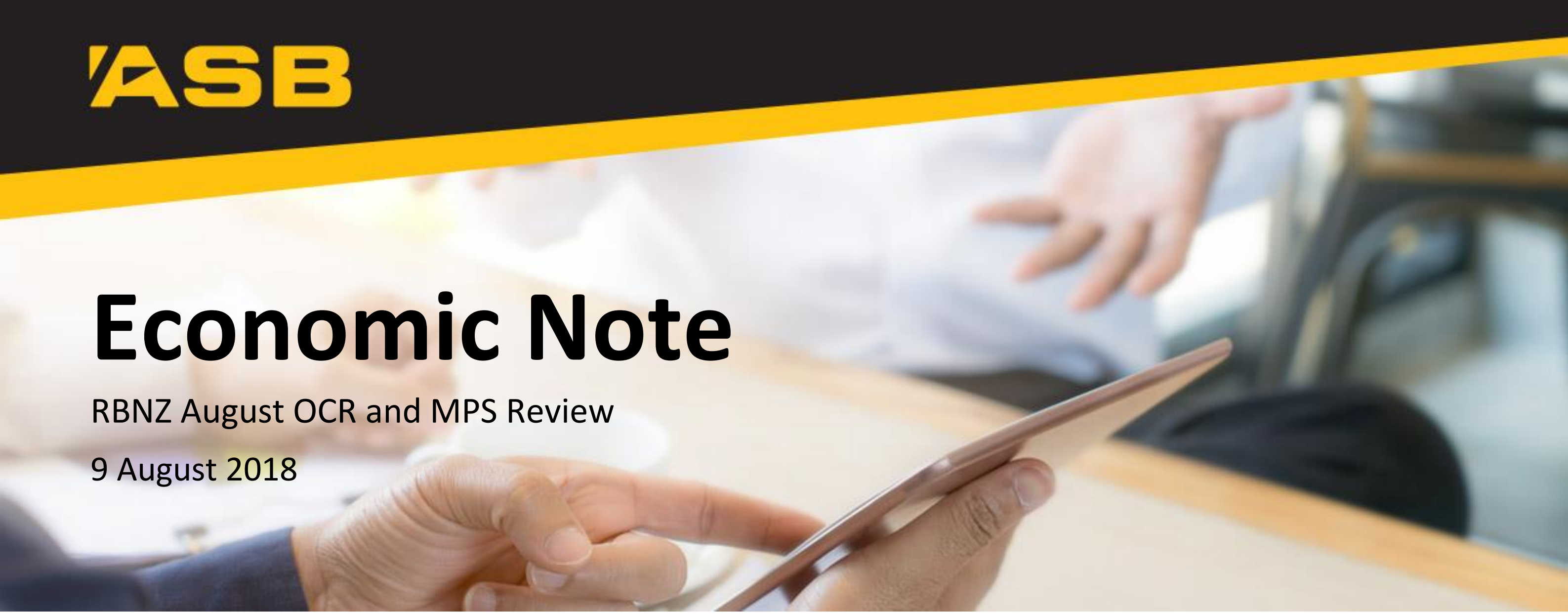


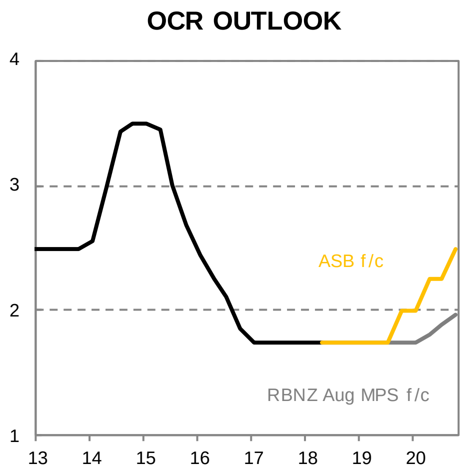
Economic Note

RBNZ August OCR and MPS Review

9 August 2018

Holding out until 2020?

- The RBNZ's tilt to a more 'dovish' view was bigger than we expected.
- But we do see inflation pressures building more quickly than in the RBNZ's new view, particularly via wages.
- Consequently, we still see late 2019 as the likely timing for OCR increases.



We had expected the RBNZ to sound a little more 'dovish' in the August Monetary Policy Statement (MPS) – but in the end **the RBNZ was considerably softer in its outlook for inflation and interest rates. The RBNZ's forecast of OCR increases was pushed out a full year, implying a late 2020 lift**. The policy assessment was explicit in saying "we expect to keep the OCR at this level through 2019 and into 2020". That phrase sums up the key point from the MPS. And, as in Adrian Orr's past two OCR decisions, the neutral stance remains clear through continued reference that the next move "could be up or down".

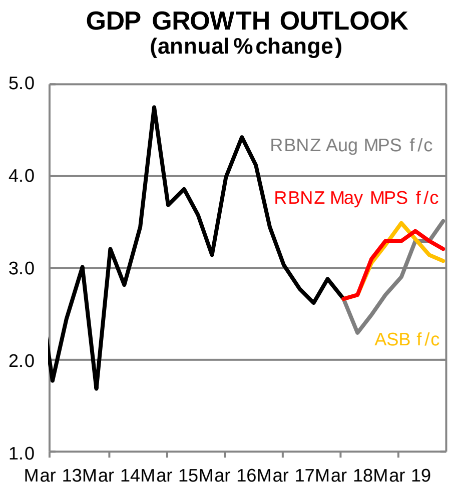
We continue to expect that the OCR will stay on hold until November 2019, though we acknowledge the RBNZ's new view of being on hold for longer. The important thing is that there is absolutely no urgency for the OCR to increase for a considerable period, and NZ short-term interest rates will remain well-anchored at low levels.

Relative to the RBNZ, we are forecasting stronger wage growth and overall a marginally weaker NZ dollar. As a result, **we do expect inflation will end up higher – and that the RBNZ is likely to end up lifting the OCR earlier than its current forecasts imply**. We also have a stronger growth outlook over the next year. However, that period has – at present – a greater degree of uncertainty than usual given the persistent weakness in business confidence to date.

Time will tell whether our view of an earlier rise in inflation (and OCR) holds true. We do see a lot more cost pressure building in the economy than the RBNZ does, though the RBNZ does acknowledge that risk. But a clear risk to our decent economic outlook is a more pronounced impact from weak business confidence or trade tensions.

Nick Tuffley – Chief Economist (649) 301 5659 nick.tuffley@asb.co.nz
Mark Smith – Senior Economist (649) 301 5657 mark.smith4@asb.co.nz
Kim Mundy – Economist (649) 301 5661 kim.mundy@asb.co.nz

Softer growth in the short term



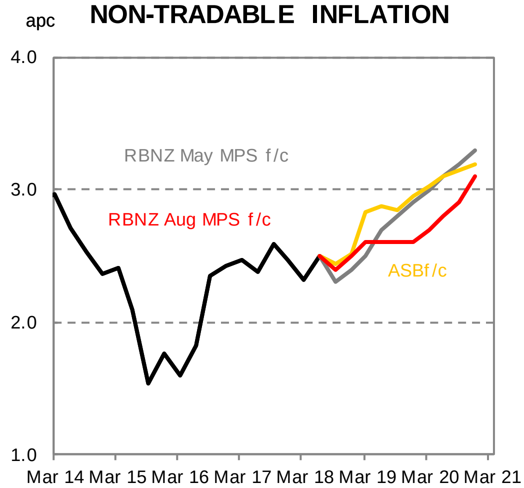
The RBNZ projections have a softer short-term outlook for growth, citing the weakness in business sentiment and softer household activity, with the RBNZ assuming that continuing softness in the housing market is expected to weigh on household spending over the projection period. **The RBNZ has also tweaked its estimates of KiwiBuild**, which is now assumed to make a smaller contribution to housing construction over the projection than previously assumed, consistent with Budget 2018 projections. **The RBNZ projections for growth over 2018 are weaker than our current view**.

Economic growth is then expected to pick up to above circa 3% trend rates in 2019, helped by higher government spending and monetary stimulus. Domestic financial conditions were adjudged to become more supportive of growth over the past year, given the lower NZD and fall in fixed mortgage interest rates. The RBNZ projections also assume some economic rebalancing will take place, with net exports expected to contribute to the pick-up in growth, supported by above-average trading-partner growth. The lower exchange rate is expected to lift exports of services, and encourage substitution from imports towards domestically-produced goods and services, with primary sector exports bouncing back from weather-related weakness. **The RBNZ view of growth over 2019 and 2020 is slightly stronger than our view.**

The RBNZ continues to anticipate above-average global growth over the projection period, averaging 3.5%. That said, the Bank points out that risks to the global growth outlook have increased since the May MPS, notably the escalation in trade tensions. And some of the risks to the dairy price outlook from trade tensions have already begun to materialise.

The RBNZ adjudges that risks to the growth outlook are tilted to the downside. Three risks are outlined. First, there is the risk that Mycoplasma Bovis has a more significant impact on agricultural production than what the RBNZ assumes. Second, global trade tensions could likely deteriorate and weigh on global demand (the MPS included a box on the impact of a global trade war). **Third, the RBNZ also has a scenario in which rising wage and other costs prompt the OCR moving up in late 2019, a year earlier than signalled in the central projection. This is closer in spirit to our current view**. Balancing that out is a downside scenario in which annual GDP growth remains sub 3% over 2019, which sees OCR cuts.

Inflation outlook not as strong as we expected



The RBNZ reiterated that tightening capacity pressures are expected to lift inflation back towards 2% over the forecast period. However, the RBNZ also noted that it will only respond to "persistent movements in inflation." On this, **the lift in core inflation was welcomed**, but it appears that the RBNZ needs to see more before it will be convinced that inflation will return to 2% and stay there. **Weaker near-term capacity pressures** (through softer near-term growth) **have weighed on the RBNZ's inflation forecast, with inflation now taking an additional quarter to reach 2%**. The RBNZ also stated that the inflation outlook was likely to be volatile and it will look through movements due to oil prices, the exchange rate and petrol excise taxes.

The RBNZ's inflation forecasts are different than our own. In particular, key differences arise from contrasting wage growth and GDP forecasts. As a result, the RBNZ is forecasting softer non-tradable inflation versus a slightly higher tradables track. **We continue to assume that stronger wage growth and tightening capacity pressures** from above-trend GDP growth drive headline inflation back to 2%.

Conversely, the RBNZ is assuming more muted wage growth and sub-trend GDP growth over the remainder of 2018. As a result, **our non-tradables inflation forecast is stronger than the RBNZ's own**. We see upside risk to the RBNZ's non-tradables inflation forecast.

Employment near maximum sustainable level

The RBNZ notes that the labour market has tightened over the past year and it currently adjudges that **employment is near its maximum sustainable level**. Indeed, Chapter Three of the MPS shows RBNZ analysis of labour market indicators suggesting that the labour market is tight, and employment may even be above its sustainable level. RBNZ projections signal that, while moderate employment growth is expected, the labour market is projected to continue tightening, with the unemployment easing to the low 4's by the end of the projection period. This is consistent with our view on employment and the unemployment rate, although we expect a stronger outlook for wage inflation than the RBNZ.

Comments on monetary conditions

In the media conference, the RBNZ Governor noted that the NZ dollar is very close to fair value. He also said the RBNZ's view of the neutral level of the OCR is 3.5%. That is similar to our own view, though the risks are the neutral rate could effectively be lower in the midst of a continued period of very low global interest rates.

Market reaction

Key Rates	8: 50 am	9:10 am	10:00 am
NZD/USD	0.6748	0.6716	0.6706
NZD/AUD	0.9079	0.9044	0.9039
NZD/EUR	0.5812	0.5784	0.5775
NZD/JPY	74.85	74.53	74.39
NZD/GBP	0.5237	0.5213	0.5205
NZ TWI	72.86	72.52	72.48
NZ 90 day Bank Bill	1.91	1.91	1.91
NZ 1 year swap rate	2.00	1.98	1.98
NZ 2 year swap rate	2.12	2.07	2.05
NZ 5 year swap rate	2.52	2.48	2.43

The statement was more dovish than expected by the market. The NZD eased 50 pips against the USD and is currently just over 67 US cents. The NZD was also weaker against other major NZD cross rates. NZD interest rates ease and the swap curve flattened with close to a 10bp fall in yields for the 5-year tenor. Yields for the bellwether 2-year swap fell 5bps following the release of the statement and at around 2.06% are the lowest since October 2016.

August 2018 RBNZ media release

Statement by Reserve Bank Governor Adrian Orr:

Tena koutou katoa, welcome all.

The Official Cash Rate (OCR) remains at 1.75 percent. We expect to keep the OCR at this level through 2019 and into 2020, longer than we projected in our May Statement. The direction of our next OCR move could be up or down.

While recent economic growth has moderated, we expect it to pick up pace over the rest of this year and be maintained through 2019.

Robust global growth and a lower New Zealand dollar exchange rate will support export earnings. At home, capacity and labour constraints promote business investment, supported by low interest rates. Government spending and investment is also set to rise, while residential construction and household spending remain solid.

The labour market has tightened over the past year and employment is roughly around its maximum sustainable level.

We expect the unemployment rate to decline modestly from its current level.

There are welcome early signs of core inflation rising. Inflation will increase towards 2 percent over the projection period as capacity pressures bite. This path may be bumpy however, with one-off price changes from global oil prices, a lower exchange rate, and announced petrol excise tax rises expected. We will look through this volatility as appropriate, and only respond to any persistent movements in inflation.

Risks remain to our central forecast. The recent moderation in growth could last longer. Low business confidence can affect employment and investment decisions. Conversely, there is a chance that inflation could increase faster if cost pressures can pass through into higher prices and impact inflation expectations.

We will keep the OCR at an expansionary level for a considerable period to contribute to maximising sustainable employment, and maintaining low and stable inflation.

Meitaki, thanks.

ASB Economics & Research			**Phone**
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659
Senior Economist	Mark Smith	mark.smith4@asb.co.nz	(649) 301 5957
Senior Economist	Jane Turner	jane.turner@asb.co.nz	(649) 301 5853
Senior Rural Economist	Nathan Penny	nathan.penny@asb.co.nz	(649) 448 8778
Senior Economist, Wealth	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 301 5915
Economist	Kim Mundy	kim.mundy@asb.co.nz	(649) 301 5661
Data & Publication Manager	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660

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