Economic Note

Preview of RBNZ June OCR Review

22 June 2018

Watching and waiting

- We expect a neutral assessment from the RBNZ over the outlook for the Official Cash Rate (OCR).
- But the risks are slightly more skewed to interest rates remaining on hold for longer.
- That aside, we see very little need for the RBNZ to substantively tweak its outlook for interest rates.

We expect a similar and to-the-point message from the RBNZ over the outlook for the Official Cash Rate (OCR): “the direction of our next move is equally balanced, up or down. Only time and events will tell”.

But the risks are slightly more skewed towards lower growth, with interest rates remaining on hold for longer. A robust global growth backdrop is at greater risk of being undermined by increasing trade protectionism, though actions to date are unlikely to significantly impact the New Zealand economy. Locally, pessimistic business confidence and uncertainties from the ongoing Mycoplasma Bovis eradication efforts could slow growth relative to the strong fundamentals still in place. These themes should get some airplay this time, after little mention in May.

That aside, we see very little need for the RBNZ to substantively tweak its outlook for interest rates. Inflation shifts are modest, and fresh employment-related data are not up for release until August. We retain our view that the RBNZ is on hold for a long time, until around August 2019.

Global gobsmack: Trump doubles down

Although global economic activity is firmly on the expansion path, risks are growing. Most of the shifts in external risks can be put down to US President Donald Trump’s travel schedule. In Canada, Donald Trump caused trade disarray amongst his G7 counterparts, followed shortly after by ploughing ahead with planned tariffs on China. Those tariffs were matched by planned Chinese tariffs on US goods of equivalent value, with the US then more than double-downing by instructed officials to identify substantially more Chinese goods on which to impose tariffs. As a share of their respective GDP, the amount of trade involved is still small. But there is increased risk now that the trade war between the US and China escalates, and that the US extends its trade war to multiple fronts that include the EU, Canada and Mexico. After winning friends and influencing people in Canada, Donald Trump moved on to Singapore to meet Kim Jong Un, where he appears to have taken a first step down a long road to reducing conflict in the Korean peninsula. The risks of something serious coming out of left field had already reduced, but the summit has underlined that risk shift.

Aside from protectionism, the global economy has had to face a number of risks, including concerns over fiscal solvency and political stability in the Eurozone, the adjustment to a higher USD and rising US interest rates, volatility in emerging markets and volatile commodity (i.e. oil) prices. The RBNZ is likely to remain vigilant and will be closely following the global scene.

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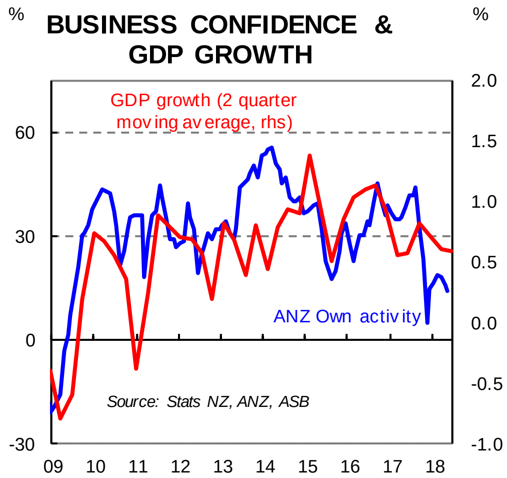
Domestic disquiet

Meanwhile, home in NZ, **business confidence is one key risk to an otherwise healthy-looking set of economic fundamentals**. Confidence had started to creep back up from late 2017. But in recent months, confidence has edged down again. The construction and agriculture sectors have specific reasons for disquiet. But pessimism has become more broad-based. One can speculate on reasons, ranging from the Government's oil & gas announcement through to anxiety about labour relations changes. The latest ANZ business confidence survey was also too early to pick up on the business community's reaction to a fiscally-prudent Budget. **Consumer confidence has not fallen to the same extent**, but respondents have become less confident over the short-term economic outlook. We had anticipated that business confidence would continue to recover, rather than start falling again. **There is now a growing risk that businesses and households start deferring key employment, investment and spending decisions**, sapping what should otherwise be a very respectable growth performance.



Mycoplasma Bovis is another source of uncertainty. The Government has taken the laudable aim of stepping up efforts to eradicate the disease. However, there is not guarantee of success and it will take some months at least to know whether the disease can be eradicated here or whether the dairy and beef industries will have to learn to manage the outbreak – which would include changes to farming practices and some productivity losses. Farmers in affected sectors are understandably going to be cautious about long-term planning and the related spending until they have greater clarity. This will dull an otherwise strong agricultural sector outlook.

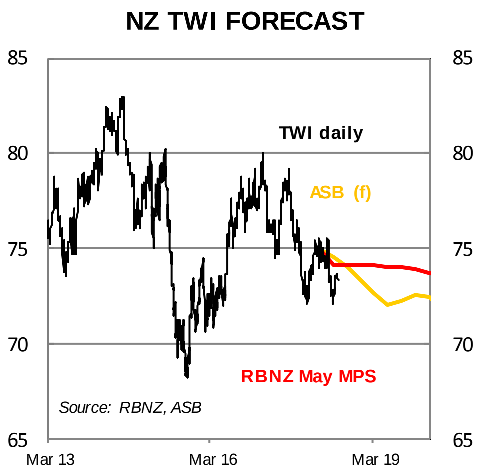
Mixed shifts in inflation pressures

The more tangible impacts on monetary policy – the inflation outlook – suggest a marginally weaker medium-term inflation track, although the near-term inflation outlook could prove to be slightly firmer than what we had previously expected.

Q1 GDP at 0.5% qoq was slightly weaker than the RBNZ's 0.7% qoq expectation, implying a fractionally weaker starting point for capacity pressures. **The RBNZ may potentially shade down its 2018 growth outlook** given that business confidence remains in the doldrums. In combination this could fractionally shade down the short-term inflation outlook relative to the May MPS projections.

The labour market looks tight, although the cooling in employment intentions over 2018 and slowing growth in job advertisements point to slower employment growth going forward. We do not expect this to shake the RBNZ's current assessment that employment appears to be around its maximum sustainable level.

The NZ dollar on a trade-weighted basis is now about 1% lower than what the RBNZ assumed in the May MPS (74.1), with the NZD having fallen close to 2% against the USD since early May. This is likely to slightly push up the inflation track but not enough to make a material difference to the RBNZ's outlook. However, **fuel prices risk being higher than the RBNZ has banked on.** Current spot prices for Dubai are around USD72 per barrel and we expect this to firm over the next few months, in marked contrast to the RBNZ's medium-term assumption of USD55. Signs that other regional councils may join Auckland in hiking fuel taxes, and the lower NZD also add to upward impetus. All up this would likely add to the RBNZ's assessment of near-term inflation and inflation expectations. However, a higher fuel



bill will weigh on domestic economic activity and could potentially dampen pressures on medium-term inflation.

Fonterra has signalled a bullish $7/kg of milk solid forecast for the 2018/19 season farmgate milk price. That forecast is a confidence booster to farmers, even if appetites for on-farm capital spending risk being crimped by Mycoplasma Bovis uncertainties.

Our assessment of the key judgements that the RBNZ made in Chapter two of the May MPS are as follows:

RBNZ key judgements and risks	**RBNZ Risk assessment (May)**	**Change to risks (ASB views)**
Robust global growth continues:	Balanced	Risk tilt to slower global growth
Global inflation increases gradually:	Some upside for oil/global CPI. Balanced elsewhere	Risk tilt to stronger global inflation
NZ grows above trend:	Some upside	Risk tilt to slower 2018 growth
NZ capacity pressures build:	Broadly Balanced	Risk tilt down from slower growth
Inflation takes its time to return to target:	Some upside risk from higher wage inflation	Risk tilt to sooner on high oil prices

Source: ASB

Our assessment is that relative to the May MPS the risks look to be tilting in favour of slightly weaker growth but slightly higher short-term inflation. The low inflation starting point provides some leeway to accommodate the higher near-term inflation outlook, but this will remain conditional on inflation expectations remain contained. A weaker growth outlook is likely to culminate in less pressure on productive capacity and hence medium-term inflation. While we expect the RBNZ to stick to its knitting and deliver a neutral statement with few substantive changes to May, the risks are slightly more skewed to the OCR remaining on hold for longer.

May 2018 MPS 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 some time to come. The direction of our next move is equally balanced, up or down. Only time and events will tell.

Economic growth and employment in New Zealand remain robust, near their sustainable levels. However, consumer price inflation remains below the 2 percent mid-point of our target due, in part, to recent low food and import price inflation, and subdued wage pressures.

The recent growth in demand has been delivered by an unprecedented increase in employment. The number of willing workers continues to rise, especially with more female and older workers choosing to participate. Likewise net immigration has added to the supply of labour, and the demand for goods, services, and accommodation.

Ahead, global economic growth is forecast to continue supporting demand for New Zealand's products and services. Global inflation pressures are expected to rise but remain contained.

At home, ongoing spending and investment, by both households and government, is expected to support economic growth and employment demand. Business investment should also increase due to emerging capacity constraints.

The emerging capacity constraints are projected to see New Zealand's consumer price inflation gradually rise to our 2 percent annual target.

To best ensure this outcome, we expect to keep the OCR at this expansionary level for a considerable period of time. This is the best contribution we can make, at this moment, to maximising sustainable employment and maintaining low and stable inflation.

Our economic projections, assumptions, and key risks and uncertainties, are elaborated on fully in our Monetary Policy Statement.

Meitaki, thanks.

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