Economic Note

Preview of RBNZ March OCR Review

16 March 2018

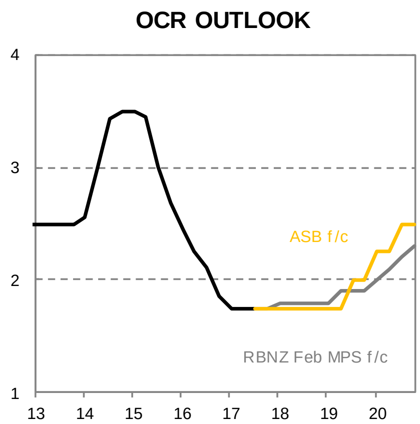
End of an era

- The RBNZ is widely expected to leave the OCR on hold at 1.75% at the March OCR review (Thursday 22nd March).
- The brief one-page statement is likely to be little changed from the February MPS, reiterating a balanced assessment and continuing to emphasise that interest rates are likely to remain low for a considerable period.
- Market focus skewed to Adrian Orr's start on March 27th and pending changes to the Policy Targets Agreement.

We expect the RBNZ will leave the OCR unchanged at 1.75% at the upcoming OCR Review. The economic outlook has not changed materially from 6 weeks ago when the RBNZ released its February Monetary Policy Statement. **We do not expect any change in the RBNZ's assessment of risks** (numerous, but broadly balanced) and guidance on monetary policy (accommodative for a considerable period). **This OCR review is likely to be overshadowed by market perceptions around the incoming Governor Adrian Orr**, and details of the new Policy Targets agreement once it's released (possibly later next week). **We continue to expect the RBNZ will not hike the OCR until the second half of 2019.** Furthermore, we believe the risk of an OCR cut has lifted in recent months given the unexpectedly low Q1 inflation outcome and near-term downside risks to inflation.

Near-term risks to inflation lurk

There has been minimal change in the inflation outlook since the February OCR Review. Headline inflation is expected to remain volatile in the near term due to fuel and food prices. **We expect Q2 annual inflation will drop to 0.9% (versus RBNZ's 1.1%).** But **the medium-term inflation outlook has not changed materially**. The TWI has trended sideways since mid-January, broadly in line with the RBNZ's February forecasts. 2-year-ahead inflation expectations lifted in the first quarter of this year and this lift appears to be consistent with survey respondents also expecting stronger wage inflation over the next few years. This dynamic will be very encouraging for the RBNZ, as it implies a greater likelihood of core inflation pressures lifting in the medium term.



Economic outlook still strong despite soft Q4

GDP growth was only slightly weaker than the RBNZ expected (see our full review here). The RBNZ will remain mindful of near-term weakness in growth as business confidence (in particular, employment and investment intentions) remains low. But like us, **the RBNZ expects business confidence to recover and strong fundamentals (low interest rates, high Terms of Trade, government spending and high population growth) to support medium-term GDP growth.** The weaker GDP

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

outcome did not change our medium-term growth assessment.

Mortgage rates have edged slightly lower in recent months on increased competition. In addition, **the housing market has bounced back somewhat** since the election, and Q4 house price growth may be slightly stronger than the RBNZ initially factored in. However, looking ahead the overall level of housing market activity remains low, the time it takes for houses to sell has lifted and Auckland price pressure remains subdued. **Like us, the RBNZ expects the housing market to remain relatively muted over the coming years.**

Global risks have spiked

The global economy continues to perform well, continuing its synchronised recovery. **But risks to the global outlook have spiked somewhat in recent weeks.** US President Trump's decision to impose tariffs has increased trade tensions with Europe and China, and risks sparking a trade war which could potentially rein in the global economic upswing.

Another risk is the recent spike in short-term funding costs seen in US and Australian bank bill markets. The increased interest rate difference between 90-day bank bills and the 90-day forward pricing of the overnight cash rate can be symptomatic of financial system stress, though that doesn't appear to be the current cause.

However, these are all developments are risks for the RBNZ to watch, and will not directly impact the forecasts at this stage. The Bank may reserve its judgement on these risks until the May Monetary Policy Statement.

Adrian Orr is knocking on the door

The details of the brief one-page announcement are likely to be overshadowed by the pending change in Governor and Policy Targets Agreement (PTA). The March 22nd statement is acting Governor Grant Spencer's last hurrah before his former colleague Adrian Orr takes the helm on the 27th. The new PTA is yet to be announced, although it's widely expected that maximising employment will be added as a second target alongside price stability. The decision-making process will move to formalise a committee versus single decision maker, although this may not take effect until the Reserve Bank Act itself is changed (possibly later this year).

How Adrian Orr's leadership will impact monetary policy decision making is unknown at this point, but it's unlikely to have a material impact. We anticipate Orr's initial focus at the RBNZ will be on managing the Government's changes to the Reserve Bank Act, not necessarily delving into the deep minutia of the RBNZ's economic forecasts. Furthermore, OCR hikes are not seriously on the table until 2019. Between now and then, unexpected economic developments are likely to have a greater impact on the OCR outlook than any differences in interpretation the new Governor and a voting committee may have from the outgoing Governors of the past five and a half years.

February 2018 MPS RBNZ media release

Statement by Reserve Bank Acting Governor Grant Spencer:

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

Global economic growth continues to improve. While global inflation remains subdued, there are some signs of emerging pressures. Commodity prices have increased, although agricultural prices are relatively soft. International bond yields have increased since November but remain relatively low. Equity markets have been strong, although volatility has increased recently. Monetary policy remains easy in the advanced economies but is gradually becoming less stimulatory.

The exchange rate has firmed since the November Statement, due in large part to a weak US dollar. We assume the trade weighted exchange rate will ease over the projection period.

GDP growth eased over the second half of 2017 but is expected to strengthen, driven by accommodative monetary policy, a high terms of trade, government spending and population growth. Labour market conditions continue to tighten. Compared to the November Statement, the growth profile is weaker in the near term but stronger in the medium term.

The Bank has revised its November estimates of the impact of government policies on economic activity based on Treasury's HYEFU. The net impact of these policies has been revised down in the near term. The Kiwibuild programme contributes to residential investment growth from 2019.

House price inflation has increased somewhat over the past few months but housing credit growth continues to moderate.

Annual CPI inflation in December was lower than expected at 1.6 percent, due to weakness in manufactured goods prices. While oil and food prices have recently increased, traded goods inflation is projected to remain subdued through the forecast period. Non-tradable inflation is moderate but expected to increase in line with increasing capacity pressures. Overall, CPI inflation is forecast to trend upwards towards the midpoint of the target range. Longer-term inflation expectations are well anchored at 2 percent.

Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly.

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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