THROUGH THE LOOKING GLASS

- Next Thursday the RBNZ will leave the OCR at 1.75%.
- With growth slowing yet inflation rising, the monetary policy outlook has gotten a bit more complicated. However, we would emphasise that the RBNZ has the flexibility to “look through” rising CPI inflation to the extent that it is not expected to be permanent.
- The RBNZ is likely to focus on the trend in inflation, which we expect will increase only gradually. Accordingly, we expect the RBNZ will reiterate its recent neutral messaging, with the forecast OCR track broadly similar.
- We continue to pencil in a first hike for late next year.

KEY POINTS

- We expect the RBNZ will leave the OCR unchanged at 1.75% at its Monetary Policy Statement next Thursday at 9am.
- Since the May Monetary Policy Statement, we’ve talked a lot about how the economic landscape appears to be shifting. The RBNZ will be confronted with this shift as it prepares for next week’s Statement.
- Inflation looks set to lift and the CPI outlook is perhaps a bit stronger at the margin. CPI inflation was in line with the May MPS forecast in Q2, but core inflation has edged up. The TWI is a little lower and oil prices are a little higher. All up, this points to a modestly higher outlook for CPI inflation.
- The economy is near maximum sustainable employment. But the outlook for employment and activity is looking less assured and downside risks have increased. Business pessimism about the outlook has intensified. Weak employment and investment intentions may see these downbeat expectations become self-fulfilling; this at a time when the economy is already navigating late-cycle challenges and previous drivers of growth have started to wane. The housing market has cooled perhaps a little faster than the RBNZ expected, and spending growth has been on the weaker side too. The global picture is looking a little less positive too. In short, the economy is delicately placed.
- Rising inflation is being driven in large part by transitory cost-push factors – minimum wage increases, tax changes, and higher oil prices. Credible, flexible inflation-targeting central banks like the RBNZ can accommodate such cost-push disturbances, provided inflation expectations are well anchored, implying the effects will dissipate. Expectations appear to be anchored, so the RBNZ can – and will – “look through” the lift.
• Going forward, the RBNZ will be watching core inflation, inflation expectations and underlying wage pressures closely to ensure that their strategy remains the right approach. We think it will, with cost-push factors to boost core inflation and underlying wage pressures only very modestly.

• It’s important to note that the RBNZ is still more concerned about core inflation being too low than too high. That’s a pretty comfortable starting point from which to mull over upward shocks to inflation. Indeed, in that light, the recent pick-up in core inflation is reassuring. That said, inflation remains below the midpoint of the target band (despite temporary factors) and underlying wage growth has stagnated.

• Two key risks will be front of mind in policy discussions. On the one hand, there is a risk that activity slows more than anticipated, potentially moving the labour market away from maximum sustainable employment and eroding underlying inflation pressures. On the other side is the risk that as CPI inflation lifts, inflation expectations become unanchored. As inflation rises, short-term expectations may be boosted, but we expect any impacts on medium-term expectations will be modest. But it’s a key uncertainty.

• On balance, we expect that the outlook for the OCR will be similar to that projected in the May MPS, signalling an increase in the OCR at the end of 2019 – far enough ahead that the RBNZ can alter their strategy as the policy trade-offs and economic conditions change.

• We expect to see the RBNZ reiterate its recent neutral messaging, even though an OCR cut now looks less likely. Core inflation has increased but downside risks have not gone away, and should these materialise a cut would be firmly on the table. As a result, we expect that the RBNZ will be comfortable with a continued wait-and-see strategy, even as inflation lifts.

• The RBNZ will want to see core inflation much closer to the midpoint of the target band (or even an overshoot) before an OCR hike will be on the table, particularly given the softer activity outlook. If inflation increases in line with our expectations, the OCR will eventually need to rise – but not any time soon. We continue to pencil in late-2019 for an eventual hike, but a lot could – and probably will – happen between now and then.
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