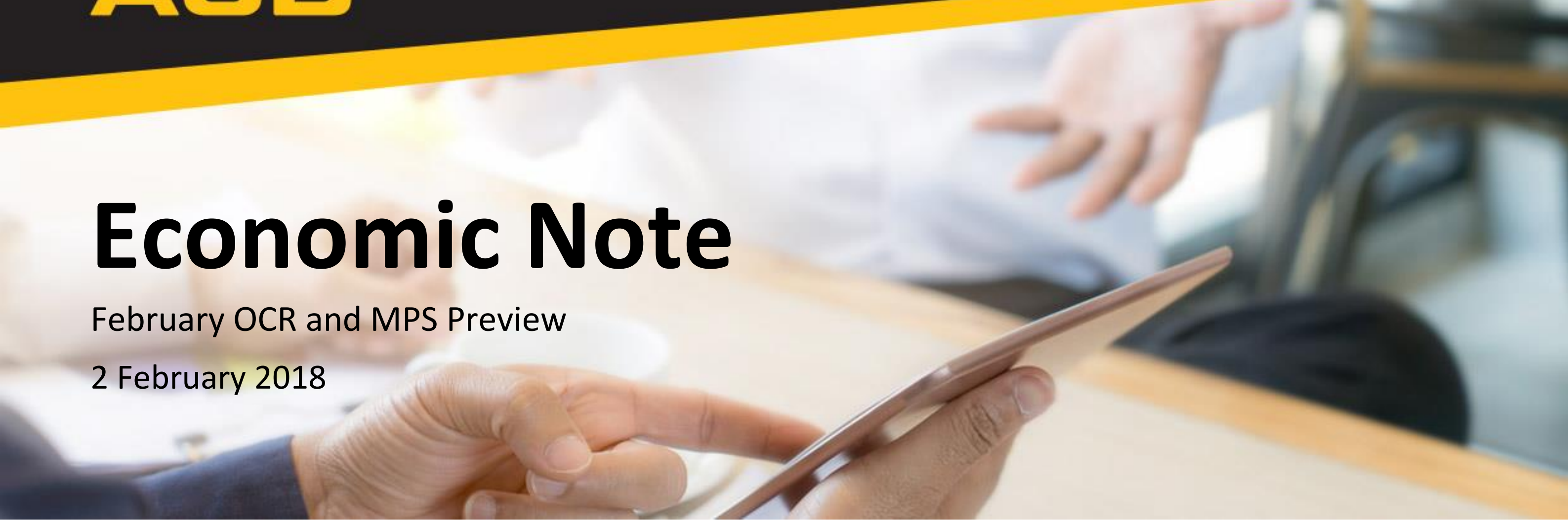

Economic Note

February OCR and MPS Preview

2 February 2018

On message

- The RBNZ is widely expected to leave the OCR on hold at 1.75%, depict a balanced assessment and continue to emphasise that interest rates are likely to remain low for a considerable period.
- With changes to the monetary policy framework pending and with Adrian Orr set to start as Governor in March, the RBNZ is expected to keep changes to a minimum.
- The published forecasts should depict a solid outlook for economic outlook. The low inflation starting point and higher than expected NZD could result in marginal downward tweaks in the published Official Cash Rate profile, but given pending changes in the monetary policy framework, financial markets should tread cautiously on drawing too much into any tweaks.

Summary

With Adrian Orr set to take up the reins in March, with a new Policy Targets Agreement (PTA) yet to be signed, and with the monetary policy review underway, there little need for the RBNZ to offer anything more than an update on where it sees inflationary pressure heading. The RBNZ is likely to keep its policy assessment similar to previous statements by delivering a broadly neutral assessment, highlighting the various uncertainties over the outlook and emphasising that interest rates will remain low for a considerable period.

The brighter global outlook and widespread number of supports to the domestic economy should keep the tone of the policy assessment reasonably upbeat, with a solid outlook for domestic economic activity depicted in the published forecasts. Concrete details on much of the new Government's policy programme are still sketchy and are unlikely to markedly shift from estimates the RBNZ made back in November. **The short-term inflation outlook, however, is expected to be somewhat weaker than the Bank had forecast in November** and there is the risk that the published interest rate track will be shaded down relative to November. **However, due to pending changes in the monetary policy framework, financial markets would be best to interpret the rate profile cautiously.**

Policy details still murky

In our last MPS preview, we noted that with shifting goal posts, a new captain(s) and a new referee, the RBNZ could possibly be playing a very different game in 2018. As such, there was little need for the RBNZ to substantively change its policy messages for now. Whilst the RBNZ did surprise us in the November Monetary Policy Statement (MPS) and provide rough estimates of the potential impact of the new Government's policies, the OCR track and the tone of the statement was virtually a carbon copy on the August MPS. **With the monetary policy review still underway, with new Governor Adrian Orr not due to start until later next month, and with the new Policy Targets Agreement (PTA) yet to be signed, we expect the policy assessment of the February statement to be in a similar vein.**

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Key areas where the Government's policies will impact on the inflation outlook will be likely re-examined in the February statement. Areas include updated estimates of the degree of fiscal stimulus, immigration policy changes, housing policy changes, a likely Auckland fuel tax, and the proposed lift to the minimum wage. The RBNZ fiscal policy estimates will be updated with December's Half Year Update projections, which signal that fiscal settings (as proxied by the Treasury fiscal impulse) will be expansionary, both this year and next. There have been a number of announcements from the Government on its "100-day plan", but aside from some tweaks to industrial relations policy (keeping the 90-day employee work trial period for smaller enterprises) and the introduction of a regional fuel tax for Auckland (from July 2018) **there is not much additional detail from which to add substantive changes from the initial RBNZ estimates.**

Lower inflation but still-solid growth expected

We expect the RBNZ to remain reasonably upbeat on the economic outlook. The global outlook has continued to strengthen. **Growth momentum has been broadly consistent with RBNZ forecasts**, although upward historical revisions to GDP are expected to firm estimates of starting point capacity pressures at the margin. Some of the cyclical drivers - the goods Terms of Trade, net immigration, construction sector activity – may be close to (or past) their peaks, but are expected to remain at elevated levels. The economy in general still has reasonable momentum overall. The fiscal stance is expansionary, with the incomes package and the tight labour market expected to underpin household spending despite the cooler housing market.

We will be closely following how the RBNZ depicts and interprets the inflation outlook. The November MPS had annual headline CPI inflation moving to around 2% by Q2 this year. This looks to be a stretch considering the Q4 2017 inflation surprise (at 1.6% yoy below the 1.8% yoy RBNZ forecast), and the likely impact of the stronger than expected NZD (roughly 2% higher on a TWI basis than the 73.5 RBNZ assumption). We expect the RBNZ to revise its 2018 CPI inflation forecasts modestly lower, although not to the circa 1% level we expect by the end of the year. The RBNZ would likely have been reassured that most of the downward inflation surprise was via lower tradable prices and that annual non-tradable inflation has remained "sticky" at around 2½%. Nevertheless, the RBNZ's preferred measure of core inflation has been below the 1-3% inflation target midpoint since 2009.

Low for longer OCR message to be emphasised.

The RBNZ is widely expected to keep the tone of its policy assessment reasonably balanced, highlight the various uncertainties on the outlook, and emphasise that interest rates will remain low for a considerable period. As such, we expect the policy assessment to retain the key last sentence: "Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly".

Changes are on the horizon, but we expect Acting Governor Spencer to adhere to the spirit of the existing PTA. Accordingly, the February statement will provide an update of the factors impacting on the medium-term inflation outlook after taking into account wider 4b criteria in the current PTA, including the efficiency and soundness of the financial system and avoiding unnecessary instability in the wider economy, interest rates and the exchange rate. There could be more discussion on the labour market in the statement, but only insofar as it applies to its impact on wider economic stability and medium-term inflation.

Market focus will, nonetheless, gravitate to the forecasts, most notably the published OCR track. We see little need for the RBNZ to markedly shift its OCR forecasts, barring some fine-tuning as a result of the stronger NZD and the weaker near-term inflation outlook. These factors (with the latter a very recent development) could see a minor pushing back of the timing of the first OCR hike (late 2019 according to the November *MPS*) and a fractionally lower OCR endpoint (currently 2.30% by late 2020). **Given the pending changes to the framework, however, financial markets would be best to interpret any changed to the rate profile cautiously.**

November 2017 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, although inflation and wage outcomes remain subdued. Commodity prices are relatively stable. Bond yields and credit spreads remain low and equity prices are near record levels. Monetary policy remains easy in the advanced economies but is gradually becoming less stimulatory.

The exchange rate has eased since the August Statement and, if sustained, will increase tradables inflation and promote more balanced growth.

GDP in the June quarter grew broadly in line with expectations, following relative weakness in the previous two quarters. Employment growth has been strong and GDP growth is projected to strengthen, with a weaker outlook for housing and construction offset by accommodative monetary policy, the continued high terms of trade, and increased fiscal stimulus.

The Bank has incorporated preliminary estimates of the impact of new government policies in four areas: new government spending; the KiwiBuild programme; tighter visa requirements; and increases in the minimum wage. The impact of these policies remains very uncertain.

House price inflation has moderated due to loan-to-value ratio restrictions, affordability constraints, reduced foreign demand, and a tightening in credit conditions. Low house price inflation is expected to continue, reinforced by new government policies on housing.

Annual CPI inflation was 1.9 percent in September although underlying inflation remains subdued. Non-tradables inflation is moderate but expected to increase gradually as capacity pressures increase. Tradables inflation has increased due to the lower New Zealand dollar and higher oil prices, but is expected to soften in line with projected low global inflation. Overall, CPI inflation is projected to remain near the midpoint of the target range and 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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