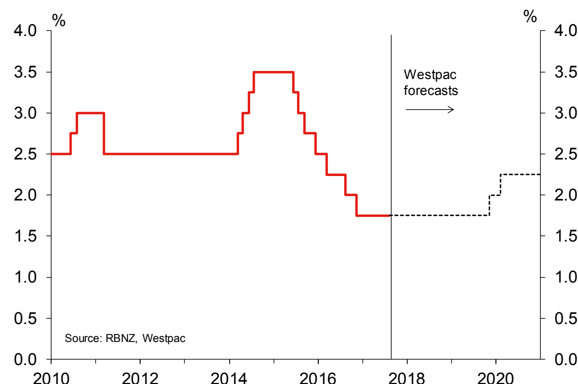
# A matter of time

## RBNZ Monetary Policy Statement review, August 2017

**10 August 2017**

- The Reserve Bank kept the Official Cash Rate on hold at 1.75%, and made few changes to its forecasts or its guidance on future monetary policy.
- The RBNZ believes that a long period of low interest rates is needed, in order to generate a sustained rise in home-grown inflation.
- We broadly agree with that view, and we think that interest rate hikes are much further away than the market is factoring in.
- We have pushed out our expected timing of the first OCR increase to the end of 2019.

**Official Cash Rate forecasts**




Today the Reserve Bank left the Official Cash Rate unchanged at 1.75%, as was widely expected, and the guidance that it provided was very similar to its previous statements. Monetary policy is expected to remain accommodative for a long time, in order to support growth and guide inflation towards the RBNZ's target on a sustained basis.

We had expected a slightly softer tone from the RBNZ given the weaker balance of economic data over the last few months. Financial markets had started to lean in that direction as well over the last week. However, while the RBNZ acknowledged the recent softer data, it held the line on just about every aspect of its forecasts. The projected OCR path was identical to the May *Monetary Policy Statement*, with a flat track for the next two years before a gentle upturn.

Weak global inflation pressures and a high New Zealand dollar mean that tradables inflation is expected to remain soft. That puts the burden on higher domestically-generated inflation, in order to keep overall inflation on target. The RBNZ believes that low interest rates will achieve this, but that they need to be given time to do their work. On that basis, market expectations for OCR hikes in the second half of 2018 seem misplaced.

We've been broadly in agreement with the RBNZ's view for some time. If anything, we're less confident that the economy is on track for above-trend growth and higher non-tradables inflation. Our GDP growth forecasts for the next few years are below the RBNZ's, and we're more inclined to believe that the current slowdown in the housing market will persist.

For that reason, we're pushing out our forecasts for the timing of OCR hikes, which were already at the far end of the range of market forecasts. Previously, we expected the first hike to be delayed until the March quarter of 2019; we now expect it to be in the December quarter of that year. As we've noted before, it's hard to be specific about dates over this sort of time horizon; the key point is that we believe OCR hikes are much further away than the market thinks.

## Details

The RBNZ has made few changes to its economic activity forecasts since the May statement. The softer than expected GDP outturns over the last two quarters were treated as temporary. GDP is forecast to grow by 3.4% over this year and 3.6% next year, both of which are well above the country's potential growth rate. This implies a shift from a zero to a positive output gap over the next couple of years, and a subsequent lift in the pace of non-tradables inflation.

Consumer prices were softer than expected in the June quarter. The RBNZ has taken this surprise as given, so that it is expected to drag down annual inflation for the coming year – in fact, the RBNZ now expects inflation to briefly drop below 1% in the year to March 2018. Beyond that, though, the outlook is largely unchanged, with inflation gradually returning to the 2% midpoint of the RBNZ's target by early 2019.

The New Zealand dollar is about 3% higher today than the RBNZ had assumed in its May forecasts, which is also weighing down the outlook for inflation over the next year. However, the RBNZ has maintained its assumption of a gradual decline in the exchange rate over the next few years, so that there is no long-run impact on the inflation outlook.

The RBNZ has acknowledged the slowdown in the housing market over the last year, though it remains concerned about the risk of a resurgence in house prices. Even its central forecast of a 4% rise in prices this year implies a substantial acceleration over the remainder of this year.

This is a significant point of difference for us. We believe that higher interest rates have played the greatest role in cooling the housing market, and that they will continue to do so over the next few years. That implies a softer path for spending, investment and housing construction, and hence less home-grown inflation pressures than the RBNZ is looking for.

## Market implications

While the basic tone of the *Monetary Policy Statement* was as expected, markets were a little surprised that the RBNZ's response to recent weaker data was so muted. The New Zealand dollar initially rose a third of a cent, though it has reversed course since then. The two-year swap rate rose two basis points.

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## RBNZ Statement

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

Global economic growth has become more broad-based in recent quarters. However, inflation and wage outcomes remain subdued across the advanced economies, and challenges remain with on-going surplus capacity. Bond yields are low, credit spreads have narrowed and equity prices are at record levels. Monetary policy is expected to remain stimulatory in the advanced economies, but less so going forward.

The trade-weighted exchange rate has increased since the May Statement, partly in response to a weaker US dollar. A lower New Zealand dollar is needed to increase tradables inflation and help deliver more balanced growth.

GDP in the March quarter was lower than expected, adding to the softening in growth observed at the end of 2016. Growth is expected to improve going forward, supported by accommodative monetary policy, strong population growth, an elevated terms of trade, and the fiscal stimulus outlined in Budget 2017.

House price inflation continues to moderate due to loan-to-value ratio restrictions, affordability constraints, and a tightening in credit conditions. This moderation is expected to persist, although there remains a risk of resurgence in prices given continued strong population growth and resource constraints in the construction sector.

Annual CPI inflation eased in the June quarter, but remains within the target range. Headline inflation is likely to decline in coming quarters as the effects of higher fuel and food prices dissipate. The outlook for tradables inflation remains weak. Non-tradables inflation remains moderate but is expected to increase gradually as capacity pressure increases, bringing headline inflation to the midpoint of the target range 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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