

Take it easy

- The balance of recent events points to the RBNZ sounding more cautious – including deferring its forecast OCR hikes.
- Inflation pressures are slow in appearing, and the higher NZD is another inflation headwind.
- This week we shifted our OCR view to expecting the first hike to happen in early 2019, previously late 2018.

Summary

We expect the RBNZ to sound a more cautionary tone in the August Monetary Policy Statement. The balance of events since the June OCR decision point to less inflation pressure. As a result, the RBNZ's OCR forecast track is likely to show rate increases will occur in early 2020, 3-6 months later than in its May MPS forecasts.

We also don't completely rule out the RBNZ lowering its 2017/18 OCR forecasts slightly if it wanted to signal that there is a higher risk that it cuts the OCR over the next year.

Reflecting the shift in risks, we have also nudged out our own view of when the RBNZ will first lift the OCR, to February 2019 (previously November 2018).

Running down the inflation road

As the OCR decision looms the RBNZ will have the proverbial 7 developments on its mind. Most of the key events since the June OCR Review indicate a lesser degree of inflation pressure:

- The NZ dollar is higher;
- The Q2 CPI was weaker than the RBNZ expected;
- The RBNZ's estimate of the neutral interest rate has edged down further.

In addition, Q1 GDP was weaker than expected for a second quarter in a row.

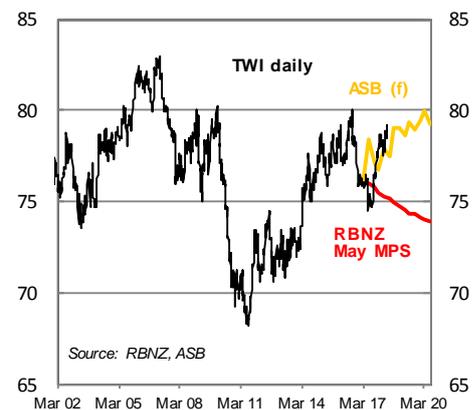
The NZD is around the level it was back at the June OCR decision, but so far it is tracking 3% higher over Q3 than the RBNZ assumed in its May Monetary Policy Statement forecasts. As the RBNZ noted in June, at least part of the strength is down to fundamentals such as strong dairy prices. But, part of the lift will dampen inflation. The RBNZ will lift its NZD outlook, which will be a drag on its inflation forecasts.

Inflation pressures also remain a missing link, highlighted again in Q2. Part of the softness from the RBNZ's perspective was a decline in fuel prices that happened after the RBNZ finalised its forecast. But it was pretty clear that domestic inflation pressures were much more muted than the RBNZ expected, beyond the usual strength in housing construction costs. Along with the recent modest GDP growth, the RBNZ's starting point for inflation will now be lower. And the temporary dip in inflation next year will be deeper.

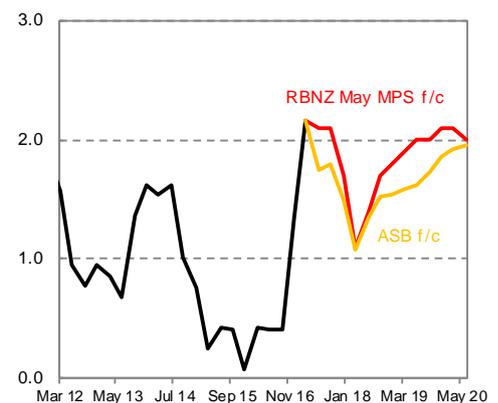
In a [speech](#) last week the RBNZ indicated it has revised down its average estimate of the neutral OCR (the goldilocks level that is not too high and not too low) to 3.5%. That figure is slightly lower than the 3.6-3.7% published in a [Bulletin](#) article just back in June, although that estimate looked like it hadn't been updated for a number of months. The implications are that the low OCR is not quite as stimulatory as the RBNZ had been assuming. The shift isn't much, but it is yet another reason for the RBNZ to reassess whether the OCR needs to remain on hold for longer. Over a period of time, the RBNZ's estimate of neutral interest rates has fallen steadily, having been above 4% as recently as a couple of years ago.

To give some context to 3.5% as a neutral rate, the OCR has averaged 3.38% over the past 10 years – including nearly a year of sitting at 8.25%. Since the

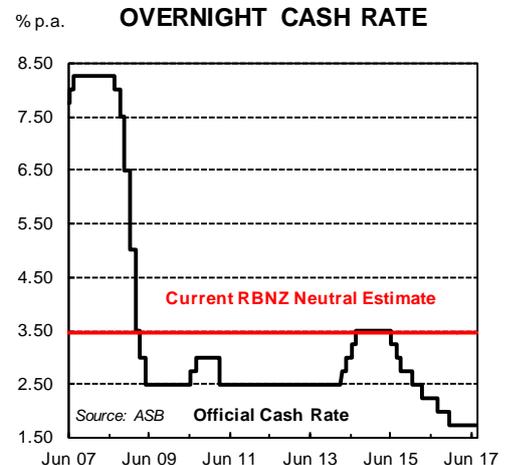
NZ TWI FORECAST



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OVERNIGHT CASH RATE



end of the Global Financial Crisis the OCR has spent less than a year at 3.5%.

It isn't all one-way traffic downwards for inflation pressures. Dairy prices are firm, and Fonterra's bullish forecast for this season will be a big confidence boost to dairy farmers. We don't think the RBNZ is fully factoring in the strength of this boost, though for this MPS we don't expect a big change in the RBNZ's assessment.

Another positive change since May is the added stimulus from the Budget. And, with the election lolly scramble just firing up its carnival float, the RBNZ will be conscious that, post-election, the fiscal stimulus risks being bigger than what the RBNZ lifts directly from the Budget numbers.

Expect more caution on August 10

It is likely that the RBNZ tweaks its OCR outlook slightly. We expect the RBNZ to show OCR hikes starting around early 2020, 3-6 months later than in its May MPS view, a reflection of the overall downward shift in inflation pressure from other sources.

There is even some prospect the RBNZ flags the potential for an OCR cut, through lowering the OCR track below 1.8% in the near term.

We expect the RBNZ to express more caution about inflation, at the least a reference to the Q2 outcome being weaker than expected. But the RBNZ will stick to its view that inflation will return to the target mid-point in the medium term.

The comments on the NZD are likely to be a rinse and repeat of June's. We don't expect the RBNZ to explicitly try to loosen conditions in this way, but it could strengthen the language slightly to express greater unease.

Finally, we expect the same key policy assessment sentence: "Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly." That sticks to the script that the OCR's next move could be in either direction.

Our own view: early 2019

We now expect the OCR will increase from the first half of 2019 and have pencilled in February. We previously thought the first hike would occur in November 2018.

Our own inflation outlook has softened, particularly for 2018 when we had expected the RBNZ to start gearing up towards lifting the OCR. As yet there are few signs that capacity pressures are broadening within the CPI. And wages, one key ingredient for higher services inflation, have yet to pick up beyond the construction sector.

We still anticipate the RBNZ will end up increasing the OCR sooner than it currently assesses. But, for quite some time the RBNZ can take it easy – hopefully without a world of trouble on its mind.

Previous Statement: June OCR Review

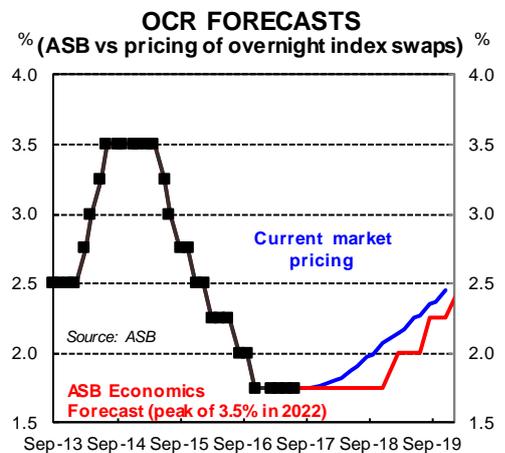
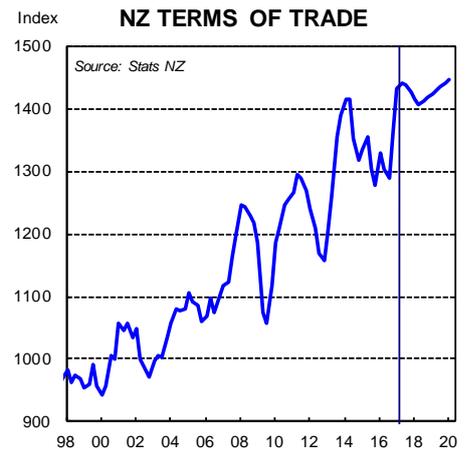
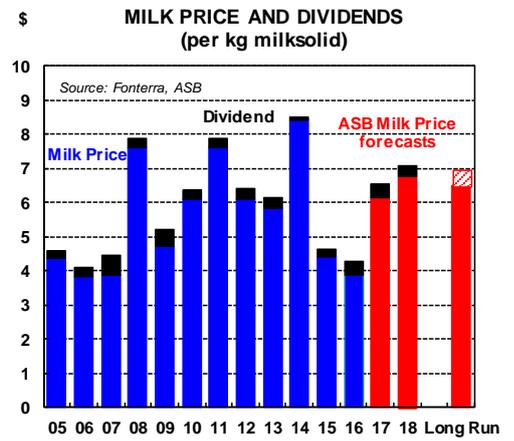
The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 1.75 percent.

Global economic growth has increased and become more broad-based. However, major challenges remain with on-going surplus capacity and extensive political uncertainty.

Headline inflation has increased over the past year in several countries, but moderated recently with the fall in energy prices. Core inflation and long-term bond yields remain low. Monetary policy is expected to remain stimulatory in the advanced economies, but less so going forward.

The trade-weighted exchange rate has increased by around 3 percent since May, partly in response to higher export prices. A lower New Zealand dollar would help rebalance the growth outlook towards the tradables sector.

GDP growth in the March quarter was lower than expected, with weaker export volumes and residential construction partially offset by stronger consumption. Nevertheless, the growth outlook remains positive, supported by accommodative monetary



policy, strong population growth, and high terms of trade. Recent changes announced in Budget 2017 should support the outlook for growth.

House price inflation has moderated further, especially in Auckland. The slowdown in house price inflation partly reflects loan-to-value ratio restrictions, and tighter lending conditions. This moderation is projected to continue, although there is a risk of resurgence given the on-going imbalance between supply and demand.

The increase in headline inflation in the March quarter was mainly due to higher tradables inflation, particularly petrol and food prices. These effects are temporary and may lead to some variability in headline inflation. Non-tradables and wage inflation remain moderate but are expected to increase gradually. This will bring future headline inflation to the midpoint of the target band over the medium term. Longer-term inflation expectations remain well-anchored at around 2 percent.

Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly.

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