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Graeme Wheeler blinks – 25 point OCR cut the first in easing cycle

The RBNZ has cut rates earlier but more conservatively than we anticipated, starting a new easing cycle with a 25 basis point cut to 3.25% that reflects a much sharper easing in the terms of trade than was anticipated in the March MPS, driven by the fall in dairy prices.

"Further easing may be appropriate" depending on data as it emerges, with one further cut implied in the forward track for 90 day bill rates, which is 60 basis points lower, at 3.1% in June 2017, than the 3.7% forecast in the March MPS. The MPS notes that financial markets are pricing in a further 34 basis points to cut over the next 12 months.

The 90 day bill rate track is now a full 200 basis points lower than forecast 18 months ago. While the bank remains concerned about house price inflation, it says supply is the ultimate answer to that. In effect, it is now switching its concern about domestic economic conditions to the deterioration in the outlook for NZ's major exports.

The central bank now expects inflation to return to the 1% to 3% target range by early next year and settle just above the 2% mid-point by the end of next year, with the source of inflation flipping to tradables, with non-tradables inflation relatively subdued.

A "further significant fall" in the exchange rate is also expected. Previous language that the dollar was "unsustainably" strong is replaced by an assertion that it "remains over-valued" with "a further significant downward adjustment ... justified".

The TWI track now shows a fall from around 75 at present to 71.3 by March 2018, compared with 75.8 expected in 2018 three months ago. However, the bank notes that "the exchange rate is prone to significant moves in response to domestic and international developments and can substantially affect the outlook for tradables inflation."

The bank also notes that "volatility in financial markets has increased", with Wheeler identifying the outcome of this month's Greek debt bailout negotiations and the timing of US Federal Reserve interest rate increases, now drifting into late this year in the RBNZ's opinion, as the two most significant international events in coming months.

The domestic economic outlook is only slightly weaker, with growth in the March 2016 year forecast at 3.4%, compared with 3.5% in the March MPS, and 3.1% in the March 2017 year (3.3%). Household savings rates improve as wallets shut on imported goods, which become more expensive with a weaker kiwi dollar. Private consumption weakens considerably in 2017, election year, although a promise of tax cuts may help offset the political impact of a more cautious household sector.

A more significant deterioration in the current account deficit is forecast than in March, pushing out to 6.8% and 6.9% of GDP in the March 2016 and 2017 years respectively, driven by the 8.4% fall in the terms of trade forecast for the March 2016 year. In March, the current account was forecast to peak at 5.7% of GDP in March 2017 on a fall in terms of trade by March 2016 of just 3%.

The RBNZ remains open to the possibility that it is misjudging how price-setting behaviour will develop in the current low inflation business cycle, compared to previous cycles. "Should low inflation become entrenched in price-setting behaviour, there would be a larger role for monetary policy to respond to re-anchor inflation expectations in the economy." The bank will "remain vigilant" of these risks but continues to regard the "neutral" interest rate level to be at around 4.5%.

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