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Assessing the economic and political environment in New Zealand

MONETARY POLICY STATEMENT EXTRA | December 10 2015 | **Confidential to HUGO members**

RBNZ cuts 25bps for 2.5% OCR, 2 years before inflation at 2%

RBNZ governor Graeme Wheeler has signalled today's 25 basis point cut to the Official Cash Rate to 2.5% should be sufficient to bring inflation back to the mid-point of the 1-3% inflation band, while acknowledging numerous uncertainties to that central outlook. Compared with the Sept MPS, which coincided with a further slump in global dairy prices and wobbly local sentiment, the last MPS of 2015 has a more optimistic outlook.

Monetary policy needs to remain "accommodative" through to the end of the forecast period, which now covers calendar 2018. **"We expect to achieve this at current interest rate settings, although the Bank will reduce rates if circumstances warrant,"** today's monetary policy statement says. The annual CPI inflation track is markedly lower than that outlined in the Sept MPS, mainly because the NZ dollar is now forecast not to weaken as dramatically as previously forecast. **While inflation is expected to move back into the 1-3% target range early next year, annual CPI inflation doesn't hit 2% until Dec 2017 under the latest forecasts.**

GDP growth returns to around 3% p.a. in the years to March 2017 and 2018, from a forecast 2.2% in 2016 and 3.2% in the current year. The biggest divergent risks to that outlook are a further substantial decline in export commodity prices, which could see a significantly lower OCR over the forecast period, while less cautious consumer sentiment than expected could lead to stronger GDP growth, a larger than forecast current account deficit, implying "tighter monetary policy would be required" – **about 60 basis points higher**.

The Dec MPS returns to a track for the economy more similar at the macro level to that projected in the June MPS, before the factors that caused the weaker economic outlook in the Sept MPS. **Today's 25bps cut means the RBNZ has cut its benchmark rate a full percentage point in six months.**

Key judgements in today's MPS include:

- **90 day interest rates** fall to 2.6% next year, and are currently forecast to stay there in 2017, unchanged from Sept;
- The **TWI** is somewhat higher throughout the forecast period than in Sept, reflecting recent appreciation, which Wheeler described as **"unhelpful". "Further depreciation would be appropriate in order to support sustainable growth,"** he said. The stronger exchange rate implies much less near-term increases in the price of imported goods and services;
- **El Nino** conditions are not assumed to produce a severe drought, although the RBNZ identifies a more serious drought among risks that could justify looser monetary policy. The projected impact of such a drought is less dramatic, however, than a further fall in export prices;
- Asia and Australia look weaker than Europe and the US over the forecast period. A further Asian slowdown, especially in China, could lead to looser monetary policy. The **risks to global economic growth are "skewed to the downside"**;
- After consistently under-forecasting net immigration, the RBNZ is now expecting a net 3% annual increase in the working age population due to migration, which will underpin domestic economic activity, as does tourist spending. International students emerge as a major source of migrant workforce growth;
- National house price inflation is seen peaking in early 2016 as "affordability constraints bite", although the impact of recent macro-prudential policy and tax moves to dampen house inflation are seen as "temporary";
- The expected tightening of monetary policy by the US Federal Reserve next week – the first in nearly a decade – is seen as less of a destabilising risk to international financial markets than it was three months ago, although divergences between US monetary policy and most of the rest of the world carries risks.

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