Economic Update
May OCR & MPS Preview
5 May 2017
ASB

On hold again, but outlook could see some action

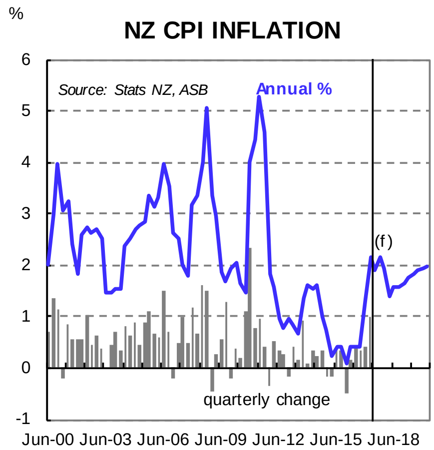
- **We expect the RBNZ to hold the OCR at 1.75% at the May Monetary Policy Statement.**
- **The RBNZ's inflation estimate is likely to lift again, with greater comfort over the outlook.**
- **The OCR track will be widely watched for a likely bringing forward of OCR hikes.**

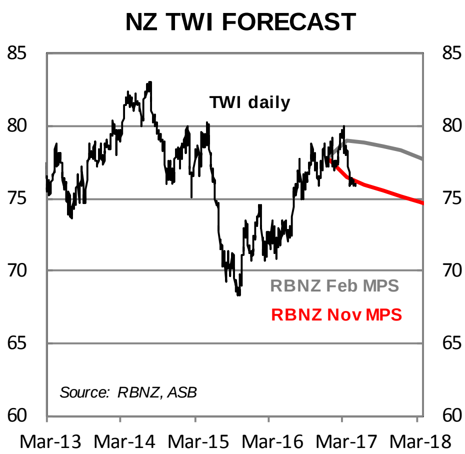
Summary

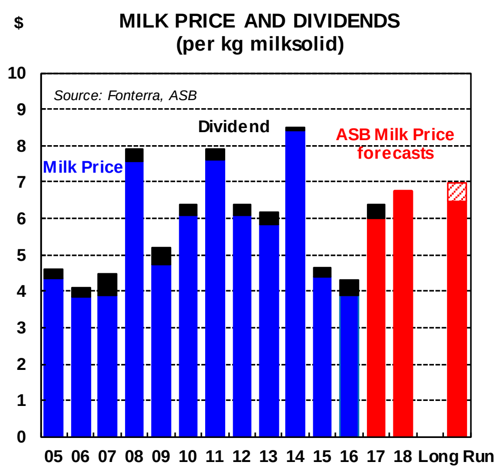
We expect another on-hold decision from the RBNZ, with the OCR unchanged at 1.75% for the third meeting in a row. Inflation has continued to firm since the February MPS, which will comfort the RBNZ, both in terms of mitigating the risks of low inflation and also in terms of aiding an increase in inflation expectations. There are, however, a number of risks to the outlook, including the potential for US President Donald Trump's policies to adversely impact NZ growth and inflation.

We expect the RBNZ's OCR track to show a slightly earlier start to future OCR increases compared to the February MPS. This after the Q1 CPI firmed to 2.2% yoy from 1.3%, with non-tradable inflation also stronger than the RBNZ had anticipated. **However, we continue to expect the track to show that any change in the OCR is still a long way off.**

Once again, the RBNZ needs to walk the tightrope of being encouraged by recent developments in inflation, but not so enthusiastic the market brings forward even further its expectations of an OCR hike. To this end, the RBNZ will again be looking to strike a neutral tone in its statement. **There is also likely to be a slight tweaking of the language around the NZD, considering its recent depreciation.**







Inflation firms again

Inflation firmed to 2.2% yoy in Q1, once again ahead of both market and (particularly) RBNZ estimates. This is also a sizeable move from Q4's 1.3% pace, taking inflation up and through the middle of the 1-3% target band. **The composition of the move was characterised by a number of temporary factors, including food prices and petrol. We expect the RBNZ to look through higher prices to the extent they are driven by one-off events**, but to a lesser extent if they reflect stronger export demand. However, non-tradable inflation was higher than the RBNZ expected. Our inflation outlook for 2017 shows inflation around the 2% mid-point for the rest of 2017 before temporarily softening in the first half of 2018, which is when current market pricing suggests the RBNZ will begin tightening the OCR.

Another positive for inflation is the decline of the New Zealand Dollar since the last full MPS in February. The RBNZ's forecast has the Trade Weighted Index (TWI) at around 78.9 over Q2 2017. However, **the TWI has actually held in a rough 74-76 range.** The NZD's weakness, if sustained, would further contribute to keeping inflation near the 2% target midpoint.

The outlook for the dairy sector is another supportive factor for inflation. Since the last MPS, dairy prices have firmed a touch, due to the very wet weather. While we do not currently expect any major revision to Fonterra's milk price, recent spot dairy price strength **may encourage the RBNZ to further 'bank' recent dairy gains in its economic forecasts.**

Inflation outlook still has areas of concern

While inflation did marginally lift above the mid-point of the RBNZ's target in Q1, there are still **a number of risks to the outlook**. Overseas risks still loom large for the RBNZ. Although Donald Trump's attempts at fiscal stimulus and tax reform have been delayed, some sort of package will get passed eventually.

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On the flip side, **rhetoric from the US still suggests there are risks to the flow of global trade.** In addition, the snap UK election and associated Brexit negotiations complicate the picture in Europe, while the outlook for Germany's September election is a little uncertain at this stage.

While the NZD has materially weakened over the last few months, the delay in the announcement of US stimulus could push the NZD higher once more. Should the NZD recover the RBNZ may have to revise down its tradable inflation before long.

There are still only limited signs of wage inflation in the NZ economy, with record levels of migration restraining income growth. While wage growth is expected to become more prevalent in the coming quarters, **there is still the potential for the acceleration to be softer than expected.**

Capacity pressures in the economy remain fairly muted. What signs there have been are limited to construction and (mainly) tourism-related services.

Finally, **growth in Q1 was some way short of the RBNZ's forecast** (as well as the market's). Should growth fail to evolve as expected, it could take longer for capacity-related inflation pressures to pick up. In addition, both consumer confidence and consumption have shown signs of softness since the turn of the year.

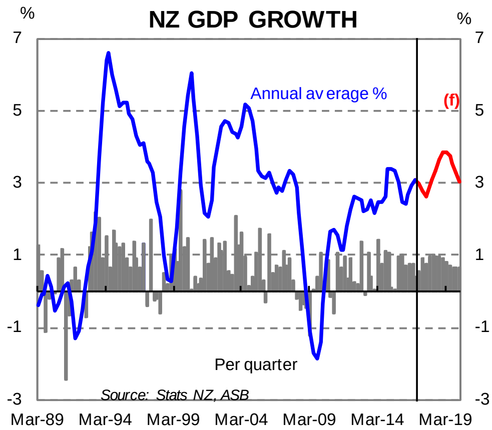
What to expect from the RBNZ

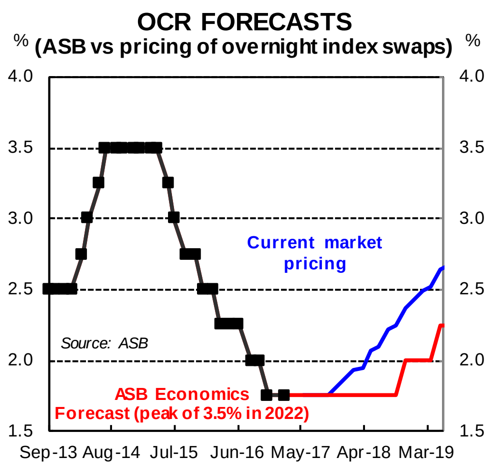
We look for the RBNZ to lift its inflation outlook, particularly for the year ahead. The medium-term track is likely to be a bit closer to 2% than was published at the February MPS.

The RBNZ's published OCR track will be much watched. In the February MPS this was lifted to 1.8% for the near term, rising to 1.9% in late 2019 and hitting 2% in early 2020. **We do not expect to see any change in the near term.** Further out, **we look for the first signs of tightening to be pulled forward at least 6 months, to mid-2019. Should the track be pulled forward into late 2018, the market is likely to read this as a hawkish signal**, prompting a market reaction.

The language the RBNZ chooses to employ is likely to have a significant impact. **We expect no change to the ending of the statement**: "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." Any adjustment here could bring forward market pricing for the timing of the next interest rate hike.

The language around the NZD is likely to be tweaked, given the NZD's continued under-performance in relation to the RBNZ's forecasts. At the March OCR Review the RBNZ said the NZD's depreciation was "an encouraging move, but further depreciation is needed to achieve more balanced growth." Given the NZD has softened further since that statement, **we could see a tweak towards "The further depreciation in the NZD since March is encouraging, but further depreciation is *desirable* to achieve more balanced growth."**





Previous Statement:

March OCR

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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