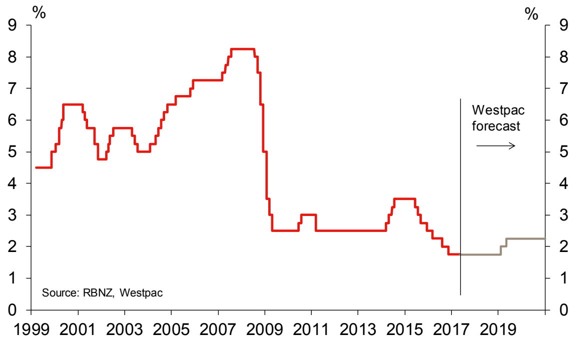
Firmly, firmly neutral

Preview of RBNZ OCR review, 22 June

16 June 2017

- We expect the Reserve Bank to hold the OCR at 1.75% next week and to maintain a neutral outlook for interest rates.
- In its May review the RBNZ regarded the recent jump in inflation as temporary, and noted that the softer than expected starting point for the economy would mean a more gradual lift in domestic inflation pressures. Recent developments will only bolster those views.
- There is a risk that next week's statement could emphasise the equal likelihood of rate cuts or hikes. That could rattle financial markets, which are largely focusing on rate hike scenarios.

NZ Official Cash Rate



We expect that next Thursday's OCR review won't stray from the firmly neutral tone of the May *Monetary Policy Statement*. Economic developments since May have been mixed, but we regard them as more or less balanced in terms of their consequences for monetary policy. So the straightforward option for the Reserve Bank would be to simply repeat much of the language from the May statement, concluding that "monetary policy will remain accommodative for a considerable period".

If there's anything that could surprise the market, though, it's that the RBNZ might decide to escalate the language around its neutral stance. For instance, in an interview that followed up the May *MPS*, the RBNZ chief economist emphasised that "there is an even chance of a hike or a cut in the future". Repeating those words next week certainly wouldn't be a shift in the RBNZ's position. But even so, elevating them to the OCR statement itself could wrong-foot financial markets, which are still pricing in a return to rate hikes by mid-2018.

It's worth reviewing why the RBNZ's firmly neutral stance in May stood in contrast to market thinking in the first place. Given the way that growth and inflation were progressing, most analysts – including ourselves – had expected the RBNZ to bring forward its projected timing for interest rate hikes, even if they remained somewhat distant. However, the RBNZ honed in on two particular factors.

The first factor was that the RBNZ regarded the recent jump in inflation (up to 2.2% in the year to March) as temporary. Fuel prices were much higher than a year earlier, but that increase was unlikely to be repeated. And fruit and vegetable prices had spiked due to flooding, but this effect would drop out by next year. We agreed on those points, but we felt that there were also some more persistent elements emerging in the CPI as well as the impact of fuel and food prices.

Recent information is unlikely to change the RBNZ's stance on this matter. Near-term inflation appears to be tracking close to forecasts, with a fall in fuel prices offsetting a further jump in vegetable prices. The higher that vegetable prices rise today, the further they have to fall in the future. So the RBNZ will remain comfortable in its view that headline inflation will drop back well below 2% over the first half of next year.

The second factor was that the RBNZ seems to have put more weight than usual on near-term GDP. December quarter growth was much lower than expected, and the September quarter was revised down as well. A lower starting point for economic activity implies a more gradual rise in inflation pressures. In particular, the RBNZ was concerned about an undershoot in construction activity, which would imply slower inflation in one of the few parts of the economy that has genuinely seen upward pressure on prices to date.

This week's GDP figures for the March quarter will only amplify the RBNZ's concerns. GDP growth was again much softer than expected – up 0.5% against the RBNZ's forecast of a 0.9% gain – and much of the shortfall was due to a drop in construction. We don't think that the slowdown in construction will be sustained, given the amount of work in the pipeline. Nevertheless it will play into the RBNZ's concerns about a weaker than expected starting point for the economy.

Other developments over recent weeks have been mixed. The New Zealand dollar is about 2% higher than what the RBNZ assumed in the May *MPS*, but this seems to be warranted by the stronger than expected terms of trade. The housing market has continued to slow, though the RBNZ will probably still remain wary of a resurgence. And at the margin, the announcements in last month's Budget will be considered mildly stimulatory.

Overall, these developments leave us comfortable with our view that the OCR will remain on hold over 2017 and 2018. While we have pencilled in hikes for early 2019, we'd describe this more generally as being too far away to be precise about the timing.

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