Economic Note

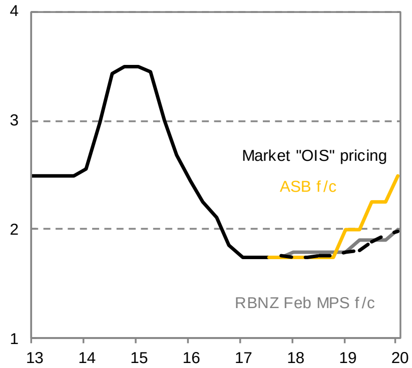
February OCR and MPS Preview

8 February 2018

Recycling statements

- OCR on hold at 1.75% in a statement of little change, including the policy assessment and OCR forecasts.
- The inflation outlook is lower over 2018, as we expected, and marginally lower over 2019. But medium-term inflation is tracking close to the mid-point of the target band from mid-2019.
- Our expectations are for a sustained period of subdued inflation – the risk is the OCR lifts later than our long-held view of February 2019.

OCR OUTLOOK



Summary

The new Government is bringing a greater focus on economic and environmental sustainability, and the RBNZ has taken this to heart in **a Monetary Policy Statement (MPS) that recycles the policy bias and interest rate forecasts from its November MPS.**

No-one will have been surprised the RBNZ kept the Official Cash Rate on hold. **The interest was more in how the RBNZ would interpret the implications of extensive upward revisions to the past three years of growth, as well as the recent weak inflation outcome.**

On the back of the extensive upward growth revisions published late last year, the RBNZ has revised up its 'speed limit' for economic growth, one contributor to the RBNZ's slightly lower inflation outlook for 2018 and 2019. But as the RBNZ's forecasts stand, **the RBNZ still has inflation comfortably tracking close to the 2% target mid-point from June 2019.** On the back of that, **the RBNZ's outlook for interest rates hasn't changed: low for a considerable period.** But, also, there were no overt concerns that inflation may need another nudge higher from further OCR cuts.

As we finalise our own Quarterly Forecasts, a clear theme of inflation remaining lower for longer is emerging. There is some risk that the first OCR hike may come later than our long-held view of February 2019. There is a lot of water to run under the bridge anyway until the RBNZ needs to lift interest rates: a new Governor, an added monetary policy objective, and the continued bedding in of a new government and fine-tuning of what that means for future inflation pressures.

Growth outlook, for want of a better word, is good

The RBNZ's GDP forecasts are broadly similar to our own. The RBNZ continues to expect growth to strengthen on the back of low interest rates, high Terms of Trade, government spending and population growth. The RBNZ notes that **compared to the November Statement, the growth profile is weaker in the near term but stronger in the medium term**. Some of this revision reflects the impact of historical GDP revisions (see below), but also some fine tuning of its

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initial estimates of the incoming Government's policies. The RBNZ also expects the stimulatory impact of transfers and allowances to be more short-lived than previously estimated. **Recent weakness in business confidence, and any growth impact, is expected to be short-lived.**

We broadly agree with the RBNZ's relatively optimistic view around our trading partner growth outlook for and its view on global trade**. According to the RBNZ, "economic growth in major trading partners has continued to strengthen since the November Statement."** Meanwhile, the RBNZ also notes that "the risks to the global growth outlook appear balanced over the medium term." On commodity prices, while we do not quibble with the assumption that whole milk powder prices remain around US$3,000 per tonne, we think it is the broader basket of dairy commodity prices that matters for farmer incomes – including strong butter prices. The flow-on effects to farm incomes and spending may be stronger than the RBNZ anticipates.

KiwiBuild is not expected to boost residential investment until 2019. Even though the RBNZ has trimmed its building outlook for 2018, **we are still wary that the RBNZ is over-estimating future residential building growth**. We have long said that construction sector capacity constraints were a downside risk to the RBNZ's residential construction forecasts, and there are some signs the RBNZ is putting more weight on these. Moreover, as the RBNZ noted: "there is a risk that KiwiBuild has a smaller effect on residential investment if private sector developments are delayed."

Historical growth revisions matter

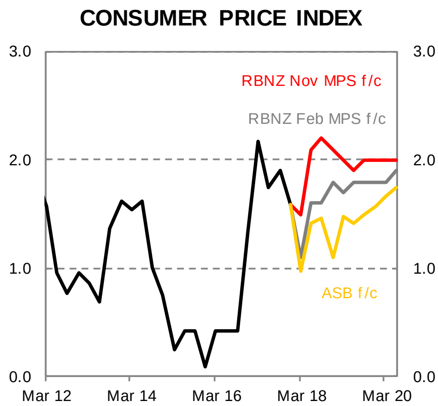
Historical GDP growth revisions by Stats NZ at the end of last year means that GDP growth was stronger than previously thought over recent history. How the RBNZ treated this revision was a key uncertainty heading into the MPS. **The RBNZ appears to see most of this upward revision as contributing to higher potential growth (the speed limit for growth).** The higher view of potential growth along with the new GDP growth profile means that the historical output gap (implied measure of spare capacity) estimate was revised only slightly higher, but **the output gap forecast over 2018 and early 2019 was revised lower** due to weaker near-term growth.

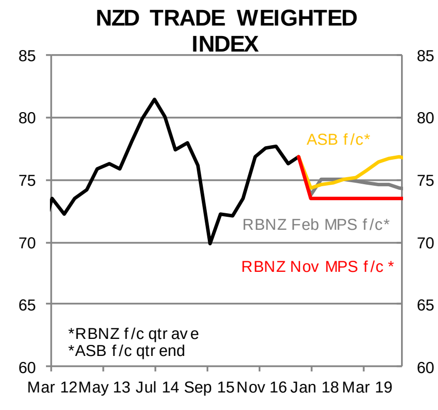
Inflation still near the target mid-point

Despite the soft inflation outcome for Q4 2017, the RBNZ remains confident that inflation will lift back to the 2% midpoint of the inflation target band. As in the November MPS, the RBNZ assumes the majority of the inflation pressure will come from domestically-generated inflation, with tradables inflation expected to remain muted over the medium term.

The RBNZ points to rising wages and tightening capacity pressures as the key drivers of higher inflation over the forecast period. However, the combination of a lower starting point and one year of free tertiary education means that the RBNZ is not forecasting the CPI to reach 2% until September 2020, a full 12 months later than forecast in November. This is more in line with our own forecasts, although the RBNZ still has inflation within coo-ee of the target mid-point from mid-2019. The net impact of the recent historical GDP revisions and a slightly weaker near-term growth outlook imply slightly more spare capacity in place over 2018 and 2019, helping explain the RBNZ's slightly lower inflation view for those years.

The RBNZ forecasts have the higher NZD starting point, with the NZD TWI assumed to decline from 75 in Q1 to 73.5 over the projection period. The MPS highlighted, both, upside and downside risks to the NZD outlook. The Nov MPS assumed a TWI of 73.5 over the projection period.





It's a long road to higher inflation…

While the RBNZ's timing of when the CPI reaches 2% is now more in line with our own view, our CPI forecasts over

2018/19 remain softer than the RBNZ's (~ 1.4% vs. ~1.8%). In our view, there is a risk the RBNZ will be surprised by softer than expected inflation outturns over the next two years. One driver of this departure is our higher NZ dollar forecasts, based on the assumption that structural factors will continue to be NZD-supportive. Our forecasts also highlight a risk that inflation expectations could soften again, which could cause the RBNZ to reassess the inflation outlook and timing of potential OCR hikes.

…and the roadmap is higher wages

The RBNZ noted that both the demand and supply sides of the labour market have experienced "considerable growth". **The MPS projections assume that employment growth will continue to outstrip that of the labour force**, resulting in a decline in the unemployment rate over the projection, with the unemployment rate plateauing at just over 4% in the second half of 2020.

That outlook is below current RBNZ estimates of the non-accelerating inflation rate of unemployment (NAIRU), which are in the vicinity of 4.7%. **The RBNZ assumes that the tightening in capacity pressure, increases in the minimum wage, and rising headline inflation are expected to increase wage growth over the projection**. Increases in the private sector Labour Cost Index are forecast to gradually firm from around 2% at the start of the projection period to 2.7% by June 2020. **This is a key assumption for the RBNZ, with the February MPS expecting an increase in domestic inflation** to bring overall inflation back to around the midpoint of the Bank's target range.

In light of the looming inclusion of some sort of employment objective for the RBNZ, the RBNZ's estimate of the NAIRU is interesting. Being more explicit on employment objectives runs the potential risk of conflict with the inflation objective.

Market reaction

The brunt of the market reaction was seen in a weaker NZD, while interest rates movements were more limited. The NZD dropped 35 points against the USD and AUD, with small falls in wholesale NZD interest rates.

Key Rates	8:55am	9:10am	9:40am
NZD/USD	0.7259	0.7227	0.7223
NZD/AUD	0.9274	0.9236	0.9230
NZD/EUR	0.5910	0.5887	0.5889
NZD/JPY	79.38	79.14	79.19
NZD/GBP	0.5228	0.5209	0.5204
NZ TWI	74.77	74.46	74.42
NZ 90 day Bank Bill	1.92	1.92	1.92
NZ 1 year swap rate	1.98	1.98	1.98
NZ 3 year swap rate	2.39	2.39	2.39
NZ 5 year swap rate	2.74	2.74	2.74

February 2018 MPS RBNZ media release

Statement by Reserve Bank Acting Governor Grant Spencer:

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

Global economic growth continues to improve. While global inflation remains subdued, there are some signs of emerging pressures. Commodity prices have increased, although agricultural prices are relatively soft. International bond yields have increased since November but remain relatively low. Equity markets have been strong, although volatility has increased recently. Monetary policy remains easy in the advanced economies but is gradually becoming less stimulatory.

The exchange rate has firmed since the November Statement, due in large part to a weak US dollar. We assume the *trade weighted exchange rate will ease over the projection period.*

GDP growth eased over the second half of 2017 but is expected to strengthen, driven by accommodative monetary policy, a high terms of trade, government spending and population growth. Labour market conditions continue to tighten. Compared to the November Statement, the growth profile is weaker in the near term but stronger in the medium term.

The Bank has revised its November estimates of the impact of government policies on economic activity based on Treasury's HYEFU. The net impact of these policies has been revised down in the near term. The Kiwibuild programme contributes to residential investment growth from 2019.

House price inflation has increased somewhat over the past few months but housing credit growth continues to moderate.

Annual CPI inflation in December was lower than expected at 1.6 percent, due to weakness in manufactured goods prices. While oil and food prices have recently increased, traded goods inflation is projected to remain subdued through the forecast period. Non-tradable inflation is moderate but expected to increase in line with increasing capacity pressures. Overall, CPI inflation is forecast to trend upwards towards the midpoint of the target range. Longer-term inflation expectations are well anchored at 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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