Economic Update

May OCR & MPS Review

11 May 2017

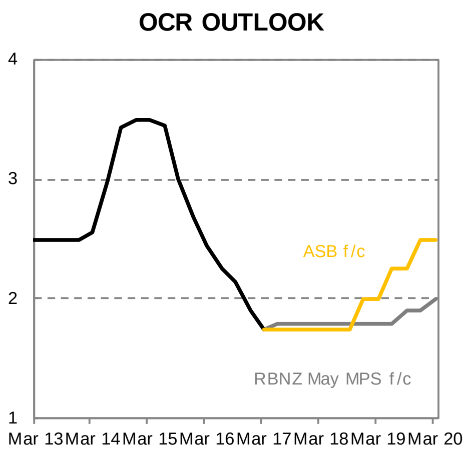
Who let the doves out?

- **OCR on hold at 1.75% as expected, maintaining neutral bias.**
- **The statement was more dovish than expected: events have not shifted the RBNZ's balance of inflation pressures.**
- **We continue to expect a higher OCR from late 2018.**

Summary and Implications

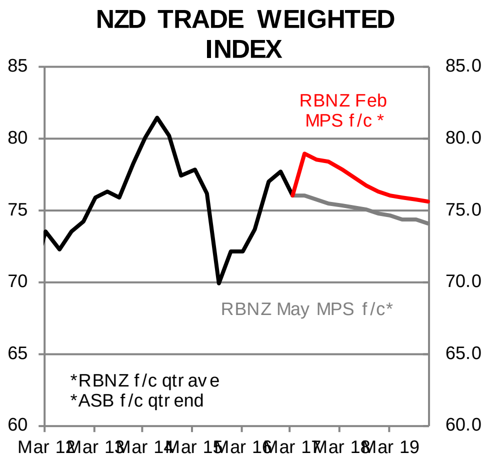
The OCR remained on hold at 1.75% as widely expected. What surprised, though, was that recent events have had a neutral impact on the RBNZ's OCR outlook. To underscore that message, **the RBNZ explicitly said the impact of recent events was "neutral"**. In addition, **the RBNZ's published forecast of the OCR was the same as that published in February**, showing a late 2019 start to the tightening cycle. We had expected the RBNZ would bring forward the implied tightening cycle at least 6 months into the first half of 2019**. The RBNZ's key message remains that there is absolutely no hurry, particularly compared to market pricing, to lift the OCR**.

We still expect, though, that the RBNZ will eventually start lifting the OCR at the end of 2018. We expect inflation pressures will firm earlier than the RBNZ expects, and that inflation's temporary dip in 2018 won't be as far as the RBNZ currently forecasts. But the end of 2018 is still a "considerable" time away, and later than market pricing. The RBNZ's unchanged stance should help anchor NZ short-term interest rates at a low level, though term rates will still be heavily influenced by global ebbs and flows.

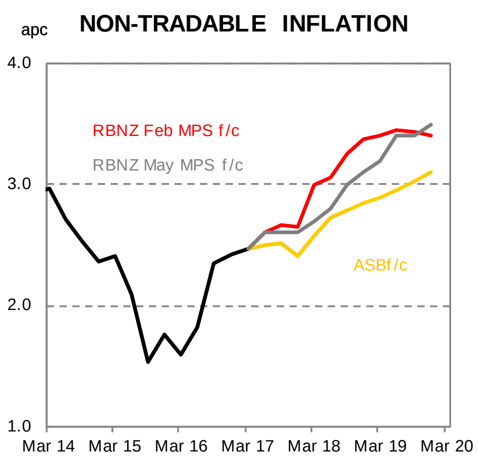


The RBNZ's key forecasts

The key revisions to the RBNZ's outlook reflect the impact of the lower Trade Weighted Index (TWI) and the impact of weaker than expected near-term GDP growth. As expected, the lower TWI results in higher tradable inflation but the lift was slightly less than we expected. Meanwhile, the weaker GDP outcomes in late 2016 result in a substantial revision to the output gap (a measure of capacity pressures) – despite the RBNZ's 2018 growth outlook now being stronger than in the February MPS. This is **a significant downward shift in the RBNZ's view on capacity pressures**. In saying that, this brings the RBNZ closer toward our own view of non-tradable inflation. Nonetheless, the mix of these revisions took ourselves, and likely others, by surprise.



Like recent statements **the RBNZ assumes a modest level for dairy prices over the medium term**. That is, the RBNZ has whole milk powder prices settling at USD 3,000 per tonne from over USD 3,200 per tonne at the most recent dairy auction. In contrast, we use USD 3,500 per tonne as our medium-term assumption. Hence **as a result of higher dairy sector incomes, we have built in higher business investment and higher consumption compared to the RBNZ**.



Inflation pressures still picking up over time

The RBNZ noted that while inflation had increased sharply over the past two quarters, much of this strength was only temporary. **Overall, the RBNZ continues to see the balance of risks around the inflation outlook as largely balanced.** An improved global growth outlook has contributed to the RBNZ slightly lifting its tradable inflation forecasts. However, on the domestic front, as noted above the RBNZ has lowered its estimate of domestic capacity pressures and non-tradable inflation forecast.

The RBNZ is confident that inflation expectations remain anchored around the mid-point of the inflation target band. While it noted the recent lift in inflation expectations, it stated that this was consistent with the recent increase in headline inflation.

Once again, **the RBNZ highlighted the subdued pace of wage growth**, which is in part attributed to the impact of low past inflation. However, the RBNZ's Labour Utilisation Composite Index does suggest the labour market is tightening.

Global: Let's be careful out there

As noted, the RBNZ sees an **improved global growth outlook**. But, even though risks around the **risks to the international outlook have reduced, they remain skewed to the downside**. Indeed, the RBNZ discusses in detail the role of uncertainty and its macroeconomic impact. While uncertainty around recent trading partner growth forecasts, for example, has reduced, uncertainty around economic policy has spiked. In this regard, events like Brexit and US President Trump's policy proposals are likely to feature heavily in the RBNZ's policy thinking.

Take it easy

Given that the risks to the inflation outlook remain largely balanced, the RBNZ stated that "the OCR is expected to remain low for a prolonged period." The more pertinent risk for markets to heed at present is that **the RBNZ warns that tightening monetary policy too quickly risks headline inflation remaining below 2% over the medium term.** On the other hand, it notes that easing monetary policy in order to lift non-tradable inflation faster would cause unnecessary volatility.

NZD decline welcome, but it's still high

As expected, **the RBNZ was encouraged by the continued decline of the NZD**, noting that if the fall is sustained it will assist in rebalancing the economy. Even so, **the RBNZ still considers the currency to be "high by historical standards"**.

Market reaction

The more-dovish-than-expected statement saw the NZD fall against most major currencies we monitor, taking the TWI down to 75 shortly after the release. **Interest rates also dipped following the release** with the 3-year swap rate coming off 4bp and the 5-year swap rate falling a more modest 2bp. Market pricing has only moved out a touch so far, pushing out the first rate hike to May 2018 from March 2018.

Key Rates	8:50am	9:10am	9:40am
NZD/USD	0.6924	0.6841	0.6850
NZD/AUD	0.9402	0.9303	0.9312
NZD/EUR	0.6372	0.6296	0.6304
NZD/JPY	79.12	78.21	78.32
NZD/GBP	0.5351	0.5288	0.5296
NZ TWI	75.88	75.00	75.10
NZ 90 day Bank Bill	1.99	1.99	1.99
NZ 1 year swap rate	2.09	2.07	2.06
NZ 3 year swap rate	2.58	2.57	2.54
NZ 5 year swap rate	2.94	2.93	2.92

RBNZ Statement:

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.

View the full Monetary Policy Statement here.

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