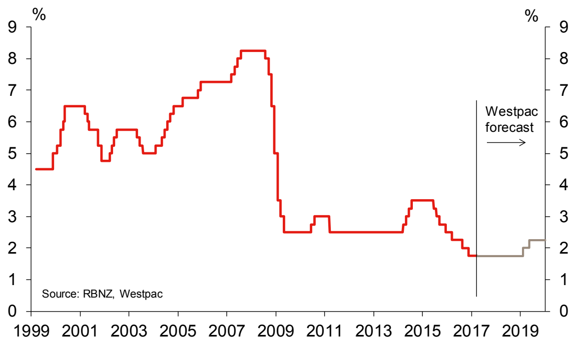
Hold the line

RBNZ OCR review, March 2017

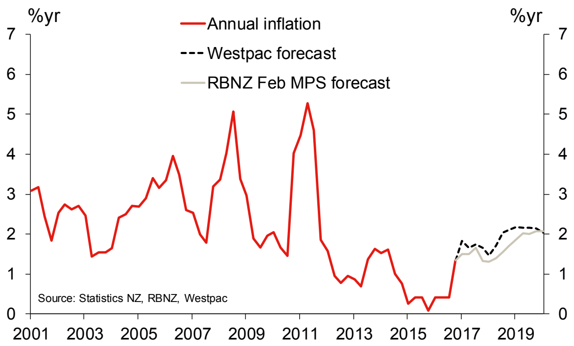
23 March 2017

- The Reserve Bank left the Official Cash Rate unchanged at 1.75%, and reiterated that interest rates will remain low for a considerable time.
- Inflation is shaping up to be stronger than expected in the near term. But the RBNZ seems to share our view that this is largely due to temporary factors.
- We continue to expect no change in the OCR this year or next.

Official Cash Rate



CPI inflation



The Reserve Bank left the Official Cash Rate unchanged at 1.75% today, as was widely expected. Overall, there was little in the accompanying statement to suggest any shift in the RBNZ's thinking, relative to the February *Monetary Policy Statement* and the Governor's speech in early March. The proof of the pudding was in the lack of reaction in either interest rates or the exchange rate after the announcement.

The bottom line is that the RBNZ expects the cash rate to remain low for a considerable period (the forecasts published in February suggested no change until late 2018). The outlook for the New Zealand economy remains positive, but the risks around the global environment are seen to the downside.

On the latter, geopolitical risks are certainly a concern, but not the only one. RBNZ Governor Wheeler has already spelled out his concerns about Trump's policy agenda and the potential impact on New Zealand, and nothing has changed in recent weeks to allay those concerns. But the RBNZ also highlighted the economic aspects: there is still significant excess capacity in the global economy, and core inflation (excluding oil price movements) remains low and stable. The implication is that imported inflation is still seen as largely absent.

In contrast to the international picture, the RBNZ is still fairly positive on the local economy, which is being supported by strong population growth, building activity and low interest rates. The RBNZ noted the weaker than expected December quarter GDP outturn, but attributed it to temporary factors.

The RBNZ also held its line on the housing market, noting again that it wasn't convinced that the recent slowdown in house prices will be sustained. This is one area where we differ. We've long emphasised the role of interest rates in determining house prices, and we think that the rise in mortgage rates over recent months will have a lasting impact on the rate of house price growth. That will have consequences for inflation, in terms of the strength of growth in domestic demand, and in the building industry's ability to keep ramping up prices.

One of the few additions to today's statement was that the RBNZ was "encouraged" by the fact that the New Zealand dollar has lost some ground in recent weeks. However, there's no sense that this will make a meaningful difference on the inflation front. Even if it's sustained, a 4% fall in the exchange rate – coming after a 10% rise in the preceding year – just isn't that significant in the scheme of things.

The RBNZ noted that headline inflation will be "variable" over the coming year due to one-off effects from food and imported goods prices. That's clearly a reference to the fact that the next inflation result is shaping up to be stronger than the 1.5% rate that the RBNZ forecast in the February MPS (we expect it to rise to 1.8%). However, the RBNZ seems to share our view that the inflation rate will struggle to move any higher over the rest of this year. Some of the factors behind the near-term rise in inflation are:

- World oil prices are up around 80% on a year ago, when they were at their lowest ebb. Unless prices continue to rise at that pace – unlikely, with US frackers once again stepping in to ramp up production – we are now passing the peak inflationary impact of oil prices.
- Locally, prices for dairy products have risen in line with the lift in the farmgate milk price for this season (which affects the cost of ingredients). Unless next season's milk price is substantially higher than the current season, these price increases won't be repeated.
- Prices for some fresh produce have been unusually high in recent months, as poor weather has delayed harvesting. These prices will drop back to normal levels as the harvest is completed.

Meanwhile, evidence of a broad-based rise in inflation pressures remains hard to come by. An unemployment rate of around 5%, and per capita GDP growth of 1% a year, just don't speak to an economy that's at risk of overheating. While we do expect inflation to be above the RBNZ's most recent published forecasts, we still see it lingering in the lower half of the 1-3% target range for at least another year.

Consequently, we agree with the RBNZ that the OCR will remain on hold for some time. We've pencilled in two OCR increases in the first half of 2019, but the way we'd describe this more generally is that the first rate hike is too far away to be precise about the timing.

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.

Macroeconomic indicators in advanced economies have been positive over the past two months. However, major challenges remain with on-going surplus capacity in the global economy and extensive geo-political uncertainty.

Global headline inflation has increased, partly due to a rise in commodity prices, although oil prices have fallen more recently. Core inflation has been low and stable. Monetary policy is expected to remain stimulatory, but less so going forward, particularly in the US.

The trade-weighted exchange rate has fallen 4 percent since February, partly in response to weaker dairy prices and reduced interest rate differentials. This is an encouraging move, but further depreciation is needed to achieve more balanced growth.

Quarterly GDP was weaker than expected in the December quarter, but some of this is considered to be due to temporary factors. The growth outlook remains positive, supported by on-going accommodative monetary policy, strong population growth, and high levels of household spending and construction activity. Dairy prices have been volatile in recent auctions and uncertainty remains around future outcomes.

House price inflation has moderated, and in part reflects loan-to-value ratio restrictions and tighter lending conditions. It is uncertain whether this moderation will be sustained given the continued imbalance between supply and demand.

Headline inflation has returned to the target band as past declines in oil prices dropped out of the annual calculation. Headline CPI will be variable over the next 12 months due to one-off effects from recent food and import price movements, but is expected to return 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, particularly in respect of the international outlook, and policy may need to adjust accordingly.

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