Westpac Institutional Bank

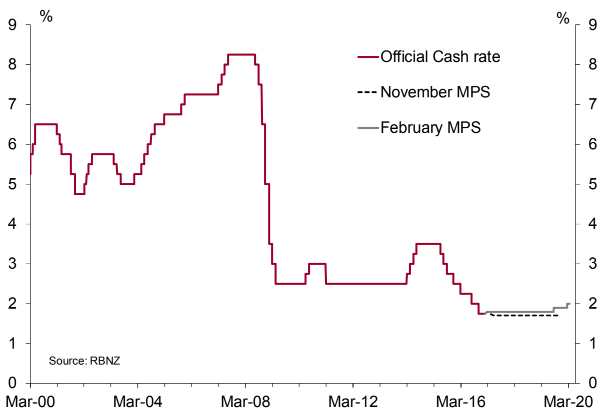
9 February 2017

RBNZ leaves OCR at 1.75%

February 2017 Reserve Bank Monetary Policy Statement Review:

- At its February interest rate decision, the Reserve Bank kept the Official Cash Rate on hold at 1.75%. The Bank also signalled that the OCR is likely to remain on hold for some time. The tone of the accompanying policy statement was very neutral.
- The Bank's forecasts for the OCR have been nudged up very slightly over the next few years, and now curve up just a little in late-2019/early-2020. This doesn't suggest that any rate hikes are imminent. Rather, it reflects that with the economy growing at a firm pace and inflation gradually climbing, the risks for the OCR have become more balanced.
- With inflation expected to lift only gradually, we see a very low probability that recent OCR cuts will be reversed any time soon.

RBNZ OCR forecasts



Even more neutral

At today's *Monetary Policy Statement*, the Reserve Bank left the Official Cash Rate on hold 1.75% and signalled that it is likely to remain on hold for some time. The tone of the accompanying policy statement was very neutral.

RBNZ Governor Wheeler described today's *Statement* as a shift from an easing bias in November to a neutral one. Though looking back at the November *Statement*, it's a shift from what was only a very modest easing bias to begin with. Back in November the RBNZ signalled an extended period of low rates and had a very balanced outlook for economic conditions. However, their projection for the OCR lingered at 1.7% though to the end of 2019. As the RBNZ's forecasts for the OCR are rounded to one decimal place, we read this as implying about a 20% chance of a rate cut, but not indicating any commitment to doing so.

Three months on and while the economy continues to face some headwinds, particularly from offshore, economic conditions in New Zealand are looking quite healthy. GDP growth is continuing to chug along. And importantly, headline inflation is back in the band. On top of this, inflation expectations, a perennial concern for the RBNZ given their impact on businesses' decisions in relation to wage and price settling, are looking well anchored.

In light of these developments, the RBNZ projections for the Official Cash Rate have been nudged up just slightly. The OCR is now projected to remain at 1.8% through to June-2019, which more-or-less points to the cash rate remaining at its current level for an extended period. Consistent with this, Governor Wheeler noted that the chances of a rate cut or a rate hike are equally balanced.

The RBNZ's projections do start to rise through the latter part of 2019 and are consistent with the OCR increasing to 2.00% in early 2020. This certainly does not suggest that a rate hike is imminent. But if economic conditions evolve in line with the RBNZ's expectations, then the next move is expected to be up, though this is still a long way off.

Despite the slight hawkish tilt in the RBNZ's interest rate forecasts, they are still a long way away from market pricing, which prior to today's *Statement* had factored in a rate hike before year's end. Consequently, the New Zealand dollar fell about half a cent to 0.7250, and the two-year swap rate fell five basis points to 2.35%.

Our view on the OCR is broadly in line with the RBNZ's *Statement*: the next move in rates is likely to be up, but it is too far into the future to be precise about the timing. All the signs point to inflation lingering the lower half of the target range for some time. On that basis, the case for reversing the recent OCR cuts any time soon looks weak.

Steady as she goes in the face of low imported inflation

While inflation has picked up and inflation expectations have stabilised, the RBNZ still expects that the return to their 2% target mid-point will occur only gradually. That's an assessment that we share.

Much of the softness in inflation in recent years has been due to the low level of imported inflation. And while prices for some commodities like oil have picked up, the prices of imported consumer goods generally remain low. Furthermore, with the appreciation of the NZ dollar in recent months, imported inflation will likely remain weak for some time.

To offset this weakness in imported prices (which is largely beyond their control), the RBNZ needs the domestic economy to continue growing at a solid pace. Things on this front are looking pretty good. There's a large pipeline of construction activity, population growth remains strong, and spending has picked up.

But one of the key factors underpinning this strength in domestic demand is low interest rates. To ensure the economy continues trucking along, the OCR will need to remain low for some time.

The big concerns still stem from offshore

The RBNZ sees the major risks to the outlook continuing to stem from the global environment. In large part, these risks largely relate to geo-political developments in the US and European economies. And although they have become more balanced in recent months, the risks for global growth and inflation are still to the downside.

Even if global growth remains steady, conditions in the global economy are still a potential source of headwinds for New Zealand. In particularly, expectations of increased infrastructure spending under the Trump Presidency and tightening by the Fed have already added to upwards pressure on borrowing rates here in New Zealand. This has seen some of the momentum coming out of the housing market. And as this is one of the key drivers of domestic demand in the New Zealand economy, it reinforces the need for the OCR to remain low.

Where to from here?

We expect that the OCR will remain on hold for an extended period. With the NZ dollar lingering at high levels and tradables inflation remaining low, it will be some time before inflation is back around the target mid-point (the RBNZ expects this to occur in early 2019; we expect it will be slightly sooner, in the back half of 2018). Furthermore, the pick-up in domestic inflation that is expected is dependent on the continuation of low borrowing rates. With this in mind, the case for reversing the recent OCR cuts any time soon looks weak.

We do expect that the next move in rates is likely to be up. But it is too far into the future to be precise about the timing.

Complicating matters for the RBNZ is the state of the housing market. For better-or-worse, house prices are a key determinant of household wealth and spending in New Zealand. While price growth has slowed, the RBNZ still expects it remain firm over the coming year. As result, financial stability concerns will remain very front of brain (as an aside, the Governor noted today that the RBNZ is still looking into lending restrictions based on borrowers' income potential). In contrast, should housing market conditions cool faster than the RBNZ expects, we could see softer household spending. With borrowing rates creeping higher in recent months, this is certainly where we see the risks.

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RBNZ Statement

The Reserve Bank today reduced the Official Cash Rate (OCR) by 25 basis points to 1.75 percent.

Significant surplus capacity exists across the global economy despite improved economic indicators in some countries. Global inflation remains weak even though commodity prices have come off their lows. Political uncertainty remains heightened and market volatility is elevated.

Weak global conditions and low interest rates relative to New Zealand are keeping upward pressure on the New Zealand dollar exchange rate. The exchange rate remains higher than is sustainable for balanced economic growth and, together with low global inflation, continues to generate negative inflation in the tradables sector. A decline in the exchange rate is needed.

Domestic growth is being supported by strong population growth, construction activity, tourism, and accommodative monetary policy. Recent dairy auctions have been positive, but uncertainty remains around future outcomes. High net immigration is supporting growth in labour supply and limiting wage pressure.

House price inflation remains excessive and is posing concerns for financial stability. Although house price inflation has moderated in Auckland, it is uncertain whether this will be sustained given the continuing imbalance between supply and demand.

Headline inflation continues to be held below the target range by ongoing negative tradables inflation. Annual CPI inflation was weak in the September quarter, in part due to lower fuel prices and cuts in ACC levies. Annual inflation is expected to rise from the December quarter, reflecting the policy stimulus to date, the strength of the domestic economy, and reduced drag from tradables inflation.

Monetary policy will continue to be accommodative. Our current projections and assumptions indicate that policy settings, including today's easing, will see growth strong enough to have inflation settle near the middle of the target range. Numerous uncertainties remain, particularly in respect of the international outlook, and policy may need to adjust accordingly.

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