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MONETARY POLICY STATEMENT EXTRA | March 10 2016 | **Confidential to HUGO members**

OCR cut 25 bps, more likely: NZ outlook suspiciously robust

Key elements of today's Monetary Policy Statement, compared with the December MPS;

- Lower interest rates – forecasts 30 basis points lower at 2.3% in the March 2017 year than was forecast in the December MPS, and 50 basis points lower than December at 2.1% in the March 2018. "Further policy easing may be required". Current consensus is on a June cut of a further 25bps;
- Stronger exchange rate than forecast in December, with a fall from an average 72.6 now to 69.3 by March 2018, compared with a 2018 forecast of 67.3 in the December MPS;
- Stronger NZ GDP growth in the near term, despite weaker global growth, accompanied by stronger employment growth and lower unemployment, despite the "possibility" of high net immigration continuing. GDP is forecast at 3.1% for the next two years, still a significant slowing from 4% growth in 2014;
- Much weaker pass-through of inflation from a lower exchange rate than previously forecast. A "material decline" in inflation expectations drives today's rate cut, despite long-run expectations being "well-anchored at 2%. Inflation does not reach the mid-range 2% target until March 2018 and is seen at 1.3% in March 2017, down from 1.5% and 2.1% forecast in the December and September 2015 MPSs respectively;
- Terms of trade decline less than previously forecast, despite dairy price decline being a key factor in driving today's cut, balance of payments deficit smaller than previously forecast, return to budget surplus earlier.

RBNZ governor Graeme Wheeler surprised most economic forecasters by moving earlier than was widely expected to cut the Official Cash Rate to 2.25%, a historic low. The decision is partly sheeted home to the weak outlook for dairy product prices, as well as to a "material decline" in inflation expectations which the central bank fears could become "self-fulfilling" if not addressed. A weaker global growth outlook and increased global financial market volatility also underpin the more cautious view, accompanied by an explicit statement that **"a decline (in the NZ dollar exchange rate) would be appropriate given the weakness in export prices."** Yet, the MPS forecasts see a stronger exchange rate through the next two years than was forecast in the pre-Christmas MPS. The TWI in the year to March 2017 is seen averaging 70.3 vs 67.9 in December and 69.3 in the March 2018 year (67.3). That is despite a forecast decline in the 90 day bill rate of 50 basis points by March 2018, compared with the December forecasts.

Most remarkably, the MPS also sees a stronger growth track for the NZ economy than it did in December, despite the downside risks to both domestic and global growth. **"Very stimulatory interest rates, net immigration, construction activity, tourist spending and foreign student arrivals, and strong growth in real incomes reflecting the low rate of increase in living costs"** support the growth outlook. Wage pressure remains minimal.

The forecasts show the central bank misjudged the extent to which a weaker exchange rate would raise import prices in the year to March. A December forecast of a 10.4% increase in import prices is replaced by a forecast 1.7% impact. That helps explain why the RBNZ now expects a lesser decline in the terms of trade than previously expected. While export prices are expected to remain weak, import prices are expected to be even weaker. "Successive downward revisions to the global growth outlook make it increasingly evident that weak demand is important," the MPS says. **"We expect commodity prices to be subdued for a prolonged period."**

At face value, the govt may take heart from today's forecasts. Although the RBNZ continues to expect to undershoot its target thanks to the continued importation of global deflation, its outlook for domestic economic growth, employment, and fiscal external balances all remain robust. The question is how much to believe that outlook. This week's cut in the Fonterra payout to below $4kg/MS looks likely to entrench the less optimistic sentiment emerging since the beginning of the year. *Pattrick Smellie for The Hugo Group*

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