Economic Update

February OCR & MPS Preview

2 February 2017

Keep calm and stay on hold

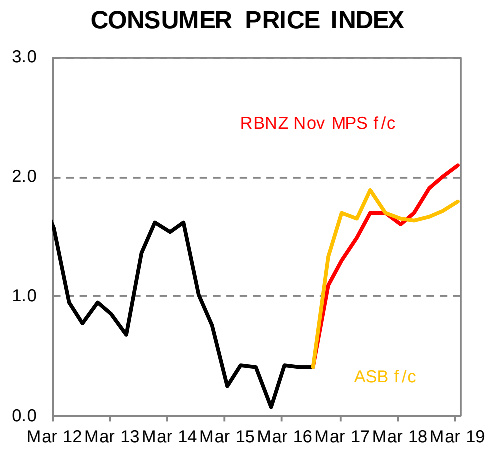
- **We expect the RBNZ to hold the OCR at 1.75% at the February Monetary Policy Statement.**
- **The RBNZ's 2017 inflation estimate is likely to lift considerably, with greater comfort over the outlook.**
- **The OCR track will be widely watched in case the RBNZ flags a distant rate hike.**

Summary

We expect the RBNZ to hold the OCR at 1.75% at the February Monetary Policy Statement, a widely-anticipated outcome. The inflation outlook has firmed since the November MPS, particularly for 2017. This should offer a greater degree of comfort for the RBNZ, with a reduced risk of inflation remaining uncomfortably low in the near term. But there are still a number of risks to the downside for inflation, key among which is the impact of new US President Donald Trump's economic and trade policies on NZ.

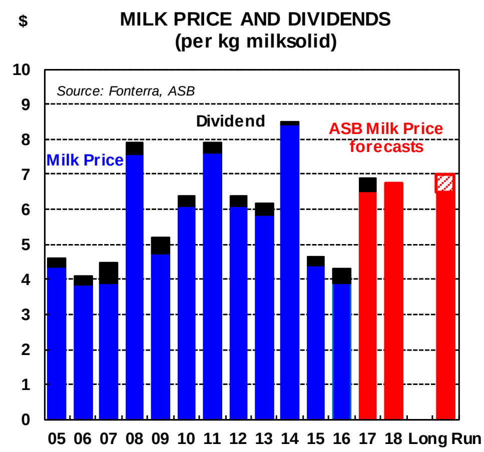
There is scope for the RBNZ to be a little more neutral in its outlook at this meeting, compared to November. This follows the firmer-than-expected Q4 CPI result of 1.3% yoy, the first time inflation moved back inside the target band for over 2 years. Even with a more neutral outlook, we still expect the OCR to remain on-hold through to late 2018.

The tricky balancing-act for the RBNZ will be to express more comfort over the inflation outlook, yet still give a clear message that OCR increases are still a long way off. Failure to strike the right balance could prompt an unwanted reaction from financial markets.



Firmer inflation outlook

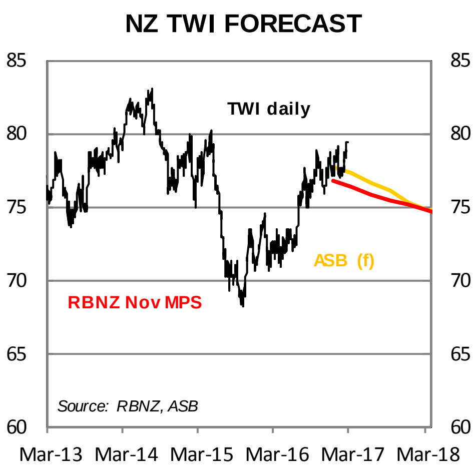
Inflation firmed to 1.3% yoy in Q4, outstripping market and RBNZ forecasts. That wasn't a dramatic surprise in itself, but the composition of the increase did point to a broadening of inflation pressures, including evidence some pricing power is creeping into some retail segments. Our inflation outlook for 2017 shows inflation will now be comfortably close to the 2% mid-point of the target band fairly early in 2017 and persist near 2% thereafter, a much firmer 2017 estimate than the RBNZ envisioned late last year. That paints a different story from expecting to spend most of 2017 with inflation still hanging awkwardly close to 1%, which would have sustained the recent wariness the RBNZ had over the risks of inflation failing to rebound within a comfortable timeframe.



The continued recovery of dairy is another factor. The RBNZ was reluctant to 'bank' gains from dairy in H2 2016. But with Fonterra giving the sector a shot of confidence with its signalled $6/kg milk price forecast, the RBNZ is likely to factor in a greater degree of inflation from an eventual recovery in spending. Household spending has also improved, underlining the momentum in the economy.

Still risks and reasons for caution

Yes, inflation did materially firm at the back-end of 2016 and is set to be near the target mid-point very soon. But the RBNZ will want to see more evidence over time of actual inflation sustaining a firmer level before contemplating OCR increases. Plenty of events could yet stop inflation from holding up around the 2% mark.



Externally, risks lie with new US President Trump, Brexit and European elections. President Trump is expected to be generally positive for growth (at least in the short run) through enacting fiscal stimulus. However, his protectionist policies could dent global growth and, by extension, keep inflation on the back foot. It is a matter of which has the larger impact on NZ.

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Continued New Zealand Dollar strength compared to expectations is also a risk. The Trade Weighted Index has been above the RBNZ's forecast for months now and shows no sign of depreciating towards the RBNZ's forecast yet. Should the NZD retain, or add to, its strength, the downside risks to inflation could increase.

Bank funding costs have increased materially over the last 4 months, resulting in higher mortgage rates. This has effectively created some monetary policy tightening. In addition, deposit growth is being outpaced by loan growth, making domestic funding that much scarcer. This has resulted in higher interest rates for deposits (to attract new funds).

Labour market data show there is very little in terms of wage growth, with migration and extraordinary high labour force participation constraining wage growth in the near term.

What to expect from the RBNZ

We look for the RBNZ to lift its inflation outlook for 2017 much closer to the middle of the 1-3% target band for 2017, perhaps even meeting the middle of that target this year.

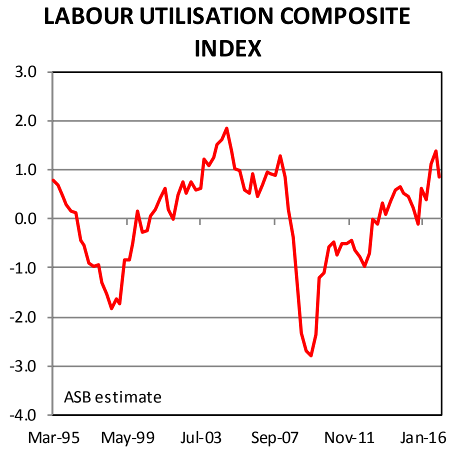
The RBNZ's published OCR track will be much watched. In the November MPS this held at 1.7% through to the end of 2019. Over the near term, we look for this to hold around 1.7-1.8%. A 1.7% outlook would fairly reflect the line-up of near-term uncertainties. It would also gently remind markets that the RBNZ's *current* focus is more on whether or not to cut rates further.

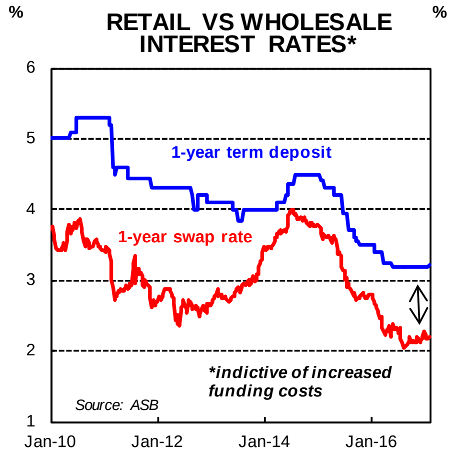
However, 1.8% OCR track should not be a huge shock to markets. It would suggest that, splitting hairs, the RBNZ has a fairly neutral, or even mild tightening bias, still soft against market expectations of a full 25bp hike before year end.

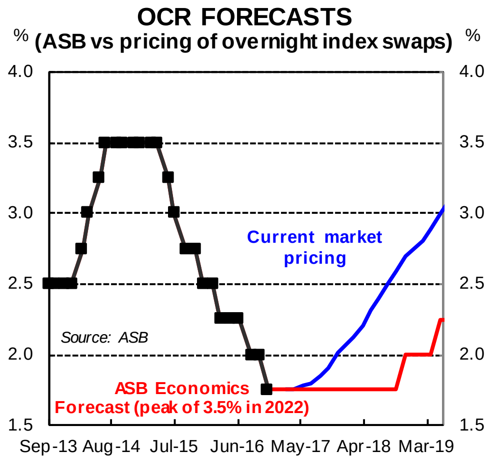
A 1.9% OCR track would be significant, signalling a clear risk of a hike. But we see this scenario as unlikely.

Further out, there is a possibility the end of the OCR track is lifted above 1.7-1.8%. Leaving the OCR on-hold until 2020 now appears unrealistic. Having some tightening in by the end of 2019 is more realistic, and would still be far softer than market pricing. But any hint of as yet higher interest rates risks unwittingly stampeding a market that is already ahead of itself.

The straight-bat approach for the RBNZ is to keep a steady OCR forecast track and comment that policy may need to adjust accordingly to a set of uncertainties that appears to be more balanced than in November's statement.







Previous Statement:

November MPS

The Reserve Bank today reduced the Official Cash Rate (OCR) by 25 basis points to 1.75 percent.

Significant surplus capacity exists across the global economy despite improved economic indicators in some countries. Global inflation remains weak even though commodity prices have come off their lows. Political uncertainty remains heightened and market volatility is elevated.

Weak global conditions and low interest rates relative to New Zealand are keeping upward pressure on the New Zealand dollar exchange rate. The exchange rate remains higher than is sustainable for balanced economic growth and, together with low global inflation, continues to generate negative inflation in the tradables sector. A decline in the exchange rate is needed.

Domestic growth is being supported by strong population growth, construction activity, tourism, and accommodative monetary policy. Recent dairy auctions have been positive, but uncertainty remains around future outcomes. High net immigration is supporting growth in labour supply and limiting wage pressure.

House price inflation remains excessive and is posing concerns for financial stability. Although house price inflation has moderated in Auckland, it is uncertain whether this will be sustained given the continuing imbalance between supply and demand.

Headline inflation continues to be held below the target range by ongoing negative tradables inflation. Annual CPI inflation was weak in the September quarter, in part due to lower fuel prices and cuts in ACC levies. Annual inflation is expected to rise from the December quarter, reflecting the policy stimulus to date, the strength of the domestic economy, and reduced drag from tradables inflation.

Monetary policy will continue to be accommodative. Our current projections and assumptions indicate that policy settings, including today's easing, will see growth strong enough to have inflation settle near the middle of the target range. Numerous uncertainties remain, particularly in respect of the international outlook, and policy may need to adjust accordingly.

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