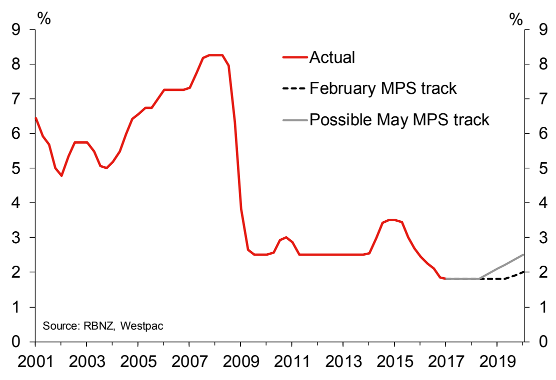
A new challenge

Preview of RBNZ Monetary Policy Statement, 11 May

5 May 2017

- We expect the Reserve Bank to hold the OCR at 1.75% next week, but with a stronger signal that the next move in interest rates will be up.
- Inflation is now close to the 2% target midpoint, though partly due to some temporary factors that are likely to fade over the next year.
- The challenge for the RBNZ now is to keep inflation on target over the medium term.
- The economy is growing steadily, but not at a pace that suggests the RBNZ needs to hit the brakes.
- And higher mortgage rates have already had a noticeable impact on house prices and consumer spending.

RBNZ OCR projection



Next Thursday's Monetary Policy Statement will address a challenge that the Reserve Bank hasn't faced in many years: not how to return inflation to the target, but how to keep it there. Headline inflation has reached the 2% mark much sooner than expected, though partly due to some temporary factors that will wane over the coming year. Still, measures of underlying inflation have also been picking up for the last year or so, which suggests that the RBNZ will need to move away from the current loose monetary policy settings at some point.

The question is how soon the RBNZ will take that step. If there were reason to think that inflation could accelerate further and threaten the upper end of the 1-3% target range, there would be a case for raising the OCR now. Instead, our view – one that we think the RBNZ will come to as well – is that inflation is likely to hold around the 2% mark for the next year or so. There's little sign that the economy is at risk of overheating, and there are still some headwinds to a further pickup in inflation over coming years.

Nevertheless, the RBNZ will have to acknowledge how conditions have changed in the last three months. The February MPS and the March OCR review both concluded that "monetary policy will remain accommodative for a considerable period", and the RBNZ's projections suggested that the OCR could remain on hold until late 2019. With inflation picking up sooner than expected, that no longer seems like a tenable forecast. We expect the bottom line in next week's statement to be more along the lines of:

"Monetary policy will continue to be accommodative, to ensure that medium-term inflation remains near the 2 percent midpoint of the Reserve Bank's target range."

We expect the RBNZ's interest rate projections to be more consistent with an OCR hike by late 2018. This would probably be neutral for financial markets on the day: an earlier start than previously signalled, but stopping short of endorsing market pricing for a hike by March next year.

Details

In a speech in March, RBNZ Governor Wheeler concluded that the risks around the OCR were evenly balanced, with downside risks from the global environment but upside risks from the domestic economy. In particular, the Governor emphasised the uncertainty around the Trump administration's policies, and the risk of a marked rise in trade protectionism.

The RBNZ's concerns about the global backdrop will probably remain. Forecasts of world growth have generally been revised up in recent months, but inflation (setting aside the rebound in oil prices over the last year) remains subdued. Moreover, US government policy is perhaps even more worrying now – the odds of a large fiscal stimulus in the near term are growing dimmer, while the risk of a wave of trade protectionism is very much at the forefront.

On the domestic front, the biggest development for the RBNZ is that inflation has risen much quicker than the RBNZ expected. After lingering at near-zero levels for much of the last two years, annual inflation rose to 2.2% in the March quarter – well ahead of the RBNZ's forecast of 1.5%, and a level that it hadn't expected to see for several more years.

Some of the surprise will have been due to developments since that forecast was made in early February, such as a weather-related spike in fruit and vegetable prices and a rise in fuel prices. The RBNZ had already braced itself for this outcome to some degree – in its March OCR review it noted that "headline CPI will be variable over the next 12 months due to one-off effects". However, the more domestically-driven components of the CPI also turned out a bit stronger than the RBNZ expected, and price rises in these areas tend to be more persistent.

On top of this, the New Zealand dollar is about 4% lower than the RBNZ projected in February, which will add to its forecast of tradables inflation over the next year at least. And the rebound in dairy prices over the second half of 2016 has proven to be more enduring than the RBNZ had assumed.

The outlook for medium-term inflation, however, is less straightforward. Fuel prices have now passed their peak impact on annual inflation – the 80% rise in crude oil prices between February 2016 and February 2017 is unlikely to be repeated – and food prices will have returned to normal by next year. So we wouldn't be surprised if inflation is back below the 2% mark through much of 2018.

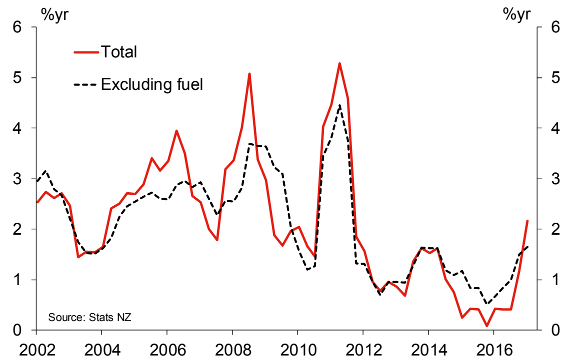
The economy is growing at a solid pace, but much of this is a reflection of population growth. Per-capita GDP growth is running at about 1% a year, not particularly high by historic standards. The unemployment rate of 4.9% is still above most estimates of the 'natural' rate, and the absence of any pickup in wage growth also suggests that the labour market still has some slack.

Finally, the housing market is proving to be a double-edged sword. House price growth has slowed sharply since August, and has flattened out completely in previous hotspots such as Auckland and Tauranga. Loan-to-value limits for property investors were tightened further in July, and – more importantly in our view – mortgage rates have risen in recent months. To date the RBNZ has treated the housing slowdown as temporary, "given the continued imbalance between supply and demand". But the evidence is now too strong to dismiss.

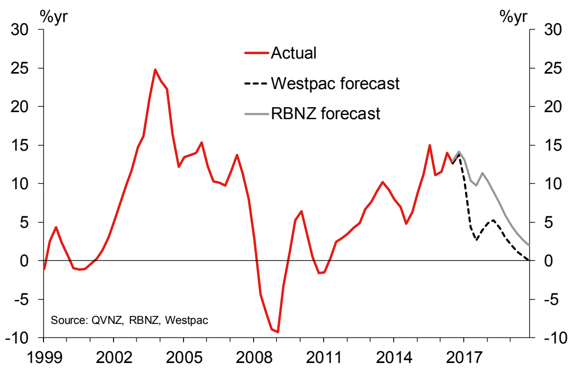
While the RBNZ may be pleased to see a cooling in the housing market from a financial stability perspective, it presents a real challenge on the monetary policy side. The RBNZ's forecasts have relied on strong household spending, supported by rising house prices, to drive economic growth and a lift in domestic inflation. In February the RBNZ forecast an 11% rise in house prices this year; so far it's tracking in the low single digits. And that already seems to be having an impact on consumer spending – for instance, card spending on durable goods has fallen in five of the last six months.

With inflation back on track earlier than expected, the RBNZ will no doubt be weighing up when it can start 'normalising' interest rate settings. But we're wary that signalling too much in the way of rate hikes at this stage could push retail interest rates and the exchange rate higher, undermining the growth that the RBNZ is relying on to meet its inflation target.

CPI inflation



House price forecasts



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