Economic Note

RBNZ June OCR Review

28 June 2018

On hold "for now"

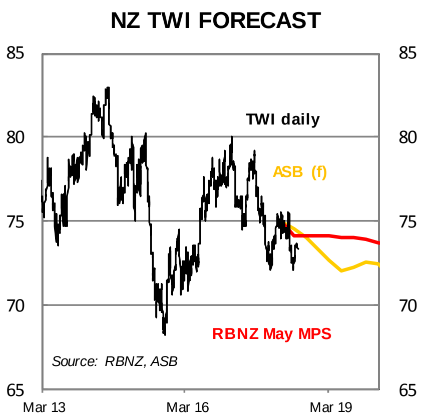
- The RBNZ kept the OCR on hold at 1.75% with a neutral bias.
- However, the RBNZ gave itself more wriggle room around how long the OCR would remain at 1.75%.
- We now expect the first OCR increase in November 2019, and the risk of a cut has grown recently.

It remains the case that there is no urgency for the Official Cash Rate to be shifted. But the risk bias to our OCR view has been shifting a little, and **we now expect the tightening cycle to start a little later, in November 2019 (previously August**). We also see growing risk that the next move may be a cut, rather than a hike. We emphasise this risk is still small, but it has got bigger over recent weeks and shouldn't be dismissed out of hand. **NZ does have some good economic supports, but rapidly escalating trade tensions and weak business confidence could conceivably create an environment in which the RBNZ cuts the OCR.**

We judge that the RBNZ's view on medium-term inflation pressures is of a slightly later pick-up than it assumed back in May. That argues for waiting slightly longer to increase the OCR. But **we also see significance in the wording change the RBNZ made to its interest rate outlook, in stating the OCR will remain at 1.75% "for now" instead of "for some time to come"**. That wording shift gives the RBNZ flexibility to react if the recent threats to good economic and employment growth prospects and to rising inflation pressures start to impact.

Global story less upbeat

The RBNZ has acknowledged that the global outlook was not as upbeat as appeared the case even a few months ago. The global outlook is still "expected to support demand for our products and services". However, the RBNZ explicitly noted that the global outlook had been tempered "slightly" by trade tensions and that volatility in some emerging market economies continues. We remain constructive on the global outlook but are concerned that trade tensions may escalate further, which would significantly dampen global economic activity.



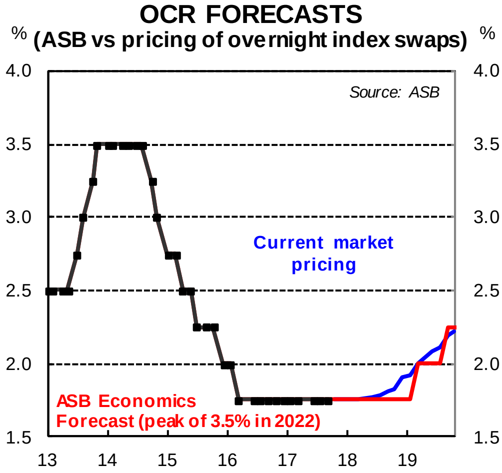
As was the case for the previous policy assessment the RBNZ did not explicitly mention the NZD, which is now roughly back to where it was at the time of the May MPS on a TWI basis, but is more than 2% lower against the USD. Despite having near-record NZ Terms of Trade, recent NZD weakness appears to be attributable the weaker domestic and global outlook. We note, however, that recent falls in the NZD may lessen any adjustment that domestic interest rates have to do to support the New Zealand economy.

Nick Tuffley – Chief Economist (649) 301 5659 nick.tuffley@asb.co.nz
Mark Smith – Senior Economist (649) 301 5657 mark.smith4@asb.co.nz
Jane Turner – Senior Economist (649) 301 5853 jane.turner@asb.co.nz

There was little labour market commentary in the policy assessment, with the comment “employment is around its sustainable level” suggesting that current OCR settings are consistent with the Policy-Targets Agreement requirements to contribute to “supporting maximum sustainable employment within the economy”. The weakening in surveyed employment intentions – if reflected in actual labour market outcomes – may come to question that view.

Softer tinge to growth and inflation outlook

The RBNZ continues to emphasise that the outlook for growth is still positive, reiterating its expectation that growth will be supported by spending and investment from both households and government. Likewise, we continue to point to strong fundamentals, such as record high Terms of Trade, population growth and low interest rates. But we see growing risk that business confidence may become a drag on an otherwise robust growth outlook.

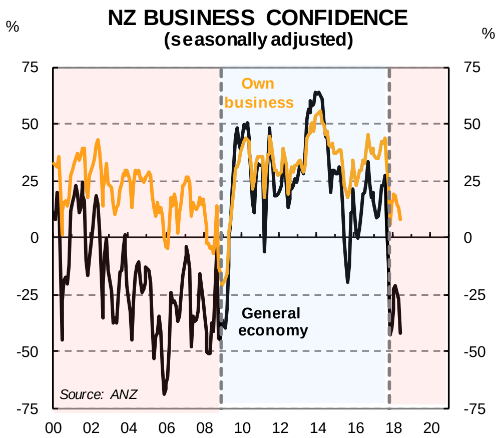


The RBNZ's growth assessment appears to have been revised down slightly, reflecting the weaker Q1 GDP outturn (0.5% qoq vs RBNZ expectation of 0.7% qoq) and a less stimulatory Budget than anticipated. The RBNZ noted that the Government spending impulse is projected to be slightly lower and later than it had anticipated.

The RBNZ now sees a greater degree of spare capacity than in May. This likely means that domestic inflation pressures (i.e. non-tradable inflation) will be more gradual to lift. On the inflation outlook, the RBNZ notes that higher fuel prices will boost CPI in the near term, but inflation pressures remain subdued elsewhere (in line with our own view). On balance, the RBNZ's reference to greater space capacity and subdued inflation pressures (outside of fuel-related volatility) implies that the RBNZ's own forecasts imply a later timing of the first rate hike.

The elephant (and cattle) in the room

Weak business confidence did not get a mention in the RBNZ's statement. However, it **is an economic risk that has been increasingly preying on our minds to a greater extent** than the global tensions. The June ANZ confidence survey showed further deterioration in sentiment to a level that is weak – even after allowing for the fact that business sentiment is usually lower under Labour-led governments.



Eight months of weak business confidence flags a growing risk that economic growth, employment growth and inflation pressures will not be as robust as assumed. The economy has healthy underpinnings, but investment and employment decisions are at risk of being deferred.

Another smaller domestic risk is the uncertainty generated by the Government's very laudable decision to step up efforts to eradicate Mycoplasma Bovis. The efforts do mean, for several months at least, dairy and beef farmers are faced with uncertainty over whether their future will be free of this disease or whether they need to change farming practices and face productivity losses as they shift to managing the disease. That environment understandably makes long-term decision-making more challenging.

Market reaction

There was minimal market reaction from the RBNZ statement. The NZD rose around 10-20pips against key TWI bilaterals (see table below). There was little change to NZ wholesale interest rates.

Key Rates	8:55 am	9:10 am	10:10 am
NZD/USD	0.6785	0.6806	0.6801
NZD/AUD	0.9244	0.9267	0.9264
NZD/EUR	0.5873	0.5889	0.5883
NZD/JPY	74.82	75.03	74.99
NZD/GBP	0.5174	0.5189	0.5184
NZ TWI	72.92	73.10	73.06
NZ 90 day Bank Bill	2.03	2.03	2.03
NZ 1 year swap rate	2.09	2.09	2.09
NZ 2 year swap rate	2.19	2.19	2.19
NZ 5 year swap rate	2.59	2.59	2.59

Side-by-side

June 2018 OCR	**May 2018 MPS**
OCR Decision	*OCR Decision*
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.	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.
Global Outlook	Global Outlook
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.	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.
Exchange rate	*Exchange rate*
No comment.	No comment.
Economic Activity	*Economic Activity*
Our outlook for the New Zealand economy, as detailed in the May Monetary Policy Statement, remains intact. 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.	Economic growth and employment in New Zealand remain robust, near their sustainable levels. 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.
Labour market	*Labour market*
Employment is around its sustainable level.	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.
Housing market	*Housing market*
No comment	No comment
Inflation	*Inflation*
Consumer price inflation remains below the 2 percent mid-point of our target, necessitating continued supportive monetary policy for some time to come. 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 emerging capacity constraints are projected to see New Zealand's consumer price inflation gradually rise to our 2 percent annual target.
Policy Outlook	*Policy Outlook*
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.	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.

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.

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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