Economic Note

RBNZ September OCR Review

27 September 2018

Looking the gift horse in the mouth

- The RBNZ left the OCR at 1.75%, and retained its OCR outlook and neutral bias – all as expected.
- The RBNZ remains cautious about the domestic growth outlook, noted risks from trade tensions.
- We still expect eventual OCR increases from early 2020; near-term risks skewed to a cut.

The RBNZ’s outlook for interest rates remained identical to the August Monetary Policy Statement’s. The latest statement had a few tweaks to suggest the RBNZ is slightly more cautious about some of the key risks.

We continue to expect the RBNZ will keep the OCR on hold, and eventually lift the OCR in early 2020. However, the risks through to mid-2019 are tilted to a lower OCR due to low levels of business confidence. The RBNZ showed a slightly greater degree of caution about the path forward: continued wariness over the domestic growth outlook (as we expected), but also noting trade tensions more prominently than in the August Monetary Policy Statement. Given still-weak business confidence, the RBNZ’s view of looking the ‘gift horse’ of strong Q2 GDP in the mouth is prudent.

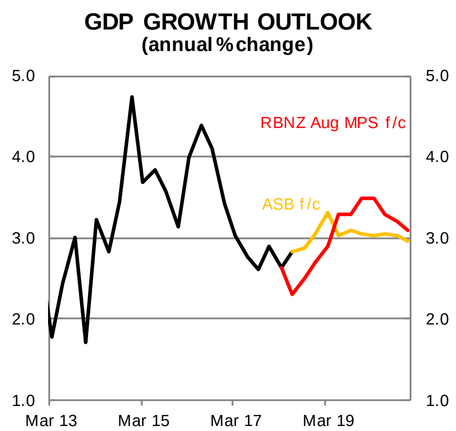
We remain of the view that inflation pressures will pick up sooner than what the RBNZ has been forecasting to date. In particular, we expect a greater degree of wage inflation and subsequent flow-through to consumer prices. That is why we expect that eventual OCR increases will occur sooner than the late-2020 indication from the RBNZ.

But the near-term risks are still skewed towards a lower OCR, primarily if growth does not live up to RBNZ expectations. Although the RBNZ will have been pleasantly surprised by the strength of Q2 GDP, continued soggy business confidence will keep it wary about the growth performance over the rest of 2018 – particularly the tail end of the year.

Growth: risks skewed to the downside

The RBNZ stated its outlook for economic growth was “little changed”, with many of the key drivers of growth remaining intact. **The RBNZ was significantly surprised by the strength of Q2 GDP growth**, with annual growth coming in at 2.8% vs the RBNZ’s forecast of 2.3%. **The RBNZ acknowledged this stronger starting point but emphasised the downside risks to growth outlook remain.** We saw some scope for the RBNZ to revise H2 2018 growth lower on the back of low business confidence.

Very low levels of business confidence remain a key threat to the growth outlook. The RBNZ noted at the August Monetary Policy Statement (MPS)



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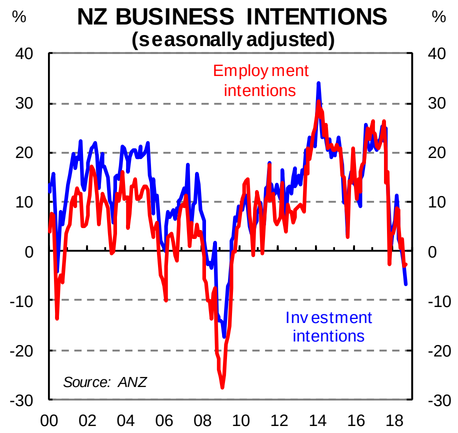
that weak business confidence can affect employment and investment decisions. In the August MPS, the RBNZ included an alternative scenario in which it cut the OCR by 100 basis points because GDP growth remained below 3% over 2019 (the RBNZ's central forecast was for annual growth to reach 3.5% growth by the end of 2019). With the RBNZ emphasising the downside risks to the growth outlook, the RBNZ continues to hint that rate cuts are possible over the next 12 months.

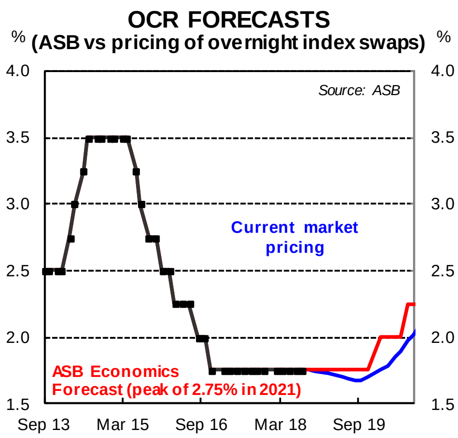


Along with the continued downside risks to the domestic outlook, **the RBNZ was more cognisant of downside risks to the global growth outlook as well**. This suggests the RBNZ sees an increased skew of downside risk to its central assessment. While the RBNZ continues to see "robust global economic growth" **it noted trade tensions for the first time in its key policy assessment**, with the tensions "increasing the risk that ongoing increases in trade barriers could undermine global growth". To date, the amount of trade affected by tariffs is still modest in relation to global trade, but the likelihood of further escalation in tariffs and protectionism is a clear risk to a small open economy such as NZ.

Inflation outlook: same, but growth dependent

The RBNZ's assessment of the inflation outlook is largely unchanged. Inflation is expected to rise modestly over the coming years as capacity pressures gradually build. Further, the RBNZ will continue to look through volatility caused by one-off movements, particularly in relation to fuel prices.

The modest inflation outlook underscores the RBNZ's lack of urgency to adjust policy settings at this point in time. However, **the pace at which inflation lifts back towards the 2% mid-point of the target band depends on both domestic and global growth**. If either global or domestic growth falters, inflation is likely to remain below 2% for longer than currently forecast, which in turn increases the likelihood of OCR cuts.



Monetary conditions a bit of a buffer

Encouragingly, the relaxation in NZ monetary conditions has minimised the amount of work that the OCR has to do to support the economy. The NZD Trade Weighted index is still slightly below where it was the day prior to the August Monetary Policy Statement (72.84). Medium- to longer-term NZD wholesale interest rates are 10-15bps lower than prior to the August MPS, with further cuts to fixed mortgage interest rates.

Market reaction

There was little reaction in domestic interest rate markets, with the bellwether 2-year swap yield unchanged at 2.17. The NZD firmed leading up to the RBNZ decision, with little change since then.

Key Rates	8: 50 am	9:05 am	9:30 am
NZD/USD	0.6657	0.6668	0.6670
NZD/AUD	0.9168	0.9183	0.9185
NZD/EUR	0.5669	0.5678	0.5678
NZD/JPY	75.02	75.17	75.16
NZD/GBP	0.5054	0.5064	0.5063
NZ TWI	72.36	72.49	72.49
NZ 90 day Bank Bill	1.92	1.92	1.92
NZ 1 year swap rate	1.98	1.98	1.98
NZ 2 year swap rate	2.17	2.17	2.17
NZ 5 year swap rate	2.43	2.43	2.43

Statement side-by-side comparison

September 2018 OCR	August 2018 MPS
OCR Decision	*OCR Decision*
The Official Cash Rate (OCR) remains at 1.75 percent. We expect to keep the OCR at this level through 2019 and into 2020. The direction of our next OCR move could be up or down.	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.
Global Outlook	*Global Outlook*
Global inflationary pressure is expected to rise, but remain modest. Trade tensions remain in some major economies, increasing the risk that ongoing increases in trade barriers could undermine global growth.	Robust global growth and a lower New Zealand dollar exchange rate will support export earnings.
Exchange rate	*Exchange rate*
Robust global economic growth and a lower New Zealand dollar exchange rate is expected to support demand for our exports.	Robust global growth and a lower New Zealand dollar exchange rate will support export earnings.
Economic Activity	*Economic Activity*
Our projection for the New Zealand economy, as detailed in the August Monetary Policy Statement, is little changed. While GDP growth in the June quarter was stronger than we had anticipated, downside risks to the growth outlook remain. Domestically, ongoing spending and investment, by both households and government, is expected to support growth.	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.
Labour market	*Labour market*
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.	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.
Housing market	*Housing market*
No comment	No comment
Inflation	*Inflation*
There are welcome early signs of core inflation rising towards the mid-point of the target. Higher fuel prices are likely to boost inflation in the near term, but we will look through this volatility as appropriate. Consumer price inflation is expected to gradually rise to our 2 percent annual target as capacity pressures bite.	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.
Policy Outlook	*Policy Outlook*
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.	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.

September 2018 RBNZ media release

Statement by Reserve Bank Governor Adrian Orr:

The Official Cash Rate (OCR) remains at 1.75 percent.

We expect to keep the OCR at this level through 2019 and into 2020. The direction of our next OCR move could be up or down.

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. Our outlook for the OCR assumes the pace of growth will pick up over the coming year, assisting inflation to return to the target mid-point.

Our projection for the New Zealand economy, as detailed in the August Monetary Policy Statement, is little changed. While GDP growth in the June quarter was stronger than we had anticipated, downside risks to the growth outlook remain.

Robust global economic growth and a lower New Zealand dollar exchange rate is expected to support demand for our exports. Global inflationary pressure is expected to rise, but remain modest. Trade tensions remain in some major economies, increasing the risk that ongoing increases in trade barriers could undermine global growth. Domestically, ongoing spending and investment, by both households and government, is expected to support growth.

There are welcome early signs of core inflation rising towards the mid-point of the target. Higher fuel prices are likely to boost inflation in the near term, but we will look through this volatility as appropriate. Consumer price inflation is expected to gradually rise to our 2 percent annual target as capacity pressures bite.

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.

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