10 August 2017

RBNZ Aggressively on Hold

- Cash rate remains at 1.75%
- No sign of a rate move any time soon
- Inflation forecasts slashed but assumed temporary
- Future clouded by personnel changes
- Markets yawn

The RBNZ is stuck in neutral. Any increase in interest rates is seen as simply not plausible given that inflation continues to sit below the RBNZ's target band mid-point. On the other hand, low (and, indeed, falling) inflation is not seen as sufficient to cut rates as (a) it's seen as transitory and (b) the economy simply does not need any more stimulus at this juncture.

On the latter point, it is notable that the RBNZ has slashed its short term inflation forecasts, forecasting annual inflation to now slump to 0.7% by March 2018. This reflects a combination of the lower starting point for inflation, a higher NZD and fallen petrol prices. As we noted in our preview, this might have been an excuse to cut rates in the past but this was never going to be the case this time around as the RBNZ maintained its focus on the medium term outlook for prices. Ironically, the current forecasts have annual inflation returning to the mid-point of the band a quarter earlier than previously in March 2019.

If the expected drop in inflation was to feed through into lower inflation expectations and lower wage growth then the Bank might respond but this would be a while down the track.

For those in the dovish camp looking for the possibility of rate cuts, the RBNZ's alternative scenario where domestic demand proves weaker than forecast might offer some solace. According to the Bank a modest weakening in private consumption and residential investment (relative to its forecast) would result in a substantially lower cash rate. We think it's highly likely that both private consumption and residential construction disappoint the Bank. We are less sure that this disappointment will result in lower inflation than the Bank is forecasting but, given its clear focus on domestic demand, we will be watching developments on this front very closely.

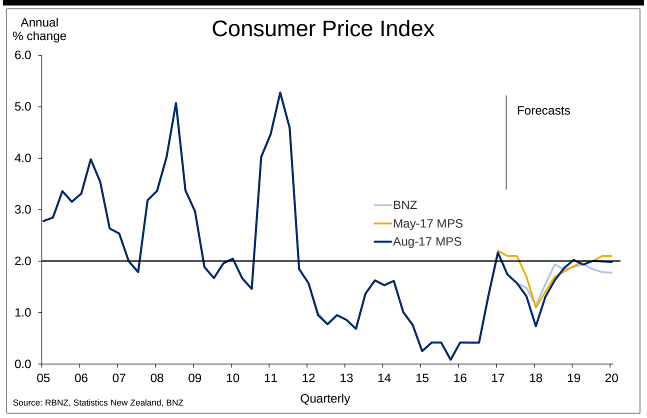
The flipside scenario for the RBNZ is that global inflation proves higher than anticipated. We think this too is plausible but less likely than the weaker growth scenario. Where there may be some extra inflationary pressure, however, is via the currency. The RBNZ clearly put its forecasts to bed when the NZD was flying at its highest. It has since fallen to the extent that the current TWI of 77.8 is now slightly below the levels the RBNZ had built into its forecast track.

The RBNZ's interest rate track is unchanged from May. An extra quarter (September 2020) was added which showed a continuation of the upward track that begins in September 2019. We don't read too much into this other than to note that it is consistent with the RBNZ's stated views that the neutral cash rate is 3.5% so any long term interest rate forecast should converge on this level.

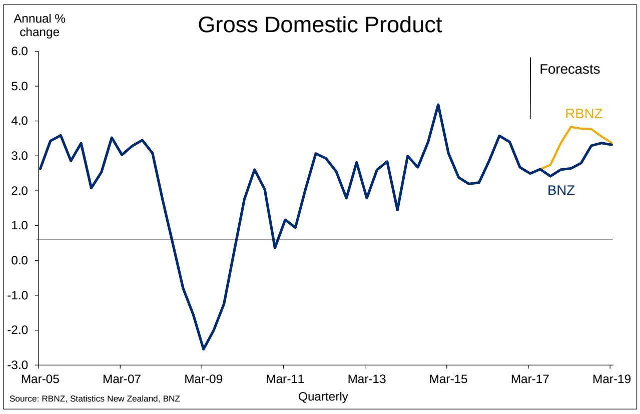
We had said, going into this statement, that we were keen to formally push out our forecast for the first RBNZ rate hike but would wait to see if the RBNZ blind-sided us with this MPS. It didn't, so we will nudge our call back from May to August 2018 - still well ahead of the RBNZ's expectation but not substantively different to market. The market is looking for a September move but that, almost certainly, won't happen as the RBNZ prefers to go at MPSs. That means August or November. September pricing will simply be markets having a bob each way.

But let's face it, we are flying blind making a call for what the RBNZ will be doing in the middle of next year:

Inflation Headed Lower



RBNZ Optimistic On Growth



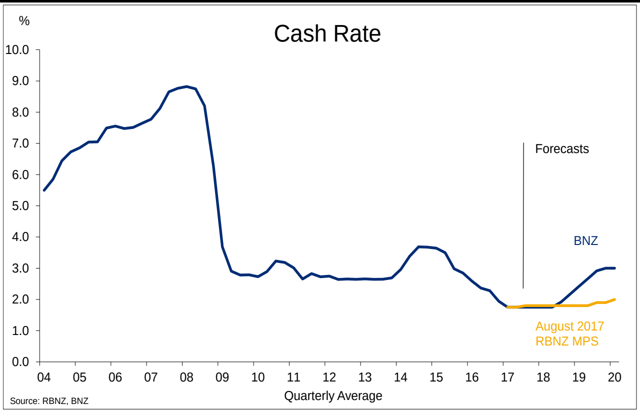
- We don’t know who the Governor or Deputy Governor will be (this was Governor Wheeler’s last throw of the dice);
- We don’t know who the Government or Minister of Finance will be (and certainty around this is diminishing by the minute);
- We don’t know if the Policy Targets Agreement will be the same as it is today.

All of these things could, clearly, have a significant bearing on the evolution of monetary policy.

Overall then, the statement was very much a non-statement. At the margin, perhaps more interesting, at least to us, was Governor Wheeler’s acknowledgement in his press conference that weak inflation is very much being driven by structural factors. That is a view that we have been running for some time. And if this is the case then one must again question the need for central banks to fight against something that is neither controllable by domestic monetary policy nor, at its core, a worrisome economic development. But that’s a debate for another time.

For financial markets, there was nothing to get excited about in today’s statement. There was an inconsequential reaction from both the fixed interest and foreign exchange markets.

Rates Lower for Longer



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Statement by Reserve Bank Governor Graeme Wheeler– Official Cash Rate 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.

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.

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.

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.

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.

Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly.

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