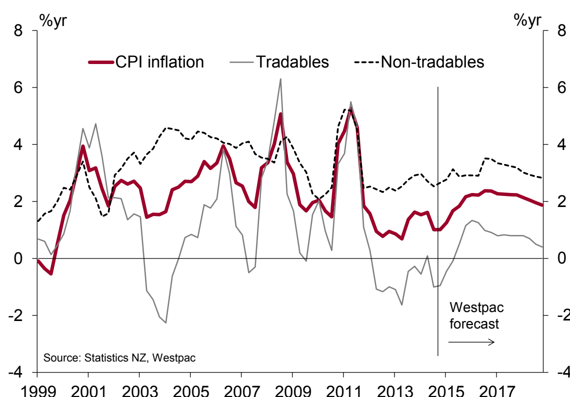
30 October 2014

Watered down, but still there

RBNZ OCR Review, October 2014

- The RBNZ's hiking bias has been watered down, but not eliminated.
- Today's statement was vague and non-committal, as befits the uncertainty of the situation.
- There is no reason to alter our forecast of the OCR remaining unchanged until September 2015, when a second tranche of OCR hikes will begin.
- Swap rates and fixed mortgage rates could fall further in the weeks ahead.
- Financial markets are not currently pricing any risk of an OCR cut over the coming six months, but ought to.
- There is a heightened risk of RBNZ intervention in foreign exchange markets at present.

Westpac inflation forecast



Today the Reserve Bank left the OCR unchanged at 3.5%, and watered down its hiking bias.

In its September statement the RBNZ had said it was on pause, but explicitly referred to future policy tightening. The new policy sentences were quite different:

"CPI inflation is currently at a low level despite above-trend growth. However, inflation is expected to increase as the expansion continues. A period of assessment remains appropriate before considering further policy adjustment."

Removing any explicit reference to future hikes was a significant change, and confirms that the Reserve Bank's thinking has evolved. However, the RBNZ does expect that the next OCR change will be up, not down, as indicated by a couple of clues within the policy guidance sentences. First of all, the indication that inflation is expected to rise leans in the direction of OCR hikes. And the reference to *"further"* policy adjustment indicates that future OCR will be in the same direction as recent OCR changes – upwards. It is a hiking bias, but one has to peer through a pretty powerful microscope to detect it.

The RBNZ's statement was vague, non-committal, and contained only four references to the future: growth was expected to moderate; the exchange rate was expected to depreciate; inflation was expected to increase; and the OCR was expected to remain unchanged for a while.

Nevertheless, we suspect that the RBNZ's thinking is pretty closely aligned to our own. The RBNZ is worried about the fact that inflation has failed to materialise despite the strong economy. In response, the RBNZ has indicated that it will not hike the OCR again until it sees the whites of the eyes of inflation. But a range of factors, from falling oil prices to lower ACC levies, indicate that inflation is going to remain quiescent for quite some time, and therefore the OCR will remain on hold for quite some time.

Our forecast is for OCR hikes to resume in September 2015. At that time the June 2015 Consumers Price Index figures will be available, and on our forecasts will show that annual inflation is 1.7%.

Financial market pricing is already consistent with a very delayed and pale OCR hiking cycle, but swap rates still have room to fall from current levels. We are surprised that financial market pricing has not yet moved to factor in the risk of an OCR reduction over the next six months. There is virtually no chance of an OCR hike over that timeframe. Conversely, there is a small chance that some unexpected downside event might give the RBNZ reason to reduce the OCR. Market pricing ought to reflect this risk, but currently does not.

Falling swap rates will only intensify the current trend towards lower fixed mortgage rates. In combination with booming population growth and an election result that returned a Government opposed to capital gains tax, falling mortgage rates could well boost the housing market over the coming months. But even if house prices are reinvigorated, the RBNZ would not change its tune on the OCR unless CPI inflation looked as though it was going to accelerate. Instead, the RBNZ would rely on macroprudential tools to guard against any financial system instability arising from high house prices.

On the exchange rate the Reserve Bank was slightly less strident compared to previous communications, noting that some of the pressure had been taken off the New Zealand dollar. However, the RBNZ did repeat its earlier warning that the level of the exchange rate is “unjustified and unsustainable”.

This indicates that intervention remains a possibility. Indeed, we are raising a flag to indicate heightened risk of intervention in the near future. Last night’s hawkish statement from the US Federal Reserve, combined with today’s dovish RBNZ statement, has created conditions under which the RBNZ actually has a reasonable chance of catalysing a drop in the NZD.

RBNZ statement:

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

The global economy is growing at a moderate rate although recent data suggests some softening in the major economies, apart from the United States. Monetary policy is expected to remain supportive for longer in all the major economies.

Growth in the New Zealand economy has been faster than trend over 2014, reducing unemployment and adding to demands on productive capacity. Strong construction sector activity, high net immigration, and interest rates, which remain low by historic standards, continue to support the expansion. Output growth is expected to moderate over coming years, towards a more sustainable rate.

Lower commodity prices and increased global financial market volatility have taken some pressure off the New Zealand dollar. However, its current level remains unjustified and unsustainable and continues to constrain growth in the tradables sector. We expect a further significant depreciation.

CPI inflation remains modest, and was 1 percent in the year to September. Contributing factors are subdued wage inflation, well-anchored inflation expectations, weak global inflation, falls in oil prices, and the high New Zealand dollar. House price inflation has fallen significantly since late-2013, in part due to interest rate increases and the LVR restrictions.

The economy appears to be adjusting to the policy measures undertaken by the Bank over the past year. CPI inflation is currently at a low level despite above-trend growth. However, inflation is expected to increase as the expansion continues. A period of assessment remains appropriate before considering further policy adjustment.

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