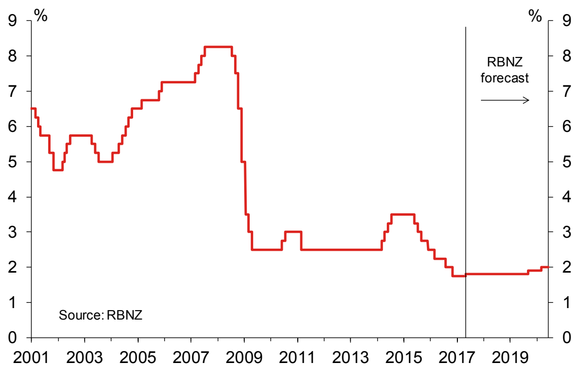
We're not going anywhere

May 2017 RBNZ Monetary Policy Statement review

11 May 2017

- At its May interest rate review, the Reserve Bank kept the Official Cash Rate on hold at 1.75%, as expected.
- However, the RBNZ also concluded that developments since the February *Monetary Policy Statement* have been neutral for monetary policy. Consequently, they kept the projected path for the OCR unchanged, with no rise in the OCR factored in until late-2019. We and the market had expected the RBNZ to signal an earlier start to interest rate hikes.
- We still think that OCR hikes will be later than financial markets are pricing (first half of 2018), but earlier than the RBNZ has signalled (late 2019).

RBNZ OCR forecasts



Stuck in neutral

The Reserve Bank left the Official Cash Rate on hold at its May policy review. However, the accompanying policy statement and interest rate projection were a bit more dovish than we and markets had been expecting.

As in the past two policy statements, the RBNZ reiterated that *"monetary policy will remain accommodative for a considerable period"*. That wasn't too surprising, as even if the OCR was to rise from here, it would still be very low. But digging into the details of today's report showed that the Reserve Bank's projection for the OCR was unchanged from February when it last published forecasts. The OCR is projected to remain on hold until September 2019, and then rise gradually further ahead.

While we expect that the OCR will remain low for some time yet, we had expected that the RBNZ would bring the timing of hikes forward a little. So what stayed the RBNZ's hand?

First up, the RBNZ has looked through the recent rise in inflation back above 2%. And rightly so in our opinion. The rise in inflation in early 2017 was largely a result of higher food and fuel prices, both of which will only have a temporary impact on inflation. Consistent with this, the RBNZ's forecasts show inflation dropping back to 1.1% in early 2018. We think that inflation will likely be a little stronger than this, but nonetheless, this isn't where monetary policy should be focusing. What's more important is the longer term outlook and the strength of domestic activity.

On activity, the Reserve Bank has become a little more downbeat. Growth surprised to the downside in the latter half of 2016. And although activity is expected to expand at a reasonable pace over the next few years, the RBNZ is of the view that there is a bit more spare capacity than they had previously been factoring in. On top of this, much of the growth that's projected is coming on the back of strong population increases. While that's adding to demand, it's also boosting the economy's supply potential, meaning only a limited rise in the associated inflation pressures.

In addition to this, house price inflation has slowed more rapidly than the RBNZ had expected, and they forecast it to drop by more over the coming months. While recent reports from the RBNZ have suggested that the link between house prices and household spending has softened, this is still an important channel that monetary policy uses to affect activity in the economy. And a softer outlook for house prices is expected to weigh on demand more generally.

Lastly, the RBNZ remains very conscious of the softness in global inflation. So even though the NZ dollar is lower than they had been expecting, tradables inflation is projected to rises only gradually over the coming years.

Putting all this together, the RBNZ projections still show inflation only getting back to their 2% target mid-point in mid-2019, as they did in February. In fact, the RBNZ's policy statement noted that: *"Developments since the February Monetary Policy Statement on balance are considered to be neutral for the stance of monetary policy."*

Same-same, but different

There are parts of the RBNZ's updated outlook that closely match our own views. In particularly, we think the recent rise in inflation is a "look through" event. We've also been a bit more downbeat on the outlook for house prices for some time.

However, there are other areas of the RBNZ's forecasts that we're a bit more circumspect about.

The RBNZ doesn't appear to have factored much into its projections for the improvement in export prices and related boost to national incomes. This may reflect a view that some of the recent increases in export commodity prices will be temporary.

On fiscal policy, the RBNZ has taken a pragmatic approach. While it's made some allowances for policy announcements to date (like increased infrastructure spending), it hasn't factored in a major boost to activity from fiscal policy at this stage. That's because with the Budget not out until the 25th of May, the RBNZ is still waiting on the precise details of any new spending plans. However, it's likely that fiscal policy will adopt a more expansionary stance over the coming year. As well as increased infrastructure spending, the Minister of Finance has already signalled some changes in tax thresholds. And it wouldn't be surprising to see a bit more announced ahead of the September election. Of course, spending plans could be materially affected by the outcome of the election. Nevertheless, we still expect that policy settings will be more stimulatory over the next few years.

Lastly, the RBNZ's projection for non-tradables looks a little on the soft side to us. While population growth is providing an offset, we think that the strong outlook for residential and non-residential construction will generate a bit more of a lift in domestic inflation over the coming years.

Where to from here?

We continue to expect that the RBNZ will keep the OCR on hold for an extended period. The current food and fuel-related lift in inflation will be temporary. Imported inflation remains muted. And generating a sustained lift in domestic inflation will require rates to remain low for some time, especially given the sensitivity of domestic activity and house prices to interest rates.

But while there is definitely the need for interest rates to remain low for some time yet, the next move in rates is likely to be up. Despite the downside surprises in late 2016, economic activity is continuing to expand on the back of population growth and investments spending. We're also seeing firm activity in the tourism sector. These conditions will generate a lift in domestic inflation over time.

In terms of when we might see the first rate hike, we don't think the RBNZ projection for the OCR should be read literally (i.e. no hikes until late-2019). Rather, this is really a signal from the RBNZ that the OCR is going to remain at stimulatory levels for a long time.

Assuming the economy evolves as we're expecting, we'd expect the OCR to rise in the early part of 2019. We noted before that rate hikes are still too far off to be too precise about the timing. However, hikes are likely to come later than financial markets are currently pricing (market pricing currently points to a rate hike by mid-2018).

The war on other (policy) fronts

During the press conference that accompanied today's policy statement, the Governor noted that the RBNZ will be releasing a paper looking at debt-to-income ratios in the next few weeks. The RBNZ also recently mentioned that they are looking at banks' capital requirements. This suggest that the RBNZ is still looking at measures that could further cool the housing market.

Market reaction

Following the announcement the New Zealand dollar fell 110 points to 0.6830 and the two-year swap rate fell 8 basis points.

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RBNZ Statement

Official Cash Rate unchanged at 1.75 percent

Statement by Reserve Bank Governor Graeme Wheeler:

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 over recent months. However, major challenges remain with on-going surplus capacity and extensive political uncertainty.

Stronger global demand has helped to raise commodity prices over the past year, which has led to some increase in headline inflation across New Zealand's trading partners. However, the level of core inflation has generally remained low. Monetary policy is expected to remain stimulatory in the advanced economies, but less so going forward.

The trade-weighted exchange rate has fallen by around 5 percent since February, partly in response to global developments and reduced interest rate differentials. This is encouraging and, if sustained, will help to rebalance the growth outlook towards the tradables sector.

GDP growth in the second half of 2016 was weaker than expected. Nevertheless, the growth outlook remains positive, supported by on-going accommodative monetary policy, strong population growth, and high levels of household spending and construction activity.

House price inflation has moderated further, especially in Auckland. The slowing 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 continuing 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 over the year ahead. 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.

Developments since the February Monetary Policy Statement on balance are considered to be neutral for the stance of monetary policy.

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

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