Westpac

Institutional Bank

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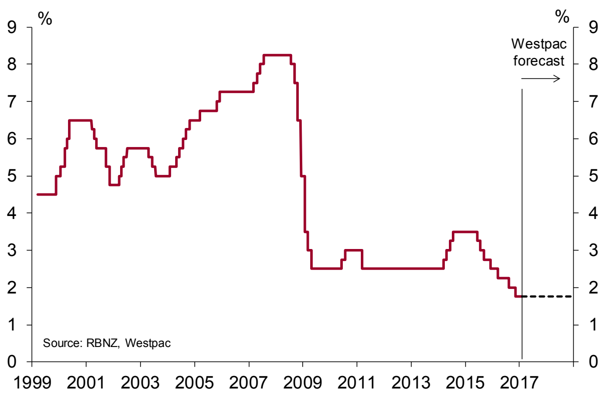
No need for further action

Preview of RBNZ Monetary Policy Statement, 9 February

- We expect the Reserve Bank to hold the OCR at 1.75%, with a firmly neutral outlook.
- The RBNZ will take some comfort from the fact that inflation is finally back within the target range. But there are still some significant barriers to a further pickup in inflation from here.
- Rising mortgage rates and a stronger New Zealand dollar mean that financial conditions have already tightened by more than the RBNZ intended.
- A statement about the RBNZ Governor's next term is expected within the next couple of weeks.

Westpac OCR forecast



The Reserve Bank shifted to a more neutral stance in last November's *Monetary Policy Statement*. While the cash rate was reduced to a new record low of 1.75%, the Statement noted that "policy settings, including today's easing, will see growth strong enough to have inflation settle near the middle of the target range". What's more, the projected interest rate track was flat at its current level for the entire forecast horizon, the message being: the time to even contemplate rate hikes is a long way off.

Nevertheless, financial markets have taken up the idea that the next move in the OCR will be up – in fact, interest rate markets are factoring in more than a 25 basis point increase by the end of this year. The reasoning seems to be that the economy is growing at a reasonable clip, inflation is back within the 1-3% target range after two years of undershooting, so the RBNZ will be eager to start 'normalising' interest rates soon.

In our view, this thinking is far too hasty. Inflation is finally back above 1%, but there are still some significant hurdles to getting it back to even the 2% midpoint of the target range, let alone into the upper end of the range. Raising the OCR again – or even signalling the possibility in next Thursday's *Monetary Policy Statement* – would merely risk inflation undershooting 2% for even longer. We expect a firmly on-hold statement next week, in line with the November projections.

Economic conditions

Annual inflation rose to 1.3% at the end of 2016, having been below 1% for the previous eight quarters. Part of the weakness in inflation over recent years was due to world oil prices, which are beyond the influence of the central bank. But excluding fuel prices, inflation appears to have bottomed out at the end of 2015, and it has gradually picked up since.

However, it would be naïve to assume that inflation is now on an upward trend. For one thing, the pickup in inflation last year came on the back of a sharp fall in the New Zealand dollar in late 2015. Exchange rate movements typically take the best part of a year to flow through into retail prices for imported goods, reflecting factors such as importers' currency hedging – hence the uptick in inflation over 2016. This situation has now completely turned: the NZ dollar has clawed back all of its losses, and more, in the last year. Given the usual lag, this points to a fresh wave of downward pressure on the prices of many consumer goods over 2017.

This means that in order to meet the inflation target, the RBNZ will remain dependent on generating home-grown inflation. The economy grew by 3% in the year to September, and is expected to maintain a similar pace this year. But much of this growth is the product of record levels of net migration, which has proven to be a more or less neutral factor for inflation during this cycle (migrants add to both demand and supply). Taking out population growth, GDP is only growing at around 1% a year – a rate that's just not that impressive by historic standards, and not really indicative of an economy that's at risk of overheating.

A related factor that the RBNZ will have to consider is the outlook for the housing market. Like it or not, house prices are an important transmission mechanism for monetary policy – rising house prices tend to support rising household spending, which boosts activity and inflation. The RBNZ's November forecasts included another year of double-digit house price gains, despite a third round of loan-to-value restrictions. However, house prices have already slowed by more than the RBNZ expected, and rising mortgage rates cast doubt on whether the housing market will reignite this year.

On the plus side, world dairy prices have remained high after a stunning 50% rebound from their August lows. In November the RBNZ didn't buy into this rebound, but acknowledged that the longer that dairy prices held up, the more they would have to factor this into their forecasts. The outlook for the rural regions is looking more assured today, with the farmgate milk price for this season expected to be around the average of the last decade.

Policy statement

Having shifted to a firmly neutral signal in November, the question is whether the RBNZ will feel compelled this time to give any indication of the timing of interest rate hikes – even if that proves to be several years away. Our view is that there is little to be gained from doing so. Developments in the economy since November have been mixed rather than unambiguously positive, and there has already been an unintended tightening of financial conditions via rising mortgage rates and a strengthening NZ dollar. Endorsing the idea of OCR hikes would risk pushing financial conditions even further in an undesired direction.

Instead, we expect the RBNZ to retain the bottom line of its November statement: "Current policy settings will see growth strong enough to have inflation settle near the middle of the target range". The RBNZ will probably also repeat its reminder that further OCR cuts are not entirely off the table: "numerous uncertainties remain, particularly in respect of the international outlook, and policy may need to adjust accordingly".

One final wrinkle

There are two notable risks around the outlook for monetary policy this year: the possibility of a new RBNZ Governor and/or policy target, and the certainty of a general election. We'll discuss these in more depth at a later date, but we think they're worth mentioning now.

RBNZ Governor Wheeler's term ends in September, and it's unknown whether he will stand for a second term. The Finance Minister has said that an announcement will be made soon, possibly even before the *Monetary Policy Statement*. If Wheeler steps down, the RBNZ Board is likely to make an appointment around June or July. And regardless of whether there's a change of Governor, a new Policy Targets Agreement will have to be negotiated with the Finance Minister before the next term begins.

To complicate things, the election will be held on 23 September, just days before the Governor's term begins. If the election results in a change of government, it's possible that the PTA could be renegotiated a second time this year.

Given these uncertainties around the RBNZ's direction, the market's degree of confidence about an OCR hike before year-end seems misplaced.

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