ASB

Economic Note

September OCR Preview

25 September 2017

In no hurry

- The RBNZ is widely expected to leave the OCR on hold at 1.75%.
- A short but balanced statement is expected, with only a few tweaks made to the August MPS message.
- The benign inflation outlook provides the RBNZ with the luxury of waiting. We expect the OCR to remain on hold until early 2019 and for a gradual and shallow path of rate increases thereafter.

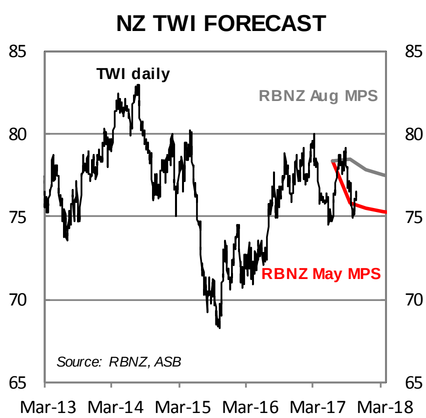
Summary

The RBNZ is widely expected to leave the OCR at 1.75%, the sixth consecutive on-hold decision. Developments have been broadly balanced for medium-term inflationary pressure since August, and the RBNZ will want to provide continuity given the current election-impasse and with a new RBNZ Governor at the helm. Uncertainty is high and with inflation low a period of stability for the OCR beckons. We continue to expect the OCR to remain on hold for a considerable period, followed by a gradual and shallow path of rate increases.

Recent Developments

As the OCR decision looms the RBNZ will have to weigh up what recent developments mean for its assessment of medium-term inflationary pressures. It has been only about six weeks since the August Monetary Policy Statement (MPS), and developments look to have panned out broadly as the RBNZ had expected:

- **Risk of more expansionary fiscal settings.** The August MPS used the Budget 2017 forecasts to generate its fiscal baseline. Whilst the fiscal stance in the August MPS was more stimulatory than in the May MPS, the likelihood is that even more fiscal stimulus will be provided regardless of who controls the Treasury benches. With the shape of the next government possibly unlikely to be known until mid-October, the additional uncertainty caused could provide a near-term head-wind to growth prospects.
- **The NZD TWI** is currently tracking about 1.3% lower relative to Q4 assumptions the RBNZ made in the August MPS (77.9). This is despite the likelihood that the elevated record Terms of Trade and export commodity prices will likely move higher over the course of 2017. A lower NZD will not unduly concern the RBNZ given the low inflation backdrop and wish for a lower NZD to help rebalance the growth outlook.
- **Global nuances have brightened since the August MPS.** Whilst the RBNZ are likely to remain cautious on the global outlook, global data have generally been on an improving trajectory and markets have remained orderly. The improved outlook has seen



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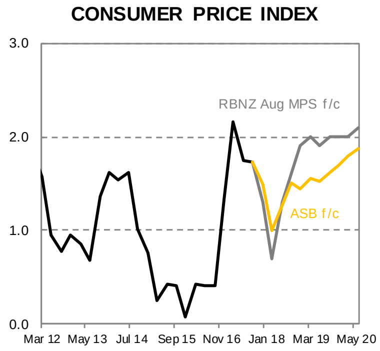
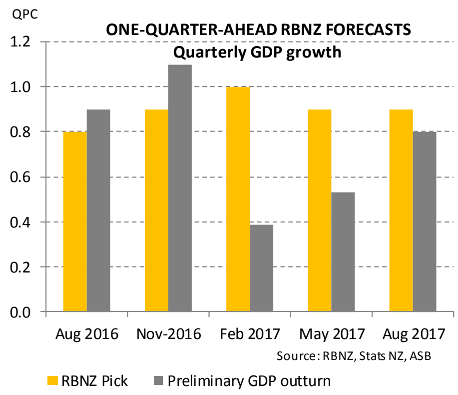
other central banks hike (e.g. Bank of Canada) or signal the intent to start/continue to reduce stimulus (Bank of England, European Central Bank, US Federal Reserve).

- **On the domestic front, nonetheless, signs of rising inflation remain AWOL.** We still expect annual headline CPI inflation to fall towards 1% by early next year, which could have a dampening impact on surveyed inflation expectations that the RBNZ relies upon to assess medium-term inflationary pressure.
- **Whilst the Q2 +0.8% qoq GDP outturn was close to the RBNZ forecasts, it still marked the third successive quarter that economic activity has undershot the RBNZ's forecasts**, although the degree of forecast misses appear to be diminishing. Per-capita GDP growth at around 0.4% per annum remained anaemic.
- **The housing market, if anything, is softer relative to the August *MPS*.** Sales volumes have plateaued at low levels and prices are arguably weaker than the RBNZ had expected. This will dampen overall economic activity at the margin. The RBNZ will remain cautious given the backdrop of dwelling shortages and risk of a housing resurgence once the election-related fog clears.





Providing continuity

Thursday's statement will mark the first in which Acting Governor Spencer will be signing off the policy assessment, and the Bank will want to assure markets that little has changed in practice. We expect a concise policy assessment, designed to generate minimal market reaction, which is likely to be close in spirit to that of the August MPS. In short, the RBNZ will acknowledge the positivity over the global outlook, the solid starting point and outlook for the New Zealand economy, and the considerable number of domestic supports, including pending fiscal loosening, still-low interest rates, strong population growth, strong commodity export prices and the elevated terms of trade. The RBNZ is also likely to affirm that despite the low inflation backdrop and weak short-term inflation outlook, settings are appropriate for delivering inflation within the target range over the medium-term. The RBNZ would also want to provide a reminder that a lower NZD is still desired.

In a nutshell, the RBNZ will likely emphasise that its assessment of inflationary pressure has changed very little relative to August. Crucially, we expect the statement to retain the key last paragraph: "Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly." That sticks to the script that the most likely outcome is protracted period of low OCR settings and that the next move could be up and down.

We also expect the OCR to remain on hold over this year and next, with the first OCR hike pencilled in for early 2019. While this is slightly earlier than signalled in the August MPS, it's margin of error stuff.

A gradual and drawn-out profile for policy tightening still beckons. A lower neutral OCR (at around 3.5% according to recent RBNZ estimates) points to an OCR tightening profile that is muted by historical standards. Lower estimates for the neutral policy rate are not confined to New Zealand. The RBA, Bank of Canada and Bank of England have all trimmed their neutral interest rate estimates.

August 2017 MPS RBNZ media release

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

Global economic growth has increased and become more broad-based. However, major challenges remain with on-going surplus capacity and extensive political uncertainty.

Headline inflation has increased over the past year in several countries, but moderated recently with the fall in energy prices. Core inflation and long-term bond yields remain low. Monetary policy is expected to remain stimulatory in the advanced economies, but less so going forward.

The trade-weighted exchange rate has increased by around 3 percent since May, partly in response to higher export prices. A lower New Zealand dollar would help rebalance the growth outlook towards the tradables sector.

GDP growth in the March quarter was lower than expected, with weaker export volumes and residential construction partially offset by stronger consumption. Nevertheless, the growth outlook remains positive, supported by accommodative monetary policy, strong population growth, and high terms of trade. Recent changes announced in Budget 2017 should support the outlook for growth.

House price inflation has moderated further, especially in Auckland. The slowdown in house price inflation partly reflects loan-to-value ratio restrictions, and tighter lending conditions. This moderation is projected to continue, although there is a risk of resurgence given the on-going imbalance between supply and demand.

The increase in headline inflation in the March quarter was mainly due to higher tradables inflation, particularly petrol and food prices. These effects are temporary and may lead to some variability in headline inflation. Non-tradables and wage inflation remain moderate but are expected to increase gradually. This will bring future headline inflation to the midpoint of the target band over the medium term. Longer-term inflation expectations remain well-anchored at around 2 percent.

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

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