Economic Update
February MPS Review
9 February 2017

Neutral but wary

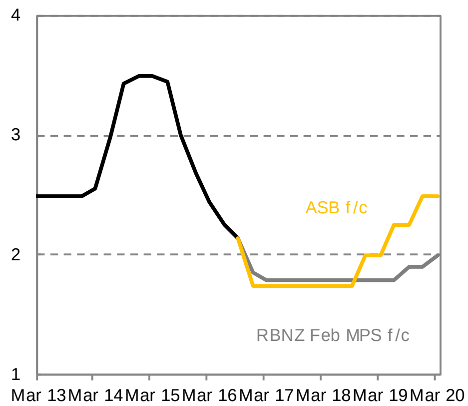
- **OCR on hold at 1.75% as expected, with a broadly neutral bias.**
- **Global uncertainty remains the clear and present danger.**
- **RBNZ emphasizes there is no hurry to raise the OCR: we see a late 2018 start.**

Summary and Implications
The OCR is on hold at 1.75% as widely expected. The policy bias is the same as in November: "Numerous uncertainties remain, particularly in respect of the international outlook, and policy may need to adjust accordingly." The RBNZ sees the **global environment as a key downside risk**.

The RBNZ's own OCR projections show the OCR remaining at 1.8% well into 2019, effectively a neutral stance. The RBNZ's outlook has a 25bp hike built in by early 2020. **The flagging of a distant tightening is more realistic. But it should not be taken as a sign of an imminent tightening,** given the RBNZ remains concerned about the high NZ dollar and sees the lift in long-term interest rates as an effective tightening.

We continue to view OCR increases as a long way off, towards the end of 2018. The RBNZ also noted premature tightening could undermine growth and stall the expected increase in inflation. In contrast, market pricing implies an early 2018 start, though has taken some heed of the RBNZ's caution.

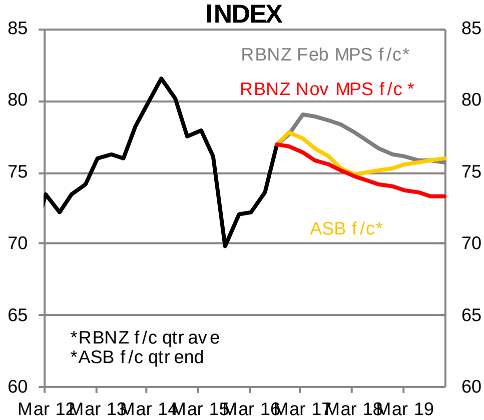
OCR OUTLOOK



Global: better but risky
The RBNZ sees the global economy as continuing to be a downward drag on NZ inflation pressures. While near-term growth prospects have improved, global risks remain skewed to the downside. In particular, **the RBNZ highlighted the uncertainties from US policy developments, Brexit and euro area elections.**

The RBNZ labels the impact of **higher long-term rates as a tightening in NZ financial conditions**, as they reflect global drivers and not expectations for improved NZ conditions. The RBNZ again noted that the **NZD is "higher than sustainable"** and that deprecation in the currency is needed. It has lifted the outlook for the Trade Weighted Index (TWI) to account for recent strength.

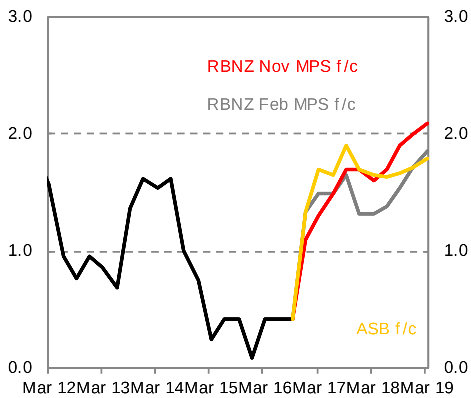
NZD TRADE WEIGHTED INDEX



Domestic growth solid
The RBNZ revised its growth outlook higher for 2017 and 2018, although continues to project a sharper slow-down in growth compared to ASB in 2019 and 2020. On the domestic front, the RBNZ appears relatively happy with how the economy is evolving. Growth is lifting due to accommodative monetary policy and high population growth. The RBNZ sees the key upside risk to the growth outlook as stronger net demand from net migration than we are currently seeing.

The RBNZ has assumed that some of the recent dairy price gain is temporary and, as in the November MPS, has whole milk powder prices settling at USD 3,000 per tonne. **In contrast, we see more of the dairy price shift as permanent** (more in line the RBNZ's upside scenario for export prices). Hence, as a result of higher dairy sector incomes, **we have built in higher business investment and higher consumption growth compared to the RBNZ.**

CONSUMER PRICE INDEX



While we have stronger consumer spending growth than the RBNZ, the RBNZ sees the risk around this sector as broadly balanced. Indeed, the RBNZ included two scenarios highlighting the upside and downside risks to consumer spending. The wealth effect (from recent house price gains) or

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stronger incomes from export prices could see stronger growth than projected. Meanwhile global uncertainty, a fall in commodity prices or household debt sustainability concerns could result in weaker consumer spending.

Inflation pressures picking up

The RBNZ appears confident that inflation will remain comfortably within the 1-3% target band, gradually lifting towards 2% by 2019. However, the RBNZ sees domestic, rather than imported, inflation as the key inflation driver going forward. The RBNZ is also less concerned about inflation expectations weighing down inflation.

On the domestic front, **capacity pressures are expected to continue to support a gradual increase in non-tradable inflation**. The RBNZ notes that capacity pressures are particularly tight in the construction sector.

Strength in the NZD is expected to continue to weigh on tradable inflation, keeping imported inflation below historical averages for some time. **The RBNZ's inflation forecast track also shows a temporary dip in inflation in late 2017**, on a combination of the high exchange rate and volatility in fuel prices.

While the RBNZ's inflation forecasts are more muted than our own, we also see non-tradable inflation as the driving force behind inflation returning to 2% over the next few years.

Market reaction:

The RBNZ's statement reminded market participants that rate hikes are some way off, although the reaction in interest rates was modest. **Longer-term interest rates nudged lower by 4 basis points**. The market has moved from having a rate hike largely priced in by the end of the year, to a 50% chance. The **NZD fell around 45 points** against the USD and around 60 points against the AUD.

Key Rates	8:55am	9:20am	9:50am
NZD/USD	0.7306	0.7261	0.7259
NZD/AUD	0.9570	0.9516	0.9507
NZD/EUR	0.6838	0.6794	0.6791
NZD/JPY	81.90	81.36	81.37
NZD/GBP	0.5834	0.5797	0.5792
NZ TWI	79.74	79.28	79.22
NZ 90 day Bank Bill	2.03	2.03	1.98
NZ 1 year swap rate	2.12	2.10	2.10
NZ 3 year swap rate	2.65	2.64	2.61
NZ 5 year swap rate	3.01	3.00	2.97

RBNZ Statement:

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

The recovery in commodity prices and more positive business and consumer sentiment in advanced economies have improved the global outlook. However, major challenges remain with on-going surplus capacity in the global economy and rising geo-political uncertainty. Global headline inflation has increased, partly due to rising commodity prices. Global long-term interest rates have increased. Monetary policy is expected to remain stimulatory, but less so going forward, particularly in the US.

New Zealand's financial conditions have firmed with long-term interest rates rising and continued upward pressure on the New Zealand dollar exchange rate. The exchange rate remains higher than is sustainable for balanced growth and, together with low global inflation, continues to generate negative inflation in the tradables sector. A decline in the exchange rate is needed.

Economic growth in New Zealand has increased as expected and is steadily drawing on spare resources. The outlook remains positive, supported by ongoing accommodative monetary policy, strong population growth, increased household spending and rising construction activity. Dairy prices have recovered in recent months but uncertainty remains around future outcomes.

Recent moderation in house price inflation is welcome, and in part reflects loan-to-value ratio restrictions and higher mortgage rates. It is uncertain whether this moderation will be sustained given the continued imbalance between supply and demand. Headline inflation has returned to the target band as past declines in oil prices dropped out of the annual calculation. Inflation is expected to return to the midpoint of the target band gradually, reflecting the strength of the domestic economy and despite persistent negative tradables inflation. Longer-term inflation expectations remain well-anchored at around 2 percent.

Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain, particularly in respect of the international outlook, and policy may need to adjust accordingly.

View the full Monetary Policy Statement here.

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