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RBNZ MONETARY POLICY STATEMENT | August 11 2016 | Confidential to HUGO members

Wheeler plays it safe with a 25bps OCR cut – kiwi dollar immediately rises

The fundamental problem confronting RBNZ governor Graeme Wheeler was writ large in the immediate financial markets reaction to this morning's Monetary Policy Statement: a cautious and predicted 25 basis point cut in the Official Cash Rate provoked an immediate rise in the value of the NZ dollar. Each reluctant cut Wheeler makes is intended primarily to take the steam out of the currency, but the currency remains stubbornly high each time.

While financial markets were giving a 24% chance of a 50bps cut before this morning's announcement, the central bank is very wary about the potential to run out of monetary policy ammunition by cutting hard and still having too little impact. In other words: damned if you, damned if you don't. Instead, OCR cuts are, in effect, designed to achieve little more than to keep NZ monetary conditions appropriately calibrated to the ongoing monetary policy easing occurring in other, larger developed economies.

"Our current projections and assumptions indicate that further policy easing will be required." At least two further cuts between now and early next year are likely, and there is room in the forecasts published today for the OCR to fall as low as 1.0% in the exchange rate were to remain around current levels rather than declining to around 73 on a TWI basis.

At this morning's press conference, Wheeler made it clear the central bank believes it is succeeding in maintaining non-tradeable inflation – about half the contribution to the CPI – in line with the 2% annual rate target, but that he has virtually no lasting influence on tradeable inflation or the exchange rate in the current environment.

Key changes from the June MPS:

- a far higher exchange rate than in the June MPS. A TWI of 75.3 is forecast for March 2017, compared with 71.5 in June, declining to 73.3 by March 2019 (69.6);
- potential for the OCR to go to 1% if exchange rate strength is maintained in circumstances where "world interest rates may remain lower for longer … maintaining or increasing NZ's interest rate differential";
- unemployment forecast to be sub-5% throughout the forecast period to March 2019, where it was previously above 5% throughout;
- current account deficit sub-4% of GDP throughout the forecast period, (previously above 4% of GDP);
- slightly higher GDP growth over the period – 3.4% forecast for the March 2017 and 2018 years, (3.2%,3.0%);
- a longer residential construction surge than previously forecast, with a 12.7% increase in residential fixed capital formation in the March 2017 year (13.0% in June MPS), 6.4% in the year to March 2018 (3.8%), and 1.6% in the March 2019 year (previously forecasting a 0.2% contraction);
- inflation does not return to the target 2.0% until March 2019, with 2.1% annual inflation forecast, a year later than forecast in the June MPS. "A further sustained decline in inflation expectations would be concerning," the MPS says and "important to reduce the risk that long-term inflation expectations fall further and become unanchored from the target midpoint";
- high net migration continues to dampen wage pressure;
- house price remains "excessive" as it spreads into the regions beyond Auckland.

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