Economic Update

June OCR Preview

16 June 2017

Still firmly on hold

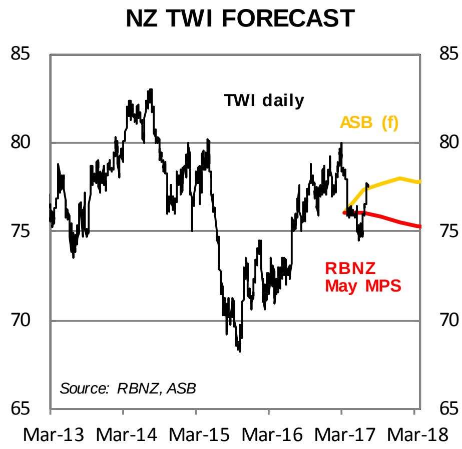
- **We expect the RBNZ to leave the OCR unchanged at 1.75% and maintain a neutral tone in the statement.**
- **On net, developments since May have been largely neutral for the inflation outlook.**
- **However, the RBNZ may tweak its NZD language given that the Trade Weighted Index has lifted again.**

Summary

We expect the RBNZ to leave the OCR unchanged at 1.75% in June. On balance, developments since May have been largely neutral for the inflation outlook. **Fonterra's opening milk price for 2017/18 suggests the dairy sector will be in good stead** next year and the **recent multi-year high in the Terms of Trade (ToT)** will also lift inflation pressures. However, **soft economic growth is calling into question how quickly domestic capacity pressures are rising.**

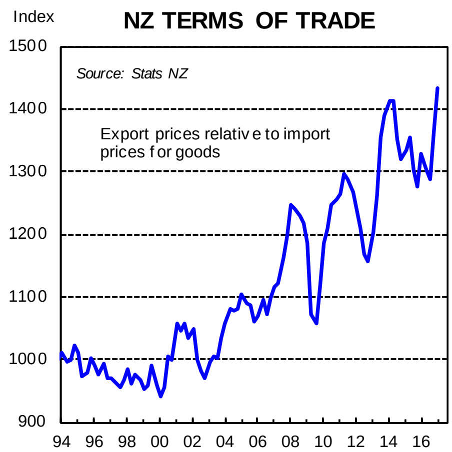
Internationally, **global growth is continuing to improve**, suggesting that excess global supply is easing. However, **offshore political uncertainty has grown** and continues to cast a shadow on NZ's inflation outlook. Further, the **NZ Trade Weighted Index (TWI) is hovering around 78** again, in part due to NZ economic fundamentals but also in part due to the above offshore political events.

As a result, we believe the RBNZ will be comfortable sitting tight. **While we expect the RBNZ to maintain an unchanged neutral tone and policy in the statement, we do expect the NZD language to be tweaked. The RBNZ is likely to reiterate that further depreciation in the NZD is needed to achieve balanced growth**.



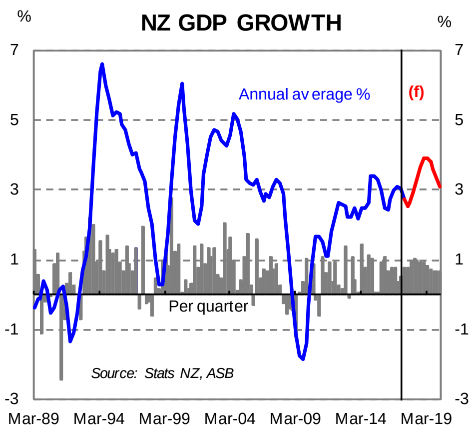
Developments largely neutral for inflation

We expect the RBNZ to view developments since May as being fairly neutral for the inflation outlook. Domestically, **dairy sector confidence will be bolstered by Fonterra's bullish opening season milk price (2017/18) of $6.50/kg.** More broadly, the **multi-year high in the ToT will add to inflation pressure**. However, these impacts are being **offset to a degree by muted near-term GDP growth.** Soft economic growth over H2 2016 resulted in the RBNZ revising capacity pressures lower. Q1's sub-trend reading means that capacity pressures are likely to remain a point of concern for the RBNZ.



On the international front, **global growth is firming** with stronger than expected Q1 GDP releases in both the US and Europe. Further, while still soft, the Chinese economy is continuing to show signs of stability. On this front, **firmer global demand should help to erode excess global capacity pressures** that have been weighing on imported prices in NZ.

However, **political uncertainty has, if anything, grown since May**. Scandals are continuing to rock the Trump administration and the **UK general election has shaken confidence even further in the UK.** While the heightened political uncertainty is unlikely to be influencing the RBNZ's core inflation forecasts, it will undoubtedly **acknowledge that this continues to represent downside risks to the overall outlook.**



Overall, we expect the RBNZ maintain a neutral tone: "*Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly*." However, **the RBNZ may tweak its NZD comments** to reflect the higher TWI. **While NZ economic fundamentals are supporting the NZD, so are global events.** The RBNZ's internal TWI forecast is likely to be similar to May's, but there is a growing risk the TWI remains above that forecast. We expect the RBNZ to note that **further depreciation in the currency is needed to achieve balanced growth.**

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Previous Statement:

May OCR

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 over recent months. However, major challenges remain with on-going surplus capacity and extensive political uncertainty.

Stronger global demand has helped to raise commodity prices over the past year, which has led to some increase in headline inflation across New Zealand's trading partners. However, the level of core inflation has generally remained low. Monetary policy is expected to remain stimulatory in the advanced economies, but less so going forward.

The trade-weighted exchange rate has fallen by around 5 percent since February, partly in response to global developments and reduced interest rate differentials. This is encouraging and, if sustained, will help to rebalance the growth outlook towards the tradables sector.

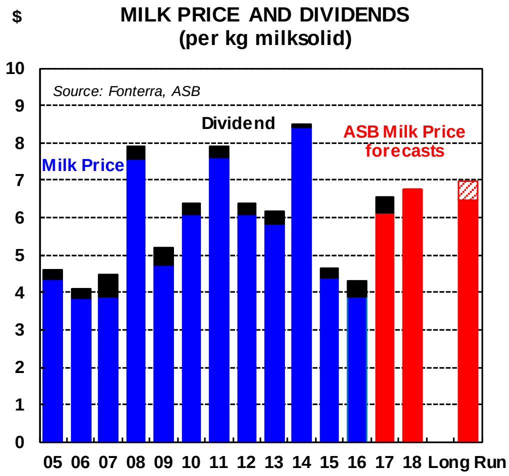
GDP growth in the second half of 2016 was weaker than expected. Nevertheless, the growth outlook remains positive, supported by on-going accommodative monetary policy, strong population growth, and high levels of household spending and construction activity.

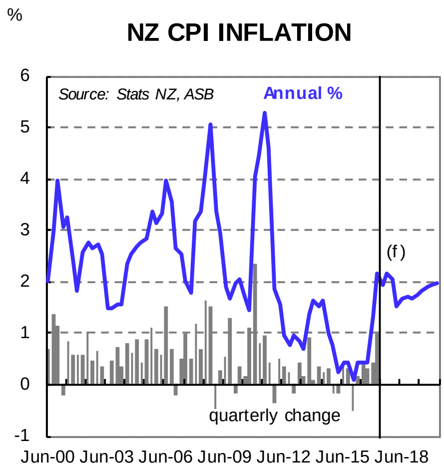
House price inflation has moderated further, especially in Auckland. The slowing in house price inflation partly reflects loan-to-value ratio restrictions and tighter lending conditions. This moderation is projected to continue, although there is a risk of resurgence given the continuing imbalance between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

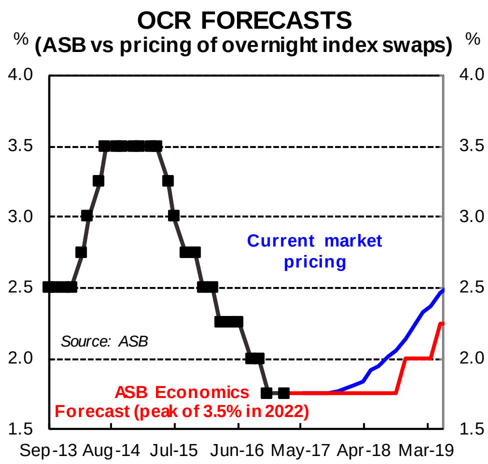
The increase in headline inflation in the March quarter was mainly due to higher tradables inflation, particularly petrol and food prices. These effects are temporary and may lead to some variability in headline inflation over the year ahead. Non-tradables and wage inflation remain moderate but are expected 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.

Developments since the February Monetary Policy Statement on balance are considered to be neutral for the stance of monetary policy.

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







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