SOMETHING OLD, SOMETHING NEW

- Next Thursday the RBNZ will leave the OCR at 1.75%. The Governor and the mandate may have changed, but the broad story will remain the same.

- Developments since February have been positive for medium-term inflation. But given the balance of risks, we expect the RBNZ will retain a cautious approach, with the policy outlook broadly similar.

KEY POINTS

- **We expect the RBNZ will leave the OCR unchanged at 1.75% at its Monetary Policy Statement next Thursday at 9am.** This is the first Monetary Policy Statement with Adrian Orr as Governor and will be watched closely for any hints that the RBNZ’s views and approach to monetary policy are changing.

- The new Governor will no doubt bring new perspectives to the table, but the RBNZ makes its decisions via a committee, which is soon to be formally legislated. A committee structure means that accountability for – and influence on – the decision is shared. Recent interviews have indicated that the new Governor intends to provide more open communication, so the press conference should provide interesting colour on the RBNZ’s assessment and perception of risks going forward.

- **This Monetary Policy Statement will also be the first under the new Policy Targets Agreement,** signed between the new Governor and the Minister of Finance. The RBNZ is now tasked with contributing to supporting “maximum sustainable employment” in the context of its medium-term inflation target – a stepping stone towards a true dual mandate. We expect the new Policy Targets Agreement will lead to greater focus on labour market developments in the RBNZ’s deliberations and communications, but in our view it will not alter the outlook for monetary policy much, if at all.

- **We expect that while the RBNZ’s Governor and mandate have changed, the broad story will be the same:** the economy and the labour market are performing well, but broad price and wage pressures remain elusive. Although the economy is arguably currently near “maximum sustainable” employment, inflation remains well below the midpoint of the RBNZ’s target band.

- Developments since the February Monetary Policy Statement have been positive for inflation, at least in the short term.
  - Oil prices have increased 6%, which will directly boost tradable prices.
  - The New Zealand dollar TWI has depreciated 1.8%.
  - The minimum wage increased from $15.75 to $16.50 on April 1 2018 (and is expected to increase to $20 per hour by April 2021).

- All of these factors will boost CPI inflation, at least in the short term. But uncertainty remains about how persistent the impacts will prove. The RBNZ has a medium-term target and will look through short-term movements in inflation – particularly those driven by the exchange rate and oil prices. A key question is how much these factors persist – and whether they correspond to a broader increase in price pressure. The RBNZ will be mulling this over as it puts together its medium-term projections.
The outlook for medium-term growth is arguably more positive than in February. Net migration inflows have held up, with a net inflow of 58,000 working-age people in the year to March 2018 (compared with 55,000 expected by the RBNZ), which will provide a small boost to demand and house prices, all else equal. The terms of trade remain elevated, with ANZ Commodity Price Index up 6% in the past three months, providing additional support to national incomes. On top of this, fiscal spending is expected to be stimulatory. But the outlook for near-term growth has moderated somewhat, with business confidence languishing and households now a little more cautious.

Global financial market volatility has returned, albeit to more normal levels. The Federal Reserve is steadily raising interest rates, and there is uncertainty about the effects of reduced global liquidity. At the same time, geopolitical and trade tensions have been at the fore and indicators of global growth have softened (off high levels). Importantly, global bank funding costs have increased since the February Statement, with LIBOR-OIS spreads widening 27 bps. In New Zealand, equivalent spreads have increased 16 basis points. While this is modest, it represents a tightening in financial conditions.

The RBNZ will be weighing up risks carefully. On the one hand, the outlook for medium-term growth is positive and an eventual pick-up in inflation is thereby looking more assured. But on the other hand, global risks remain, as does the risk that any boost to inflation could prove temporary. CPI inflation is 1.1% y/y, with price pressures elusive, despite capacity pressures. And weakness in wage inflation earlier this week will have given the RBNZ further pause for thought. With inflation around the bottom of the target band, downside risks are more problematic from the perspective of achieving the medium-term inflation target.

Given the balance of risks, we expect the RBNZ will retain a cautious approach, with the policy outlook little changed. It’s possible that the OCR track will be nudged up a touch, with the outlook for inflation a little more positive and the economy near “maximum sustainable employment”. But we believe changes to the OCR track will be minimal. At the February Monetary Policy Statement, the RBNZ indicated the possibility of increases in the OCR in mid-2019. We expect they will continue to indicate modest OCR tightening in the future – but far enough ahead that they can alter their strategy as conditions change.

As always, the RBNZ’s scenarios will give strong clues about the risks they are thinking about – and how they might react to future developments. We suspect these might explore the risks of stronger migration, higher bank funding costs, a lower exchange rate, or trade war. We wouldn’t be surprised to see a box discussing the Bank’s interpretation of recent funding market developments and/or the RBNZ’s interpretation of labour market data in light of its new mandate.

The RBNZ will retain a consistent message, despite ongoing organisational changes. We expect the Monetary Policy Committee will be cautious not to change its messaging abruptly and that the RBNZ will be broadly comfortable with its previous communication and policy strategy. A clear message that acknowledges recent developments, but is consistent with a gradually evolving policy outlook will be the aim. The RBNZ will remain cautious until it sees a definitive broadening in inflationary pressures, with the OCR to remain on hold for some time yet. We continue to pencil in August 2019 for the first increase.
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