New Zealand Economic Comment

RBNZ cuts 25bp; further easing will be required

Economics

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RBNZ cuts OCR 25bp to 2.0%, as widely anticipated

With the release of its August Monetary Policy Statement (MPS), the RBNZ reduced the Official Cash Rate (OCR) by 25bp to 2.0%. The 25bp policy rate cut was in line with our expectation and that of economist polls, which put high odds on such an action. The market response (NZ dollar higher and bond sell-off) suggests that markets were pricing more of a risk that the RBNZ could cut 50bp on this occasion. We did not regard this as a serious option (nor did the RBNZ, it would appear).

Signals that 'further policy easing will be required'

In respect of forward guidance, the RBNZ made it clear that 'Our current projections and assumptions indicate that further policy easing will be required to ensure that future inflation settles near the middle of the target range' and that 'The Bank judges that monetary policy will need to be more stimulatory than projected in June'. The Bank's 90-day track shows rates reaching a low of 1.8% by Q2 next year, against a low of 2.1% projected by that quarter in the June MPS.

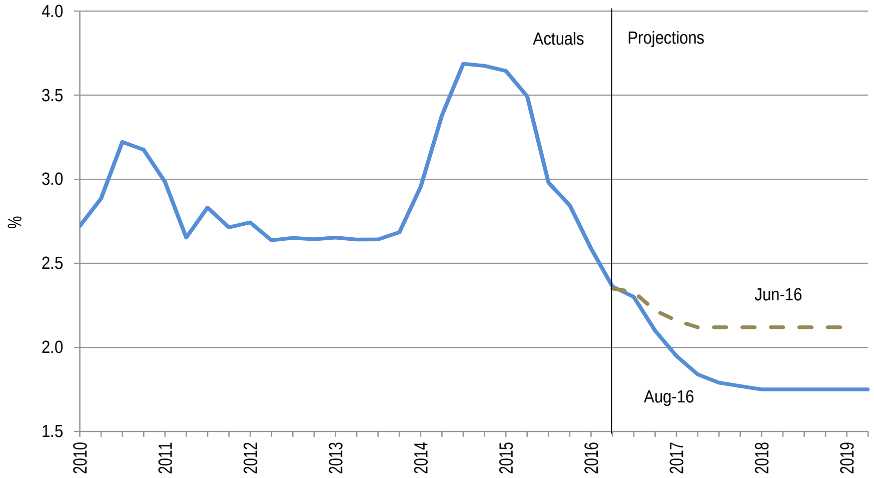
Most risks are to the downside for inflation and rates

While the RBNZ has upgraded growth forecasts over the full forecast horizon, the near-term inflation outlook has been reduced, largely on account of the higher currency. An expected depreciation in the NZ dollar relies on improving global conditions but the RBNZ observes that the downside risks to the global outlook remain 'substantial'. Both the 'higher exchange rate' and 'lower inflation expectations' scenarios suggest the OCR could (all else equal) fall as low as around 1% towards the end of next year.

Implications: We now expect the OCR to fall to 1.75% and stay there until 2018

We agree with the RBNZ's assessment that an additional OCR cut is likely to be required and (despite the timing implied by the 90-day projections) will probably happen at the 10 November MPS. We then expect that emerging capacity pressures, and ongoing housing market tensions, will keep the OCR on hold at 1.75% for an extended period, through the end of next year. The start of 'normalisation' we had pencilled in for mid-next year has been pushed out to the beginning of 2018.

Figure 1: 90-day rates



Source: RBNZ, UBS

August 2016 Monetary Policy Statement

With the release of its August Monetary Policy Statement (MPS), the RBNZ reduced the Official Cash Rate (OCR) by 25bp to 2.0%, having left the OCR unchanged in June and April. This is the first OCR move since the March MPS, which was also a 25bp reduction. The 25bp policy rate cut was in line with our expectation and that of economist polls, which put high odds on such an action.

The market response (NZ dollar higher and bond sell-off) suggests that markets were pricing more of a risk that the RBNZ could cut 50bp on this occasion. We did not regard this as a serious option (nor did the RBNZ, it would appear), with 50bp moves generally reserved for situations where there is some form of 'emergency', requiring a rapid change in policy settings. Certainly, the RBNZ's 21 July Economic Update did not convey any sense of urgency that would have suggested that a 50bp move was being considered. Moreover, while markets may have thought a 50bp move was a necessary 'surprise' to budge the NZ dollar, we do not believe the RBNZ would use monetary policy in such a manner unless it was already justified by inflation-related factors.

Figure 2: Key policy projections

	2016 Q1	2017 Q1	2018 Q1	2019 Q1
CPI (q/q)	0.2	0.2	0.4	0.5
CPI (y/y)	0.4	1.1	1.7	2.1
90-Day Bank Bill	2.6	2.0	1.8	1.8
TWI	72.2	75.6	74.0	73.0

Source: Statistics NZ, RBNZ, UBS

In respect of forward guidance, the RBNZ made it clear that 'Our current projections and assumptions indicate that further policy easing will be required to ensure that future inflation settles near the middle of the target range' and that 'The Bank judges that monetary policy will need to be more stimulatory than projected in June'. The Bank's 90-day track shows rates reaching a low of 1.8% by Q2 next year, against a low of 2.1% projected by that quarter in the June MPS.

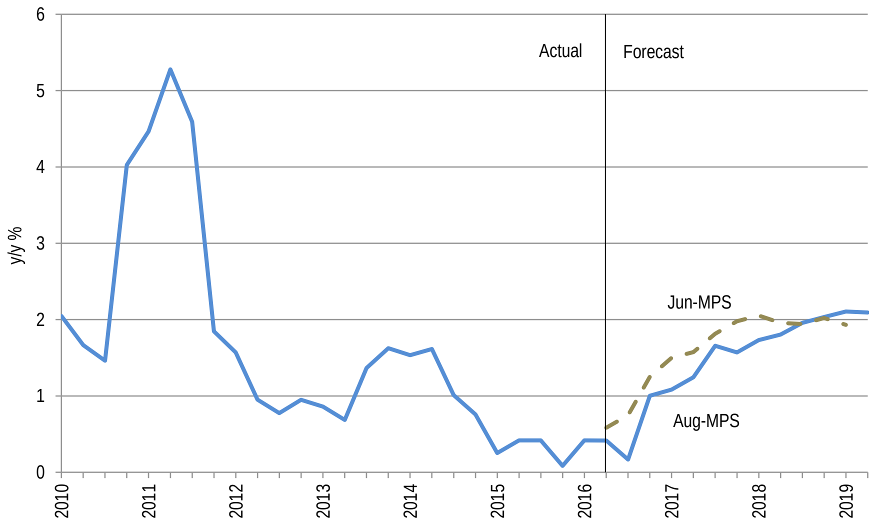
On the global front, there has been further deterioration and the RBNZ notes that, in addition to downward revisions to the global growth outlook, 'Global economic conditions are fragile' and 'Downside risks to the global growth outlook remain substantial'. However, much of the discussion on international developments concerns the situation where subdued, below potential, global growth has meant significant spare capacity and, in association with falls in commodity prices, low global inflation. In turn, this has led to further policy easing and historically low global interest rates, contributing to the attractiveness of NZ dollar assets.

As was highlighted in the RBNZ's 21 July update, the high exchange rate is making 'it difficult for the Bank to meet its inflation objective'. Since the June MPS, the TWI has appreciated about 4% and is currently over 6% above the TWI assumed for the current quarter in the June MPS. Accordingly, the RBNZ has lifted its assumed TWI path by around 6% but still assumes a near 4% depreciation over the forecast horizon, reflecting a gradual improvement in global economic conditions and a narrowing in interest rate differentials (presumably, US in particular).

The RBNZ states that 'A decline in the exchange rate is needed', which is not especially aggressive language but describes the exchange rate as 'elevated in comparison to the level of NZ's export commodity prices, interest rate differentials,

and relative economic activity' i.e. verging on the 'unjustified by economic fundamentals' terminology condition for intervention but not quite! The 'higher TWI' scenario (discussion of which has moved from the back of the document to the front policy assessment) has the TWI unchanged from 76 and, 'all else equal' the 90-day rate falling to near 1% by late 2017 (much the same as in the June MPS).

Figure 3: CPI inflation



Source: Statistics NZ, RBNZ, UBS

The 21 July RBNZ update said that the stronger NZ dollar implied that the 'outlook for inflation has weakened'. Indeed, the RBNZ's updated inflation forecasts show forecast CPI inflation 0.4 percentage points lower than in the June MPS for the March 2017 quarter (1.5% y/y to 1.1% y/y), although in part this is lower projected petrol/fuel prices in Q3, and for the March 2018 quarter (2.0% y/y to 1.6% y/y). The RBNZ has CPI inflation returning to near the mid-point of the target band by Q3 of 2018, three quarters later than projected in the June MPS. Inflation goes a little higher at the end of the projections (over 2% as opposed to under, previously), arguably on account of a stronger growth forecast on the back of more stimulatory monetary policy.

The RBNZ is projecting the economy to expand by 3.4% in each of the next two years (March year averages), up by 0.2 percentage points for 2017 and 0.4%pts for 2018 compared with the June MPS. While the Bank expects growth to moderate in the year to March 2019, the 2.6% average growth forecast is 0.5%pts higher than projected in the June MPS. The rate of potential growth is expected to remain near 2.7%, supported by strong growth in labour supply. The output gap is estimated to be currently around zero. As capacity pressure increases, annual non-tradables inflation is expected to rise throughout the projection. Over the medium term, tradables inflation is expected to increase gradually, in part due to the exchange rate depreciating from its current level.

Figure 4: Economic Projections

		2015	2016	2017	2018	2019
CPI inflation	y/y%	0.3	0.4	1.1	1.7	2.1
Real GDP	An Av%	3.6	2.5	3.4	3.4	2.6
Unemployment Rate	1Q, sa	5.4	5.2	4.8	4.4	4.5
Gov't Operating Balance	Jun Yr, % GDP	0.2	0.2	0.3	1.0	1.7
Current Account	% GDP	-3.4	-3.0	-3.2	-3.4	-3.0

Source: Statistics NZ, RBNZ

Domestic growth is expected to remain supported by strong inward migration, construction activity, tourism, and accommodative monetary policy. However, low dairy prices are seen depressing incomes in the dairy sector and reducing farm spending and investment. Construction activity is expected to be an important source of output growth and capacity pressure over the projection. The increase in residential investment is expected to be larger and more sustained than in the June MPS. This increase is underpinned by the existing housing shortage, strong population growth, high house prices, and low interest rates.

The RBNZ notes that short-term inflation expectations appear to have stabilised since March, while long-term expectations appear well anchored but there remains a risk of further declines in expectations stemming from persistent low inflation (the Bank now forecasts annual inflation to drop to 0.2% y/y in the current quarter). The RBNZ argues that a further sustained decline in inflation expectations would be concerning and would make it difficult to meet the inflation target. Thus, a key element in the rationale for further easing is that 'It is important to reduce the risk that long-term inflation expectations fall further and become unanchored from the target midpoint'.

The RBNZ suggests that house price inflation 'remains excessive' and has become more broad-based across the regions, adding to concerns about financial stability. There is a risk that the additional monetary stimulus will intensify house price inflation but the Bank points out that the recently proposed changes to macro-prudential policy should help to mitigate the risks to financial stability stemming from high house prices and rapid house price inflation.

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