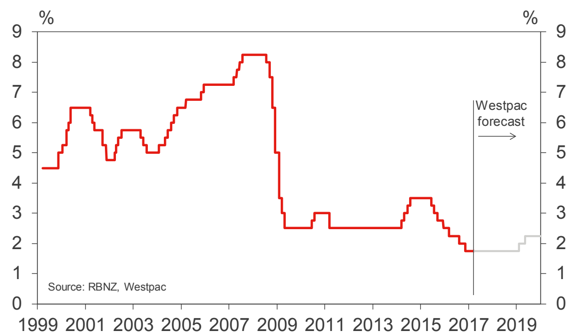
The little engine that could?

Preview of RBNZ OCR review, 23 March

17 March 2017

- We expect the Reserve Bank to hold the OCR at 1.75% and to maintain a neutral outlook for interest rates.
- While near-term inflation is looking a bit stronger, growth in activity has fallen short of the RBNZ's very optimistic forecasts. The slowdown in the housing market may have been a factor here.
- The risk is that the economy simply may not have enough puff to generate the sustained lift in inflation pressures that the RBNZ is looking for.

NZ Official Cash Rate



In its February *Monetary Policy Statement*, the Reserve Bank left the OCR unchanged and pointedly moved away from an easing bias to a more neutral stance. And in a speech two weeks ago, the Governor reiterated that "we consider the risks evenly balanced in respect of the OCR".

Is there any reason to expect a change in that assessment at next Thursday's OCR review? Given the absence of a full forecasting round, and the limits of what can be conveyed in a one-page statement, we suspect the message will be largely unchanged this time. But we'd emphasise that the balance of economic news in recent weeks has been on the softer side, making the case for an OCR increase look even more distant.

The issue for the RBNZ is not that the economy is slowing; the underlying picture looks pretty steady, with growth running at what we'd characterise as 'average'. But the RBNZ needs more than 'average' growth to meet its inflation target. The risk is that the economy simply doesn't have enough puff to generate the domestic price pressures that the RBNZ is hoping for.

Yesterday's GDP report showed growth of just 0.4% in the December quarter, much softer than the 1% gain that the RBNZ had forecast in February. Combined with a downward revision to September quarter growth, that amounts to a significant shortfall relative to the RBNZ's assessment.

As we've pointed out, some of the softness in December quarter GDP was due to temporary factors that have little to do with the economy's productive capacity. Even so, the RBNZ's expectation that underlying growth will head towards 4% this year, in turn generating enough domestic price pressure to bring inflation back up to the 2% target, is looking increasingly like a stretch.

Some of that shortfall in domestic growth may be due to the cooling in the housing market, as loan-to-value restrictions and higher mortgage rates have taken their toll. House prices tend to have a strong relationship with consumer spending in New Zealand, and indeed the RBNZ's forecasts have long relied on strong growth in both of these measures.

The February *MPS* forecasts assumed that house prices would be re-accelerating by this point, with a 2.4% gain in the March quarter alone; instead, house prices are tracking close to flat for the quarter. And while it's early days, there are signs that growth in consumer spending has slowed in recent months.

Curiously, the Governor's speech earlier this month, which was ostensibly about monetary policy, seemed to celebrate the slowdown in house prices from a financial stability point of view. Yet there was no mention of the negative implications for domestic demand, inflation and monetary policy.

The other negative factor in recent weeks has been the pullback in world dairy prices. However, the RBNZ had already taken a very cautious view of the rise in dairy prices over the second half of 2016, and the recent fall in prices seems to have brought them back towards what the RBNZ was already assuming in its forecasts.

Against these negative factors, inflation is looking stronger than expected over the near term. The RBNZ was forecasting a 0.3% rise in prices for the March quarter (1.5% annual); we're now expecting a 0.7% rise (1.8% annual).

Food prices in particular have picked up in recent months, having been close to flat for the last several years. However, some of this seems to be due to unusually large seasonal increases; if that's the case, we can expect to see some unusually large price declines as the year progresses. The key point here is that with inflation still tracking on the lower side of the 2% target, the RBNZ has plenty of time to make that judgement about whether recent price gains will continue.

We expect next week's statement to retain the message that "monetary policy will remain accommodative for a considerable period". While the February MPS interest rate projections showed an uptick towards the end of 2019, we'd characterise this as saying that the first OCR hike is too far away to be specific about the timing. Next week's statement is likely to be just as vague on the matter.

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