9 October 2015

RBNZ Risks Cutting New Zealand's Lifeline

- RBNZ will cut again
- Though we're not sure when
- Any more thereafter is questionable
- Inflation may be too low
- But will lower interest rates fix the problem?

The RBNZ is unequivocally on an easing bias. At the time of its September Monetary Policy Statement it said that "some further easing in the OCR seems likely". It's our central view that no further easing is necessary. But the RBNZ makes the decisions so we continue to acknowledge its determination to reduce interest rates one more time. It simply has to deliver this from a consistency perspective as the data since the MPS has not been sufficiently different from expectations to dissuade it from its central view. However, what remains less certain is whether that rate cut will be in October or December and whether it will be the last.

While the balance of data since the September MPS should not deter the RBNZ from its central view, the detail has certainly provided reason for debate. At the margin, the data tend to suggest that growth (and the accompanying inflationary pressure) might be higher than anticipated but that, despite this, the strengthening in the New Zealand dollar and inability of companies to pass on cost increases might leave inflation lower than anticipated.

For the hawks:

- Dairy prices have bounced spectacularly over the last few weeks. The GDT Price Index is now 63% above its early August lows. Most importantly, the RBNZ revealed that it had assumed dairy prices averaging USD1,500 a tonne when putting its forecasts together. Now they are sitting at USD2,824/T. Futures prices are over USD3,000/T suggesting even further upside risk to current prices.

- Business expectations for activity levels have remained more elevated than might have been expected and are suggestive of GDP growth around 2.75%. This includes the PMI, PSI and recently released NZIER QSBO.

- House price inflation remains elevated though there is anecdotal evidence that the froth may be coming off the top of the Auckland market.

For the doves:

- The NZD is currently sitting at 71.2 on a TWI basis. This is 4.9% up on the level that the RBNZ had assumed for Q4. In part this will be seen as a natural response to the surge in dairy prices but, that aside, will still impart a downside impact on the Bank's medium term inflation forecasts.

- QSBO pricing indicators also suggest that inflationary pressures (on a CPI basis) continue to dissipate despite rising input costs.

- While dairy prices may be rising, global commodity prices, generally, are still soft.

- Expectations for Federal Reserve rate hikes have been further delayed.

While the above developments still argue for a further rate cut from a consistency perspective, they do not argue for additional easing over and above that cut. Indeed, we see little argument for further reduction full stop.

Earlier this week, Ivan Colhoun, NAB's Chief Economist – Markets, wrote a nice piece around the top six reasons the RBA should not cut rates. His piece bears a frightening resemblance to the environment in New Zealand.

His top six reasons for Australia are:

- The non-mining economy is improving;

- Mining investment, business investment and commodity prices are not interest rate sensitive;

- Still lower interest rates would boost the rate sensitive sectors of the economy and increase financial risks;

- Rates are already very low and the full impact of the cuts to 2% in H1 2015 is still to flow through;

- The AUD is now more clearly supporting growth;

- The RBA only has 200bps of rate cuts left.

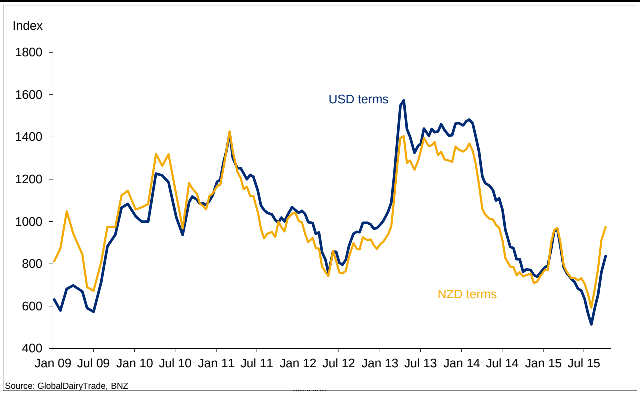
So to New Zealand . . .

The non-dairy sector is doing nicely thank-you. Real retail sales grew 6.0% in the year to June 2015. Over the same period, residential construction increased 5.1%, non-residential construction was up 4.9%, and plant and

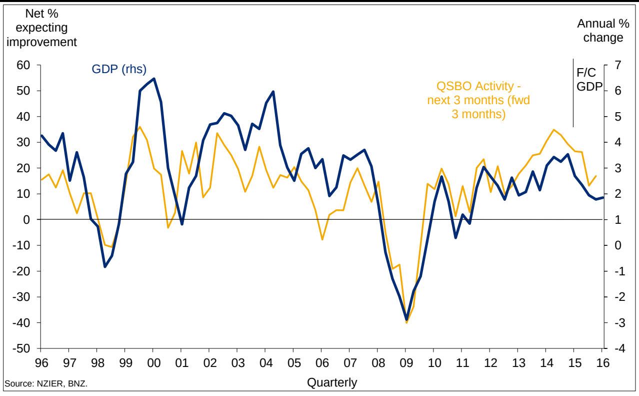
Plusses and Minuses

For The Hawkes

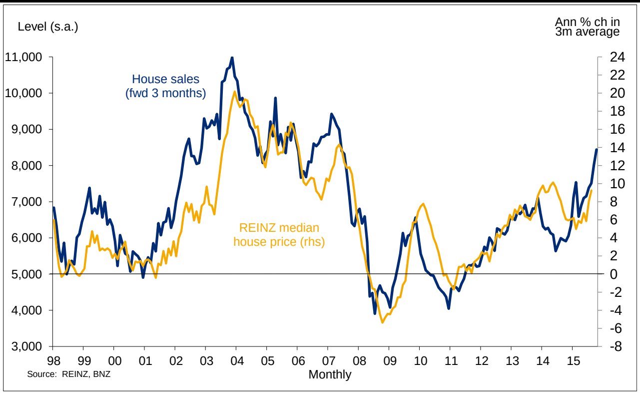
Dairy Prices Bounce



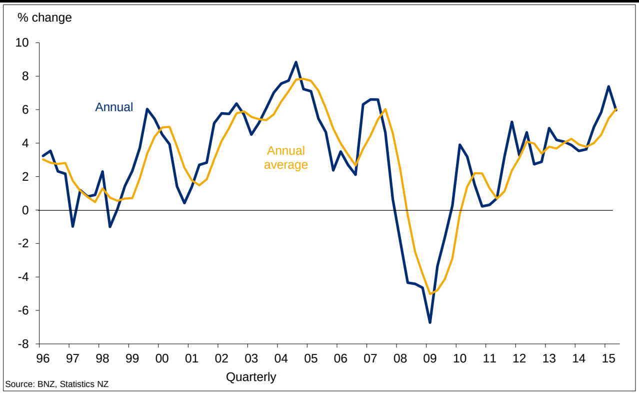
Confidence Elevated



Housing Booms

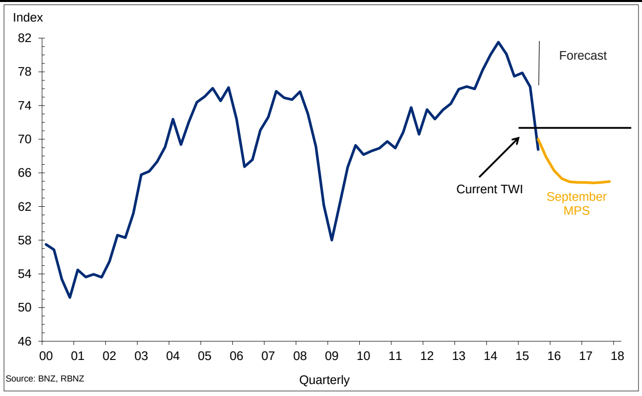


Consumer Spending Soaring

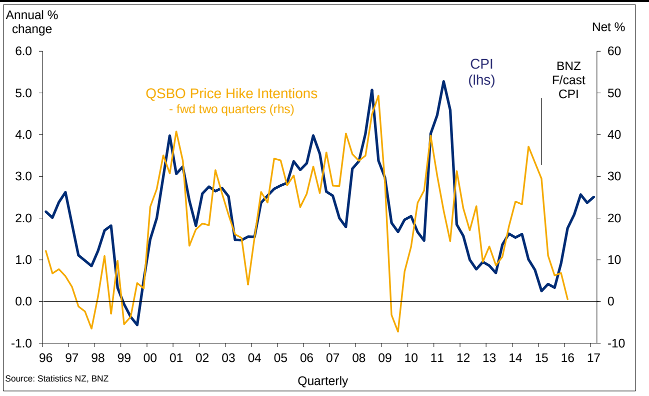


For The Doves

TWI Strengthens



Pricing Intentions Weaken



Commodities Soft

Unemployment Rising

machinery investment rose 9.3%. Manufacturing confidence remains positive, tourism numbers are growing strongly and the services sector is strengthening. Anything to do with the housing market, in particular, is going gangbusters. The primary sector, outside of dairy, is benefitting from good price levels. The forecast is for economic growth to ultimately slow significantly but we are not there yet. Moreover, there are now signs that even the dairy sector may have received a get-out-of-jail-free card by way of the bounce in prices.

There is no shortage of investment activity in New Zealand at the moment and any slowdown that is likely to occur will largely be a function of the peak in Christchurch-rebuild construction occurring. No manner of interest rate cuts will impact this nor will they help commodity prices except to the extent that local currency returns are assisted by a rate-cut induced fall in the NZD.

The interest rate sensitive sectors of the economy – predominantly housing and admittedly with a significant Chinese tailwind – are responding well to lower interest rates, with a significant upswing in housing construction underway. Indeed, the strength of the upswing in investor lending has led to action from the government and also to continued warnings from the RBNZ about potential risks to financial stability. Cutting interest rates further, without a significant negative development in the outlook for the New Zealand economy, would counteract the intent of these macro-prudential policy moves and risk renewed house price rises and borrowers becoming over-stretched.

It's also hard to argue that the current level of interest rates is providing a hindrance to the economy or unduly rationing the availability of credit. Indeed, in the latest NZIER QSBO, only 6% of respondents reported that finance was their major factor constraint. In contrast, 57% cited demand and 15% capacity. Some of the impact of the three recent rate cuts is still flowing through to the economy, as is the benefit to growth from the lower NZD. The RBNZ must be (and usually is) very cognisant of the lags that operate both with changes in interest rates and the exchange rate.

The NZD *has now fallen to a level where it is more clearly supporting growth. Anecdotes of stronger tourism abound. The lower NZD would also be offsetting some of the weakness in USD commodity prices. And, importantly, the NZD has fallen independently of US and New Zealand interest rate developments, which is a break from the situation a few months back when the Kiwi was stubbornly high in the face of declining commodity price fundamentals.*

Our final argument incorporates many of the top five arguments. Given the above conjunction whereby:

- *the economy appears to be strengthening;*
- *the interest rate sensitive sectors are strong (and in some aspects, too strong);*
- *the currency has fallen;*
- *there is still some further boost coming through from previous rate cuts; and*
- *the weakness in the economy cannot be addressed with further rate cuts anyway;*

it would seem irresponsible for the RBNZ to use part of its remaining monetary policy arsenal for what would likely be little benefit at the present time (and which conceivably might add to medium-term problems for the economy).

Until there is a clear case for lower rates, the remaining policy ammunition should be conserved in case a significant shock was to hit the economy.

To reinforce just how similar the situation is in New Zealand to Australia, all the text above which is in italics is taken word for word from NAB's recent note on the Australian economy. For all intents and purposes, all we have done is removed RBA and replaced it with RBNZ and replaced AUD with NZD.

So, taking all the above into consideration, do we need New Zealand's cash rate to head below 2.5%?

Probably not.

Will it?

It depends on how fixated the RBNZ remains with getting inflation back to 2.0% whatever the cost. Given the combination of recent past RBNZ rhetoric, the likely slowing in growth and absence of inflation, the balance of risk remains that interest rates will thus go lower still after the RBNZ's next move.

And if rates are cut will they help push up inflation and growth?

Highly unlikely, as the current level of monetary accommodation is already highly stimulatory.

And the remaining question: will the RBNZ cut in October or December?

In our opinion, and again for consistency's sake only, if the RBNZ genuinely has an easing bias it shouldn't wait until December to cut rates. No point would be served by doing so. However, consecutive meeting consistency has not been the Bank's forte of late and there will be some who will argue (inappropriately we would say) that waiting until December's full MPS would give the Bank a better chance to fully explain its current and future actions. This desire to wait would be given further backing if financial markets (as is the case now) are reluctant to price such a cut in. Currently a 28% chance of a cut is priced. Accordingly, we think that the October/December decision is too close to call.

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