Economic Update

August OCR Review — 10 August 2017

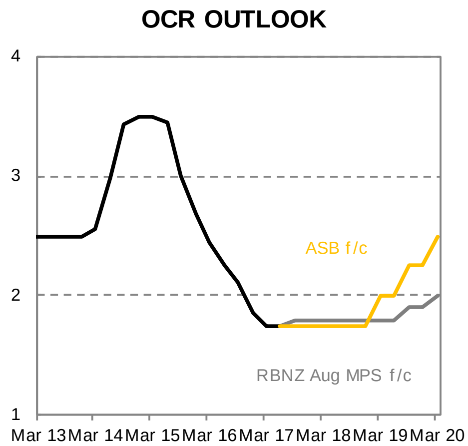
Living on a non-tradable prayer

- **OCR on hold at 1.75% as expected, maintaining the neutral bias of recent statements.**
- **RBNZ's OCR outlook was identical to May's, not as 'dovish' as expected.**
- **We continue to expect a higher OCR from early 2019.**

Summary

The mild surprise in the release was the lack of any shift in the RBNZ's OCR outlook. We had seen a good chance the RBNZ deferred the tightening implied in its forecasts by 3-6 months, to early 2020. On balance we saw the shift in events of the past 3 months as unequivocally to weaker inflation pressures. But, as was the case in May, when the risks seemed to move in the other direction, the RBNZ has held a steady view.

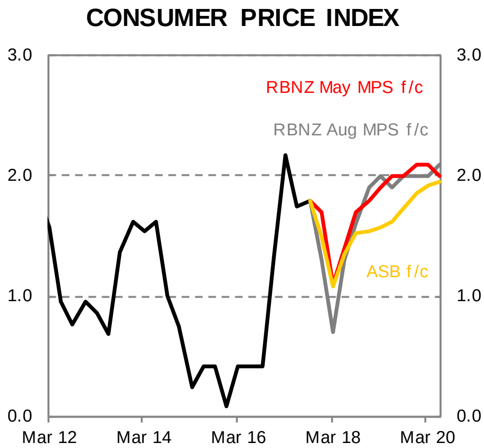
Nevertheless, we still expect the RBNZ will end up lifting the OCR slightly earlier than its forecasts imply, in early 2019. We still judge that the RBNZ is underestimating the stimulatory impact of the recovering dairy sector, and migration inflows risk boosting inflation more than the RBNZ assumes. But with headline inflation set to ease over the next year, the RBNZ will remain cautious for some time yet.



Inflation: banking on non-tradable

The RBNZ remains confident in the inflation outlook, but reiterated that "annual CPI inflation is expected to be variable over the next year," reflecting temporary movements in food and fuel prices. Despite the near-term volatility, the RBNZ continues to see inflation lifting back towards the 2% midpoint of the inflation target in 2018 (slightly earlier than our forecasts currently suggest).

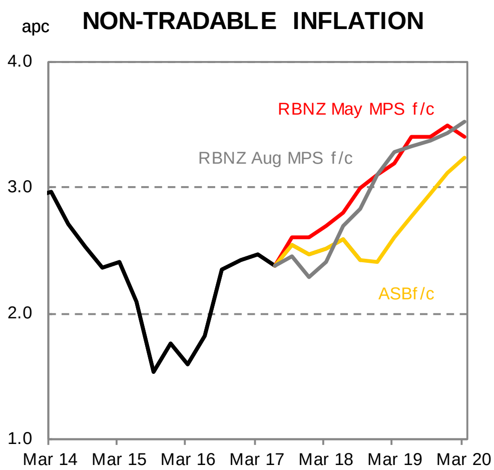
Reading through the MPS, it becomes apparent that the **RBNZ is relying heavily on non-tradable inflation to drive headline inflation back to 2% as soft global conditions suggest that tradable inflation will remain subdued for some time yet.** It also notes that currently, non-tradable inflation is subdued. Given the fact that non-tradable inflation is currently soft, the RBNZ requires "a strong lift in non-tradable inflation" in order for inflation to settle near the target midpoint in the medium term. Further, given the RBNZ sees little inflation pressures coming through higher price-setting behaviour, **above-trend GDP growth is highlighted as a key driver. This suggests that any further softness in GDP growth could result in a downward revision of the RBNZ's inflation forecasts and the OCR being on hold for longer.**



Growth outlook little changed

There was little change in the RBNZ's growth outlook. The RBNZ sees **recent weakness in growth as temporary (as do we),** and notes high-frequency data for Q2 points to some recovery. The RBNZ still expects a recovery led by low interest rates, strong population growth, high Terms of Trade and fiscal stimulus. **We still see upside risk to the RBNZ's medium-term dairy price assumption** and upside risks to the **RBNZ's largely unchanged migration assumption**.

The RBNZ's residential construction outlook was revised down slightly, but still stronger than our own. The RBNZ noted a tightening in capacity and lending criteria, and said residential construction could be weaker than expected if these constraints become more binding.



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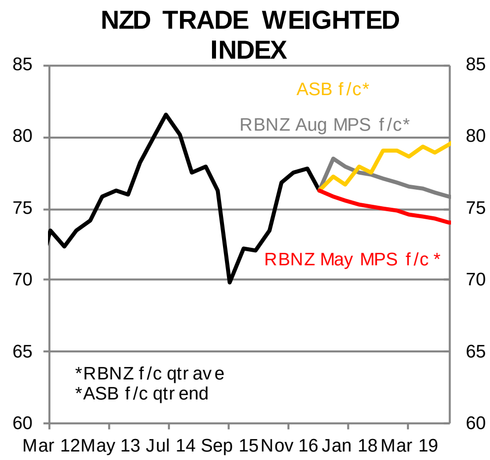
The RBNZ has maintained its conservative dairy commodity assumption; we disagree. The assumption that whole milk powder prices trend towards US$3,000/MT in the medium term has been maintained despite Fonterra's recent upgrade to its milk price forecast to $6.75/kg of milk solids. Moreover**, the RBNZ makes no mention of what we deem to be a structural shift in global milk fat demand**. Admittedly, this demand surge may only lift whole milk powder prices moderately from current levels. However, NZ dairy exporters are likely to substitute whole milk powder for other more profitable products, resulting in higher overall dairy export prices over time. As a result, **we anticipate higher farm incomes, spending and investment over the forecast period relative to the RBNZ.**



In contrast, we broadly agree with the RBNZ's view around the growth outlook for our trading partners. According to RBNZ, "global economic growth has become more broad-based in recent quarters." Nevertheless, "risks around the economic outlook for New Zealand's trading partners remain skewed to the downside."

NZD comments a bit firmer

The RBNZ's language on the NZD was altered in its one-page statement (which receives more attention from financial markets than the full MPS), **in order to express greater concern around the high level of the NZD**. The RBNZ **pivoted focus away from recovering NZ export prices to the role of the weaker USD** in driving the NZD higher. The RBNZ also stated **a lower NZD was "needed"** to increase tradable inflation. In the recent past, the RBNZ has merely said a lower NZD would rebalance growth. However, within the RBNZ's full Monetary Policy Statement, the RBNZ returns to its more usual language, noting the higher NZD was a result of 3 factors: strong foreign investor appetite for NZ assets, the weaker USD and recovery in NZ export prices.

We do see a risk that **the NZD is firmer over time than the RBNZ assumes**, even though it has lifted its 2017 outlook to build in some persistence. A persistently-high NZD would emphasise the importance of non-tradable inflation picking up. But as noted earlier, we judge there are a couple of sources of added inflation pressures the RBNZ is likely to more fully account for in time.

Housing view unchanged and cautious

The RBNZ's outlook on the housing market was relatively unchanged. However, it did question the implications of affordability constraints (especially in Auckland) on future price growth. Despite this, **the Bank remains unsure about how long the current softness might persist for, given the demand shortage.**

Market reaction

The RBNZ's Monetary Policy Statement was less dovish than expected, with the RBNZ leaving the OCR track unchanged vs. wide-held expectations it would be somewhat flatter (with some expecting the OCR hike forecast to be removed altogether). In light of this, the market reaction was surprisingly subdued, with swap rates up 2-3 basis points and the NZD up 10 basis points. However, we may see a stronger market reaction later in the day as the Asian markets open and offshore market participants digest the statement.

Key Rates	8:55am	9:10am	9:35am
NZD/USD	0.7335	0.7348	0.7352
NZD/AUD	0.9301	0.9318	0.9324
NZD/EUR	0.6238	0.6249	0.6251
NZD/JPY	80.73	80.84	80.87
NZD/GBP	0.5639	0.5648	0.5652
NZ TWI	77.54	77.65	77.69
NZ 90 day Bank Bill	1.96	1.96	1.96
NZ 1 year swap rate	2.01	2.01	2.02
NZ 3 year swap rate	2.33	2.34	2.35
NZ 5 year swap rate	2.63	2.65	2.66

RBNZ media release

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

Global economic growth has become more broad-based in recent quarters. However, inflation and wage outcomes remain subdued across the advanced economies, and challenges remain with on-going surplus capacity. Bond yields are low, credit spreads have narrowed and equity prices are at record levels. Monetary policy is expected to remain stimulatory in the advanced economies, but less so going forward.

The trade-weighted exchange rate has increased since the May Statement*, partly in response to a weaker US dollar. A lower New Zealand dollar is needed to increase tradables inflation and help deliver more balanced growth.*

GDP in the March quarter was lower than expected, adding to the softening in growth observed at the end of 2016. Growth is expected to improve going forward, supported by accommodative monetary policy, strong population growth, an elevated terms of trade, and the fiscal stimulus outlined in Budget 2017.

House price inflation continues to moderate due to loan-to-value ratio restrictions, affordability constraints, and a tightening in credit conditions. This moderation is expected to persist, although there remains a risk of resurgence in prices given continued strong population growth and resource constraints in the construction sector.

Annual CPI inflation eased in the June quarter, but remains within the target range. Headline inflation is likely to decline in coming quarters as the effects of higher fuel and food prices dissipate. The outlook for tradables inflation remains weak. Non-tradables inflation remains moderate but is expected to increase gradually as capacity pressure increases, bringing headline inflation to the midpoint of the target range 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.

Read the Monetary Policy Statement

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