we think will prove to be temporary). Consequently, the RBNZ will now be revising down its view on house prices, relative to its August forecast of a whopping 18% rise in prices this year.

All together, these factors suggest there is no need for the RBNZ to deviate from the path that it set out in August. A 25 basis point OCR cut in November still looks like a reasonable prospect – not least because the next scheduled opportunity to do so is not until February. And given the constraints of a one-page statement, the RBNZ need not be explicit about its intentions beyond the next review date.

We expect one more OCR cut in November, followed by an extended pause. Inflation is likely to be back above 1% by the second half of next year, as some temporary factors drop out. This suggests that the challenge the RBNZ faces is one of an uncomfortably slow return to the inflation target, rather than a sustained undershoot. And that calls for incremental moves, rather than drastic action.

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