Economic Update

November OCR & MPS Preview

3 November 2016

Another OCR cut expected but probably the last

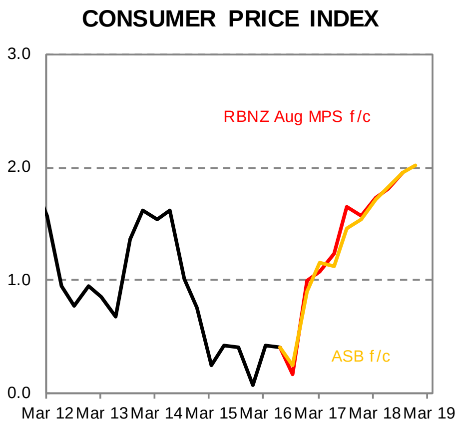
- **We expect the RBNZ to cut the OCR to 1.75% at the November Monetary Policy Statement.**
- **We expect a continued easing bias, but it will be toned down.**
- **Inflation risks remain skewed to the downside, so a further cut can't be ruled out.**

Summary

We expect the RBNZ to cut the OCR to 1.75% at the November Monetary Policy Statement, a widely-anticipated outcome. From here, we expect the RBNZ to signal that any further easing is still where the risks lie, but that a further cut is not the RBNZ's base case.

The RBNZ will now publish an OCR outlook alongside its decision. This replaces the 90-day bank bill outlook. We expect it to show a track that flags the risk of a sub-1.75% OCR, but not low enough to imply another 25bp cut is the RBNZ's central view.

Getting across this message without prompting a spike in wholesale interest rates and the NZD is a tricky sell. But the strength of recent economic data has increasingly pushed market pricing to largely rule out the prospect of a sub-1.75% OCR.



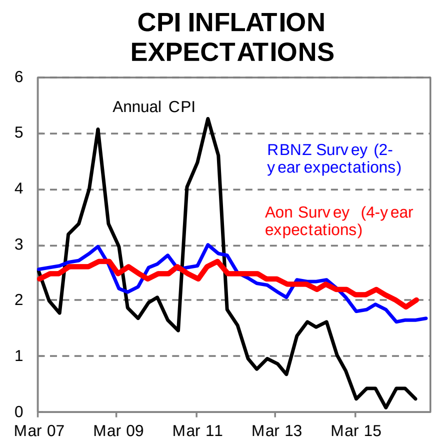
Why a cut is firmly on the cards

A 25bp reduction in the Official Cash Rate would be consistent with the RBNZ's outlook and recent developments. In addition, the risks are still skewed towards the downside and are centred on:

- Potential for the NZD to strengthen further;
- The possibility inflation expectations soften further;
- Global uncertainty and the risk global growth slows.

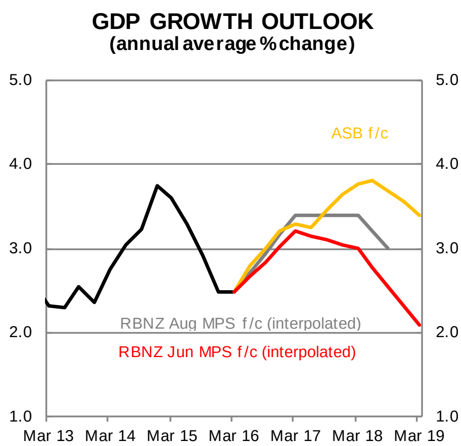
In addition, a cut on November 10 is fully anticipated by financial markets; if the RBNZ did not follow through on its clear 'cut' signal it would prompt a marked lift in the NZD and interest rates.

Beyond November, we expect the RBNZ to remain on hold. The risks do indeed remain skewed to further action, but strong economic momentum and rising dairy prices will generate greater inflation pressure over time.



Inflation developments in line

For the first time in a long time, the RBNZ inflation outlook is in line with our own. Previously, the RBNZ had an overly-optimistic view of the speed of the expected lift in inflation. Q3's CPI data was in line with RBNZ expectations, although still some way below target. Sources of inflation have been hard to come by, although the impact of oil price drops last year are starting to roll off. This, combined with the more recent rise in oil prices, is giving the RBNZ something akin to a 'get out of jail free card' through lifting inflation away from zero in the near future.



Inflation expectations: low but steady

The RBNZ's Q4 inflation expectations survey showed little change, with 2-year ahead inflation expectations just ticking up to 1.68% from 1.65%. That is still close to the 1.63% result that prompted the surprise cut from the RBNZ back in Q1. As such, soft inflation expectations are still a key driver for reducing the OCR this month. But very long-term inflation expectations have actually edged up, so the RBNZ will be confident that inflation expectations remain anchored. Inflation expectations will remain a key watch point. But at this stage they are not a driver for further rate cuts, in our view, beyond November.

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Growth: good, but risks are ever present

The New Zealand economy is displaying signs of robust momentum, aided by record high levels of migration and strong tourism. Very encouragingly, the recent recovery in dairy prices will eventually boost growth and inflation. In the past the RBNZ has expressed caution over 'banking' dairy price improvements, but we see the lifts as driven by solid fundamentals. The RBNZ may express a little more confidence in the dairy outlook this time round. However, there are still a number of downside risks to the outlook. These include:

- The strength of the NZD, which is hampering efforts to boost inflation;
- Inflation expectations;
- Global uncertainty, including the US Presidential election;
- China's growth picture.

NZD strength is still an issue

The strength of the New Zealand Dollar is a potential bugbear for the RBNZ. On a Trade Weighted Index basis, the NZD is still above the RBNZ's assumptions (78 vs. 76), although not significantly, as the gap has narrowed from near 80 in August. The RBNZ's NZD outlook won't change much for the November MPS. Even so, we continue to see risks the NZD remains firmer than the RBNZ's outlook. Factors holding the NZD up include:

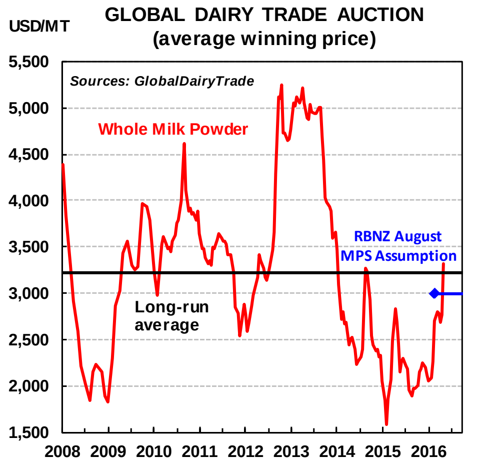
- The slow pace of interest rate increases from the US Federal Reserve;
- Favourable terms of trade for New Zealand;
- The recent dairy price recovery, and;
- Relatively high interest rates.

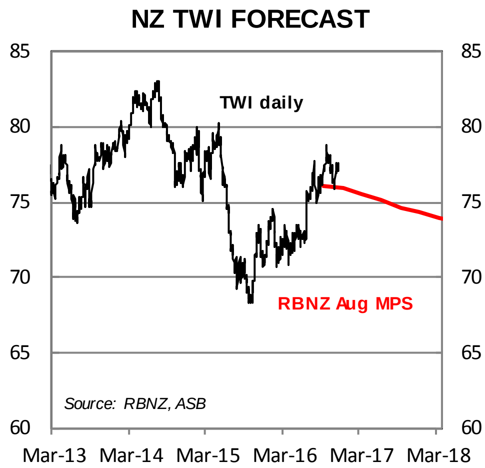
There are also plenty of risks of volatility, with the US Presidential election chief among these, right ahead of the MPS release.

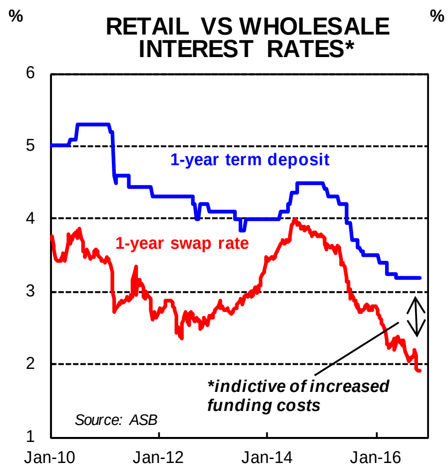
Bank funding costs: more than just the OCR

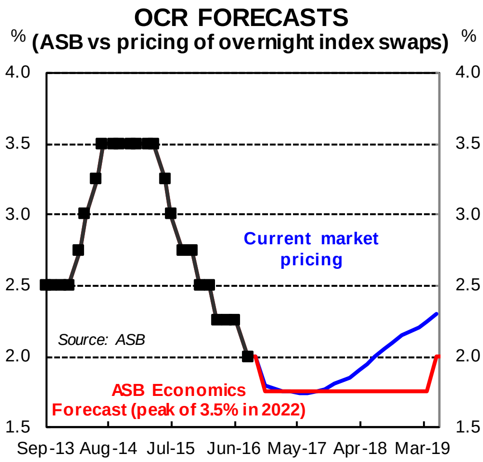
A complication for the RBNZ is how much of the OCR cut is passed through to customer deposit and lending rates. Recently, longer-term interest rates have started to rise off extraordinary lows, led by increases in offshore interest rates as well as higher risk premiums that banks pay to obtain wholesale funding. In addition, growth has been slowing in banks' main source of funding over the past few years (deposits). Low interest rates have increasingly encouraged stronger borrowing demand but slower deposit growth. That leaves banks with a need to obtain an ever-greater amount of alternative funding, mainly from those relatively expensive wholesale funding sources. In that environment, banks will also be keen to hang onto their retail deposits, restraining the ability for deposit rates to follow the OCR lower.

You can argue that muted pass-through to effective deposit and lending rates is an added argument for more aggressive OCR action. But, equally, if the impact is small and inflation will be back in the target band soon anyway, that may simply raise the threshold for taking an action that is not particularly pressing in the current environment.









Previous Statement:

September OCR review

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.0 percent.

Global growth is below trend despite being supported by unprecedented levels of monetary stimulus. Significant surplus capacity remains across many economies and, along with low commodity prices, is suppressing global inflation. Volatility in global markets has increased in recent weeks, with government bond yields rising and equities coming off their highs. The prospects for global growth and commodity prices remain uncertain. Political uncertainty remains.

Weak global conditions and low interest rates relative to New Zealand are placing upward pressure on the New Zealand dollar exchange rate. The trade-weighted exchange rate is higher than assumed in the August Statement. Although this may partly reflect improved export prices, the high exchange rate continues to place pressure on the export and import-competing sectors and, together with low global inflation, is causing negative inflation in the tradables sector. A decline in the exchange rate is needed.

Second quarter GDP results were consistent with the Bank's growth expectations. Domestic growth is expected to remain supported by strong net immigration, construction activity, tourism, and accommodative monetary policy. While dairy prices have firmed since early August, the outlook for the full season remains very uncertain. High net immigration is supporting strong growth in labour supply and limiting wage pressure.

House price inflation remains excessive, posing concerns for financial stability. There are indications that recent macro-prudential measures and tighter credit conditions in recent weeks are having a moderating influence.

Headline inflation is being held below the target band by continuing negative tradables inflation. Annual CPI inflation is expected to weaken in the September quarter, reflecting lower fuel prices and cuts in ACC levies. Annual inflation is expected to rise from the December quarter, reflecting the policy stimulus to date, the strength of the domestic economy, reduced drag from tradables inflation, and rising non-tradables inflation. Although long-term inflation expectations are well-anchored at 2 percent, the sustained weakness in headline inflation risks further declines in inflation expectations.

Monetary policy will continue to be accommodative. 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. We will continue to watch closely the emerging economic data.

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