ASB

Economic Note

Preview of RBNZ August OCR and MPS Review

2 August 2018

Higher and lower

- Near-term inflation looks to be firmer, but medium-term inflation pressures appear lower, with more negative risks on the horizon.
- Watch for RBNZ comfort about the near term but caution about the longer-term inflation outlook.
- Expect the RBNZ to indicate it is clearly on hold, with OCR hikes remaining just as distant.

The main messages from the RBNZ's August Monetary Policy Statement (MPS) will be that **Official Cash Rate (OCR) hikes remain ever distant, with a neutral stance conveyed** and preparedness to move the OCR in either direction. **There will, nonetheless, be some shifts in the RBNZ's assessment of inflation**. The near-term outlook is likely to have CPI inflation back around the middle of the inflation target much quicker than previously anticipated. But we expect the RBNZ to counterbalance this by noting that medium-term inflation pressures will build more slowly than previously anticipated. Many of the key judgements the RBNZ made in preparing its May MPS have shown a tilt downwards in their risks to the inflation outlook.

We expect the RBNZ's OCR forecasts to remain very similar to May's, continuing to imply a late 2019 start to OCR hikes, with a mild tightening profile thereafter. Risks are tilted to a pushing out of the OCR profile as capacity pressures look to be slower to build up. It will also be interesting to watch the language the RBNZ uses to describe how long the OCR is likely to stay where it is: the June statement implied less confidence of a long time without a move (which we interpreted as the RBNZ being slightly more open about cutting the OCR if needed).

Near-term inflation higher

Anyone filling up their vehicle in recent months would have noticed that the combination of higher oil prices and a weaker NZD/USD has significantly pushed up retail fuel prices. That goes more so for Auckland motorists now paying an extra 11.5 cents/litre due to the new regional fuel tax, though from an inflation outlook perspective the tax has already been factored in by the RBNZ.

As we showed in our note last week, the lower NZD/USD (currently 68 US cents as opposed to just below 74 US cents in mid-April), increases in fuel taxes, and the higher minimum wage are likely to see headline CPI inflation approach 2% far sooner than the start of 2020 view assumed by the RBNZ in May. Undoubtedly, underlying inflation pressures will still need to firm over time to sustain annual inflation above 2%. But we note that the most significant result from the recent Q2 CPI release was that the RBNZ's core inflation measure – the sectoral factor model – rose to a 7-year high (+1.7% yoy) and is now showing a distinct upward trend. The swifter return to a more moderate inflation rate will make the RBNZ comfortable that inflation expectations will help – rather than hinder – the RBNZ in meeting its inflation target.

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But medium-term inflation pressures lower?

Offsetting the current bump up in inflation, **capacity pressures look like they will be slightly weaker than assumed given likely downward revisions to the growth outlook.** Since the May MPS projections:

- Q1 GDP was slightly weaker than the RBNZ had factored in;
- Business confidence has significantly weakened, increasingly putting employment and business investment growth at risk. Pricing intentions, however, are moving up;
- The Budget was slightly less stimulatory than the RBNZ had factored in;
- But some offset over the next year through a rebound in Auckland housebuilding, based off a surge in consent issuance.

Downside risks to the outlook for economic activity have also grown. The global upswing could be dampened from a substantial escalation in trade protectionism and while the volume of global trade facing higher tariffs is small, the direction of risk is clear. The NZ economy is at the mature stage of the expansion and, with some of the key growth drivers either at (or past) cyclical peaks, sustaining solid growth will be harder to achieve.

Monetary conditions easing via lower NZD and narowing bank bill spreads

Nevertheless, there are some offsets reducing the need for the RBNZ to signal interest rate cuts. The NZD has fallen of late. Pressures in credit markets look to have eased somewhat with bank bill rates having fallen 10bps over the last month. There have been cuts to fixed carded mortgage interest rates. Moreover, if the outlook was to significantly deteriorate, the RBNZ would also be keen to keep some of its OCR powder dry.

Employment target: no need for added stimulus

The Q2 labour data continued to show that the state of employment is healthy, with historically-high employment and participation rates and a still-low unemployment rate. Wage inflation ticked up, courtesy of the minimum wage, but there was scant evidence that wage inflation looks set to take off. At this point, the RBNZ's added goal of maximising sustainable employment neither needs help from more stimulus nor is a constraint to an eventual lift in the OCR.

All up: more caution?

In the May MPS the RBNZ helpfully put together a table of key judgements on Page 12. **Our assessment is that most of those key judgements have edged towards softer than assumed outcomes:**

RBNZ key judgements and risks	**RBNZ Risk assessment (May)**	**RBNZ new assessment (ASB view)**
Robust global growth continues:	Balanced	Downside: on trade tensions
Global inflation increases gradually:	Some upside for oil/global CPI. Balanced elsewhere	Reduced upside: through weaker dairy auction prices
NZ grows above trend:	Some upside	Balanced: residential construction firmer, but business confidence weak, house prices and retail weaker
NZ capacity pressures build:	Broadly Balanced	Downside: from slower 2018Q1 growth, slower medium-term growth
Inflation takes its time to return to target:	Some upside risk from higher wage inflation	Stronger upside: Risk tilt to sooner on high fuel prices

Source: ASB. Red denotes a downgrade to the RBNZ's assessed risk, green an upgrade to the risk.

All up, developments suggest **the RBNZ's forecasts will show a firmer short-term inflation outlook**. However, **the medium-term inflation outlook is expected to remain centred around 2%.** We expect the August policy assessment to reiterate the intent to keep the OCR at "an expansionary level for a considerable period", with the RBNZ still well positioned to either raise or cut the OCR if need be. The published OCR outlook is expected to be little changed on the May MPS profile, with the OCR remaining on hold until late 2019, followed by around 2 hikes and a low OCR endpoint**. Relative to the May projections, our bias would be a slight delaying in the forecast start to OCR hikes given the weaker medium-term growth outlook and more negative skew of risks.**

We note that the June statement included a changed reference to the OCR remaining on hold "for now", suggesting less certainty about keeping the OCR on hold for a prolonged period – and, in our interpretation, implicitly flagging a small possibility of an OCR cut. Watch the wording in the August statement for any potential shifts amidst the mildly conflicting signals the RBNZ is getting.

June 2018 RBNZ media release

Statement by Reserve Bank Governor Adrian Orr:

Tena koutou katoa, welcome all.

The Official Cash Rate (OCR) will remain at 1.75 percent for now. However, we are well positioned to manage change in either direction – up or down – as necessary.

Our outlook for the New Zealand economy, as detailed in the May Monetary Policy Statement, remains intact. Employment is around its sustainable level and consumer price inflation remains below the 2 percent mid-point of our target, necessitating continued supportive monetary policy for some time to come.

Global economic growth is expected to support demand for our products and services. Global inflationary pressure is also expected to be higher but remain modest. This outlook has been tempered slightly by trade tensions in some major economies. Ongoing volatility in some emerging market economies continues.

Domestically, ongoing spending and investment, by both households and government, is expected to support growth. However, the recent weaker GDP outturn implies marginally more spare capacity in the economy than we anticipated. The Government's projected spending impulse is also slightly lower and later than anticipated.

CPI inflation is likely to increase in the near term due to higher fuel prices. Beyond that, inflation is expected to gradually rise to our 2 percent annual target, resulting from capacity pressures.

The best contribution we can make to maximising sustainable employment, and maintaining low and stable inflation, is to ensure the OCR is at an expansionary level for a considerable period.

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