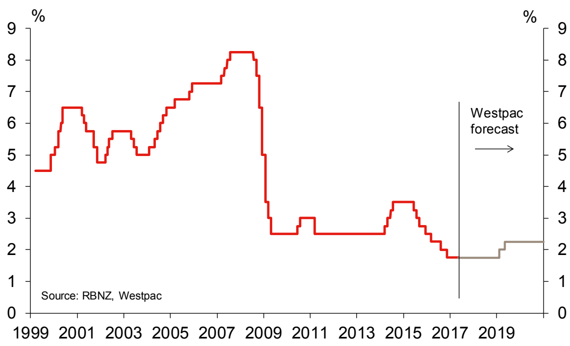
A statement of neutrality

RBNZ OCR review, June 2017

22 June 2017

- The Reserve Bank left the Official Cash Rate unchanged at 1.75%, and reiterated that interest rates will remain low for a considerable time.
- The RBNZ is braced for some volatility in the inflation rate. The recent upturn is likely to prove temporary, followed by a temporary slowdown next year.
- The RBNZ remains positive on the outlook for the local economy. However, with a softer than expected starting point, the pick-up in underlying inflation is expected to remain gradual.
- We continue to expect no change in the OCR this year or next year.

Official Cash Rate



This morning the Reserve Bank once again left the Official Cash Rate unchanged at 1.75%. As we expected, the RBNZ seems to have taken developments over the last six weeks as neutral for monetary policy, and today's statement ended on the same note as the last several statements: *"Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly."*

While we expected the RBNZ to largely cover the same ground as its May *Monetary Policy Statement*, we saw a risk that it might use today's statement to reinforce what a 'neutral' stance actually means – namely, that rate cuts are just as likely as hikes. But with no explicit reference to rate cut scenarios in today's statement, there was a small relief bounce in the New Zealand dollar, which rose about 30 points to 0.7250. Market interest rates were unmoved.

Our view remains that the OCR will remain on hold through 2017 and 2018. In that sense, we're closer to the RBNZ's view than to the wider market, which is still pricing in an OCR hike by mid-2018. Given that the RBNZ expects inflation to be testing the lower end of the 1-3% target range again by early 2018 (and recent developments have made this more likely), this seems like an unlikely timing for a tightening of monetary policy.

Details

Today's statement repeated much of the wording from the May statement, with a few changes to acknowledge some of the developments since then. The RBNZ remains positive on the outlook for the domestic economy, despite another softer than expected GDP result in the March quarter. The RBNZ still expects economic growth to find support from low interest rates, strong population growth and the rebound in export prices, along with the stimulatory measures announced in the Budget last month.

The RBNZ didn't express any significant discomfort with the New Zealand dollar. The trade-weighted index has risen in recent weeks, and is within just a few percentage points of its record highs. But while the RBNZ noted that a lower exchange rate would help to rebalance growth, it made no mention of the currency as a risk to the inflation outlook.

In fact, the RBNZ's overall assessment of inflation was unchanged from May. It expects annual inflation to be volatile over the next year or so, as one-off factors enter and then drop out of the calculation. Nevertheless, underlying price and wage growth is expected to lift only gradually.

While the RBNZ didn't mention recent price developments, we think these will strengthen the RBNZ's view that annual inflation will slow substantially over the first half of 2018. Vegetable prices surged even higher in May after flooding earlier this year wiped out some crops. But this just means that they have further to fall over the next year, which will act as a drag on inflation. In addition, fuel prices have fallen sharply in recent weeks (and are now down on the same time last year), due to lower world oil prices and the stronger New Zealand dollar.

Of course, the coming pullback in annual inflation will also be temporary (we expect it to be back up to 2% by 2019), and the RBNZ will be prepared to look through this as well. But as long as the pickup in underlying inflation remains gradual, and inflation expectations remain well anchored, the RBNZ is unlikely find itself under pressure to raise rates by this time next year.

Michael Gordon
Acting Chief Economist

Full text of the RBNZ media release

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

Headline inflation has increased over the past year in several countries, but moderated recently with the fall in energy prices. Core inflation and long-term bond yields remain low. Monetary policy is expected to remain stimulatory in the advanced economies, but less so going forward.

The trade-weighted exchange rate has increased by around 3 percent since May, partly in response to higher export prices. A lower New Zealand dollar would help rebalance the growth outlook towards the tradables sector.

GDP growth in the March quarter was lower than expected, with weaker export volumes and residential construction partially offset by stronger consumption. Nevertheless, the growth outlook remains positive, supported by accommodative monetary policy, strong population growth, and high terms of trade. Recent changes announced in Budget 2017 should support the outlook for growth.

House price inflation has moderated further, especially in Auckland. The slowdown 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 on-going 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. 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.

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

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