Economic Update

RBNZ Update May 2015

6 May 2015

ASB

Time for OCR cuts

- Inflation risks are tilting to a lower OCR – we have changed our call to reflect that.
- Though cuts depends in part on how the RBNZ interprets its “medium term” target focus.
- We expect 50bp of cuts from the RBNZ, most likely 25bp apiece in September and October.

We have now moved to forecast the RBNZ will cut the OCR later this year, having since mid-January ruled out OCR increases for the “foreseeable future”. We believe the risks of inflation taking too long to make a sustained return to the 2% mid-point of the inflation target have now got high enough to warrant a response. Accordingly, we think the RBNZ will give inflation a nudge up through 50bp of cuts, most likely 25bp in each of September and October. But an earlier start is conceivable.

We put a 60% probability on any cuts occurring. The outcome is as much about the extent to which the RBNZ’s inflation forecasts start to fall as it is about how strictly the RBNZ interprets its fuzzy “on average over the medium term” inflation target. But the risks are skewed to inflation remaining low relative to the target band; there is very little risk of inflation overshooting the target.

The main risk from a lower OCR is the housing market through the likelihood of added price growth. Even there, we would expect the RBNZ to keep working on making the financial system even more resilient, while exhorting local and central government to do more to address the root causes of Auckland’s housing imbalance.

Low inflation concerns

Even softer inflation pressures.

There are a mix of events that suggest the RBNZ’s assessment of inflation pressures will now be softer (though some will have been accounted for in the April Review):

Greater labour market slack…muted wage pressures.

- Labour market slack is likely to be greater than the RBNZ recently assumed, as the labour force grows strongly on the back of migration and high labour participation. With unemployment likely to be higher over coming years than the RBNZ has past expected, wage pressures are also likely to be more muted – even without any behavioural responses to low inflation;

Backwards-looking businesses are adding to risk.

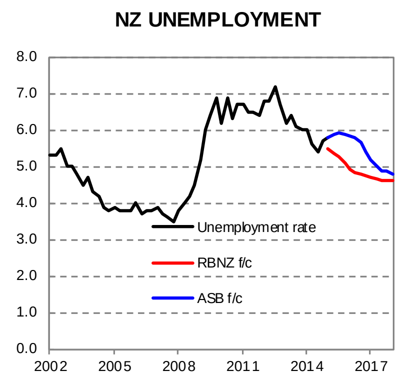
- Research cited by the RBNZ in a speech suggests businesses are backward-looking when setting prices, and become even more so when inflation is low. This research suggests added risk of a sustained period of low inflation becoming ingrained in wage/price-setting behaviour;

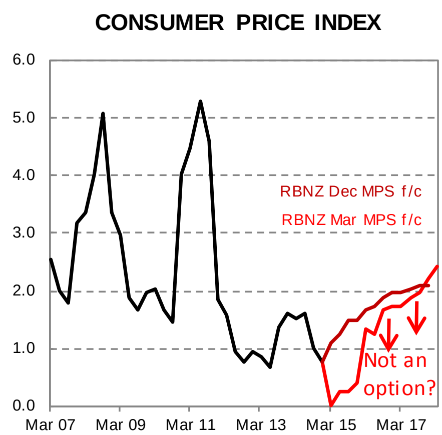
NZD likely to remain strong for longer.

- The NZD has been drifting higher than the RBNZ’s published March forecasts, and the risk is it remains firm. Although there has been some retracement from recent highs against the AUD and euro, the NZD/USD (and NZD/CHY) risk remaining stronger for longer;

Considerably more negative dairy outlook…we have revised down our 2015/16 forecast to $5.70/kg.

- The dairy price outlook has become considerably more negative between the March and April OCR decisions, and has become softer since the April OCR statement was finalised. Fonterra revised down its 2014/15 milk price forecast to $4.50/kg from $4.70. Moreover, we have revised down our 2015/16 forecast to $5.70/kg, having been as high as $6.50 earlier this year. There is a greater risk that farmers lose confidence in a recovery in dairy prices, in which case even more cautious spending would





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soften GDP growth for next year to a pace that is non-inflationary;

Lower near-term growth than RBNZ previously expected.

- Growth over the first half of 2015 is likely to be considerably weaker than the RBNZ's March MPS forecasts, in part through greater accounting for the impact of dry conditions on dairy production and for a near-term flat patch in construction;

Riskier global outlook.

- The global outlook is riskier than it was back in March, with muted growth in Australia and China a key focus (and the Greeks trying to be relevant in the background).

There is little leeway for the RBNZ to reduce inflation targets further.

In our view, the inflation target's "focus on keeping future average inflation near the 2 per cent target midpoint" gives little leeway for the RBNZ to reduce its inflation forecasts further. To be more consistent with the inflation target, we favour the RBNZ lowering its 90-day bank bill interest rate outlook, which – relative to the March MPS outlook – would imply the need to cut the OCR from the current 3.5%.

3-year moving average of RBNZ's inflation forecasts don't lift above 1% until late 2017.

The inflation target is fuzzy, with its objective of keeping inflation between 1% and 3% "on average over the medium term". It may surprise, but a 3-year moving average of the RBNZ's last inflation forecasts does not lift above 1% until the second half of 2017 – meaning 2 and a half years that the RBNZ's last published forecasts imply inflation to sit on the lower bound of its inflation target (by one possible definition of "on average over the medium term"). Looking at the RBNZ's inflation forecasts from this perspective underscores just how little leeway the RBNZ has for any developments that will keep inflation low for longer than anticipated.

Housing conundrum

RBNZ's prime housing concern is financial stability.

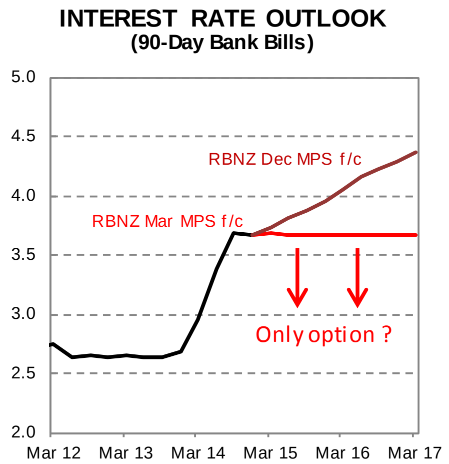
The prime argument for not cutting the OCR centres on the housing market – or, more precisely, the failure for much of the past decade for Auckland's housing supply to keep pace with Auckland's population growth. But housing is not a source of general inflation pressures.

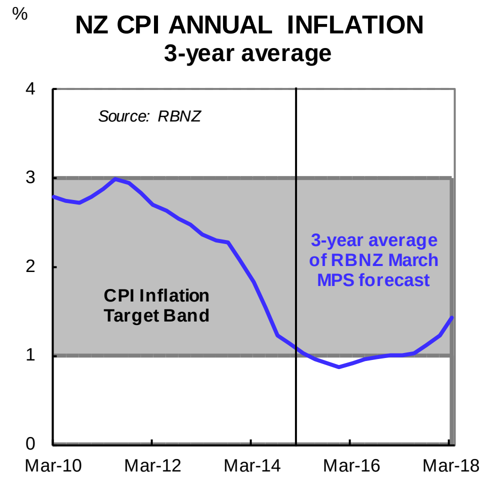
That narrows the RBNZ's housing concerns to financial stability. And it is concerned on that front. We expect the RBNZ will continue to plug away at measures that will mitigate the impact of any marked housing downturn. But, as a recent speech on housing hinted, the RBNZ can only do so much with those tools to lean against house prices. It is instead urging local government and central government to do more to boost housing supply and moderate demand.

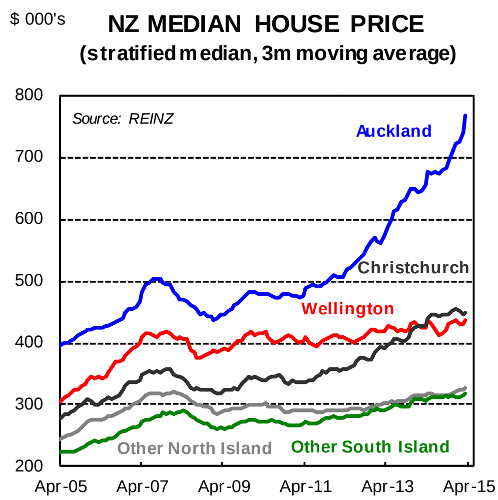
Implications

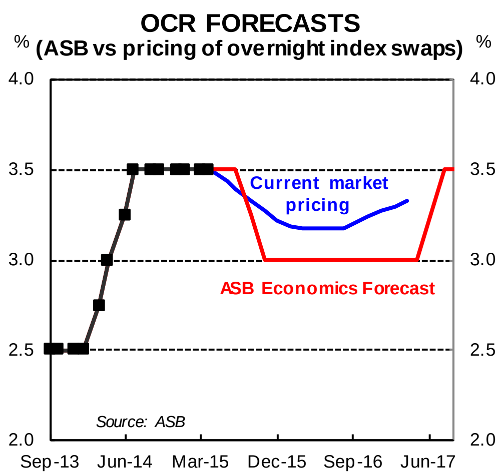
We see a 60% probability on cut(s) occurring later this year.

We have now taken the plunge to forecast the RBNZ will actually cut the OCR later this year: we place around a 60% probability on cut(s) occurring. We see the most likely timing as being two 25bp cuts in September and October. Such moves would imply a gradual shift in the RBNZ's









September start, but earlier start is possible.

stance over time, and a preparedness to wait for August's labour market and inflation expectations data. But earlier cuts are possible. Weak GDP and CPI prints in June and July could prompt a first cut in July. Odds appear against a June cut, but we don't rule one out if the RBNZ starts looking harder at the risks to the medium-term considerations of its inflation target.

Market pricing has around 30bp of cuts priced in by early 2016, so roughly pricing in the probabilities and magnitude of our forecast rate cuts (60% of 50bp). But, if the RBNZ's tone continues to soften over time, anticipation of a lower OCR will grow.

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