RBNZ AUGUST MONETARY POLICY STATEMENT

10 August 2017

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STATUS QUO

BOTTOM LINE

- **The RBNZ stuck to its guns this morning, delivering a very similar statement to June.**
- **It is clear that it sees the need for a strong domestic economy to offset tradable inflation weakness.**
- **This means that hikes are a long way off and its stance is ultra-neutral, although there was a hat-tip within the forecasts to the next move in rates being up.**
- **Our OCR forecasts are under review as we weigh up structural inflation suppressants versus capacity and NZD prospects.**

KEY POINTS

- **The RBNZ maintained the OCR at 1.75% this morning, in what was Graeme Wheeler's final OCR decision as RBNZ Governor.** With recent economic developments largely consistent with its cautious stance, the RBNZ stuck with its clear ultra-neutral tone, repeating that "monetary policy will remain accommodative for a considerable period".
- **To be fair, we had expected there to be a few more dovish nuances within the statement than is apparent.** There was the odd tweak. Comments on the NZD were stiffened: whereas previously a lower NZD "would help" rebalance growth, is it now seen as "needed" to increase tradable inflation and deliver more balanced growth. A reference to wage growth being expected to increase gradually was dropped from the policy assessment (although it was still referred to in the broader statement). Affordability constraints were added to the list of factors moderating house prices (with this moderation still expected to persist). But essentially the policy assessment was a very 'BAU' message.
- **It is clear the RBNZ is focusing on the medium term, and recent developments do not appear to have changed its views on the medium-term outlook.** The RBNZ is maintaining a relatively positive view on the domestic growth outlook, continues to see the unemployment rate trending lower, and wage growth rising. As such, non-tradable inflation still rises gradually within the forecasts.
- **The tone of the document signals clearly that it is going to take a lot of accumulated evidence to warrant a departure from this cautious stance** (in either direction). The RBNZ is not going to respond to one or two data points.
- **In terms of the Bank's projections explicitly, there were few surprises.** The RBNZ has cut its inflation forecasts further, reflecting the lower starting point and recent oil price falls. Annual headline inflation hits 0.7% in Q1 2018. However, it is actually forecast to get back to 2% a quarter earlier than projected in May. The RBNZ's sequential growth forecasts are little changed, with the RBNZ forecasting quarterly GDP growth of between 0.8% and 1.0% over the next two years. We end up with a 1% plus positive output gap but modest inflation.

RBNZ MPS REVIEW

- **The bottom line is that the RBNZ feels the need to push the domestic economy along at a strong rate** to lift non-tradable inflation in order to offset weakness coming through the tradable channel (driven by the NZD and the low global inflation pulse). The situation is complicated by low past inflation contributing to weak price-setting behaviour by businesses. We think that's half true. In our view technology has been the big game-changer that is simply removing pricing power.
- **This strategy is not without risk.** Overcooking the domestic economy typically seeps into nasty imbalances. On that front we note the RBNZ expects the current account deficit to remain around 3% of GDP, which is an implicit hat-tip to the role prudential policy and the bank funding gap are playing in cooling housing-related excesses.
- **While the MPS wasn't as dovish as we expected (with an unchanged, rather than lower, OCR track) we think the "upside" surprise will fade quickly.** Although the 2yr swap has traded lower in recent weeks, OCR hikes were never priced out and market expectations still sit well above the RBNZ's projections. In addition, the high NZD remains a frustrating "watch and wait" variable for both inflation and the short end. The NZD has moved lower of late on the expectation of something more dovish today; that hasn't happened, so it is intuitively reasonable that it has corrected higher. But there are cross-currents aplenty at play still (global geopolitics, domestic politics, now increased RBNZ/Fed policy dispersion, and still-high soft commodity prices). Beyond the knee-jerk reaction we remain somewhat neutral on the NZD, expecting it to remain elevated. Nothing the RBNZ said today will embolden the NZD bears.
- **Our OCR forecasts are under review.** There are strong reasons to believe the OCR might not move much, if at all. Technological change is removing pricing power. The world needs to deleverage; that's deflationary. It's been 9 years since the GFC; that's a "long" cycle despite global growth remaining sombre. Tighter monetary policy is being delivered via prudential policy and other structural shifts such as competition for deposits, which is forcing term deposit rates well above the OCR – and the same is true for borrowing rates. That is taking pressure off the OCR, and is not going to change any time soon.
- **Nonetheless there are two key reasons why we remain biased towards lifts in the OCR, but with questions over the timing.** The first is a tightening in the labour market, which typically lifts wage growth and inflation. That said, low wage growth is a global phenomenon, with wage-bargaining power being diluted by disruptive technology that is threatening scores of jobs. On balance, we expect the former to modestly win out, while recognising the importance of the latter. Second, we do expect the NZD to correct at same stage as the liquidity cycle turns. This is taking longer than expected but remains our central scenario – and the turn when it comes will be sharp.

RBNZ MPS REVIEW

RBNZ SIDE-BY-SIDE

10 AUGUST MPS	22 JUNE OCR
The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 1.75 percent.	The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 1.75 percent.
Global economic growth has become more broad-based in recent quarters. However, inflation **and wage** outcomes remain subdued across the advanced economies, and challenges remain with on-going surplus capacity. Bond yields are low, **credit spreads have narrowed and equity prices are at record levels.** Monetary policy is expected to remain stimulatory in the advanced economies, but less so going forward.	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 since the May Statement, **partly in response to a weaker US dollar**. **A lower New Zealand dollar is needed to increase tradables inflation** and help deliver more balanced growth.	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 in the March quarter was lower than expected, adding to the softening in growth observed at the end of 2016. Growth is expected to improve going forward, supported by accommodative monetary policy, strong population growth, an elevated terms of trade, and the fiscal stimulus outlined in Budget 2017.	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 continues to moderate due to loan-to-value ratio restrictions, **affordability constraints**, and a tightening in credit conditions. This moderation is expected to persist, although there remains a risk of resurgence in prices given continued strong population growth and resource constraints in the construction sector.	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.
Annual CPI inflation eased in the June quarter, but remains within the target range. Headline inflation is likely to decline in coming quarters as the effects of higher fuel and food prices dissipate. The outlook for tradables inflation remains weak. Non-tradables inflation remains moderate but is expected to increase gradually as capacity pressure increases, bringing headline inflation to the midpoint of the target range over the medium term. Longer-term inflation expectations remain well anchored at around 2 percent.	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.	Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly.

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