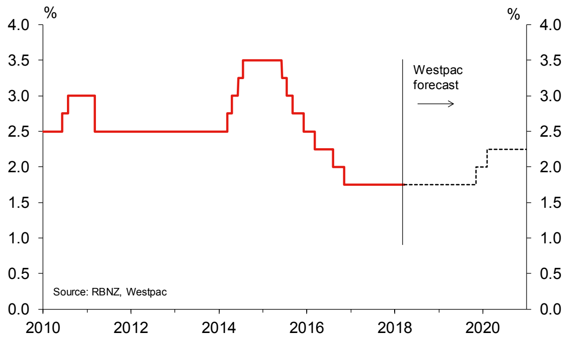
Last turn at bat

RBNZ OCR preview, 22 March 2018

16 March 2018

- We expect the OCR to remain at 1.75% until late 2019.
- Recent developments have given the Reserve Bank little cause to change its stance. Low inflation means that interest rates will need to remain low for a considerable period.
- The incoming RBNZ Governor is due to sign a new Policy Targets Agreement shortly. Employment will be a consideration in future OCR decisions, but the details have yet to be resolved.

Westpac OCR forecast



Next Thursday's OCR review will surely be a low-key affair. There are times when the Reserve Bank has had to contend with a range of surprises that have had offsetting implications for inflation, leaving its assessment broadly unchanged. This is not one of those times. There is very little since the February Monetary Policy Statement that will have come as a surprise to the Reserve Bank. So its bottom line is likely to remain the same: *"Monetary policy will remain accommodative for a considerable period"*.

The last piece of information ahead of the OCR review was yesterday's GDP release, which showed that the economy grew by 0.6% in the December quarter last year. This was only a little below the RBNZ's forecast of 0.7% growth, and some of the recent softness relating to the poor dairying season could be regarded as temporary. We've noted before that we think the RBNZ is too optimistic about an acceleration in growth this year. But yesterday's GDP figures, on their own, will not be enough to prompt the RBNZ to reassess its view.

Near-term inflation looks to be on track to meet the RBNZ's forecast of a drop to 1.1% in the year to March. Food prices have been softer than usual in the first two months of the year, though they may jump higher again in March, as flooding has once again damaged some vegetable crops.

Data on the labour market and inflation expectations would have been available to the RBNZ on the day of the February OCR decision, even if they didn't make it into the forecasts published in the MPS. The fall in the unemployment rate to 4.5% was in line with the RBNZ's view, though wage growth was on the soft side. Inflation expectations for two years ahead ticked up a little, despite a surprise fall in the most recent inflation outturn.

The global picture seems to be a matter of wait and see. Analysts have been revising up their world growth forecasts in recent months, and the US Federal Reserve is on track to continue its gradual normalisation of interest rates (with a hike expected on the same morning as the RBNZ statement). The downward lurch in share prices happened before the February MPS; since then, financial markets have been volatile, but have picked up from their lows. The recent escalation of 'trade war' rhetoric from the US threatens to undermine the otherwise positive outlook for the world economy. This will probably rate a mention in the

RBNZ's statement, but it is far from the point at which it could sway monetary policy decisions here.

Finally, the exchange rate has been right in line with the RBNZ's assumption, with the trade-weighted index sitting at around 75.

Altogether, developments over the last six weeks give little reason for the RBNZ to change its stance or the tone of its statement. And even if that weren't the case, there is another matter to consider.

Next week's OCR review will be the last one for Acting Governor Grant Spencer, whose term ends on 26 March. Perhaps more importantly, it's also the last one under the current Policy Targets Agreement (PTA) between the RBNZ Governor and the Minister of Finance. Of course there will still be a great deal of continuity beyond that, in terms of the RBNZ's assessment of the economy. But with some impending tweaks to the RBNZ's targets, there's no scope for making any commitments about the future direction of monetary policy.

Incoming Governor Adrian Orr will need to sign a new PTA before he takes up the role on 27 March. No date has been given as to when we'll see the details of the new agreement. But it would be understandable if it was released after Thursday's OCR review, to avoid overshadowing the rate decision itself (and to avoid any confusion as to which agreement the RBNZ is currently operating to).

The Finance Minister has said that the new PTA will reflect his desire to include employment as part of the RBNZ's mandate. With that in mind, we could see some reference to "conducting monetary policy in a way that will best contribute to full employment", along the lines of the Reserve Bank of Australia's policy target. But this may only be a first draft of the employment mandate, ahead of the review of the Reserve Bank Act that is still under way.

Market reaction

We have been predicting for some time that the OCR won't be increased until late 2019. The Reserve Bank's (intentionally ambiguous) projections for the OCR are consistent with that view. We've also long argued that the market has been too forward in anticipating OCR hikes. While economists and financial market pricing have been pushing out their expected timing of hikes, they're still clustered around early 2019 as a start date.

A broadly unchanged OCR review statement next week is unlikely to have much impact on market pricing one way or the other. How the market might react to the details of the new PTA is less clear. What could be more important is any signal about how the new Governor plans to interpret the agreement.

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