

11 May 2017

## RBNZ Dismisses Inflationary Developments

- Cash rate unchanged at 1.75%
- Interest rate track identical to February MPS
- Inflationary pressures seen as transitory and/or unthreatening
- We beg to differ
- Move to a tightening bias demanded

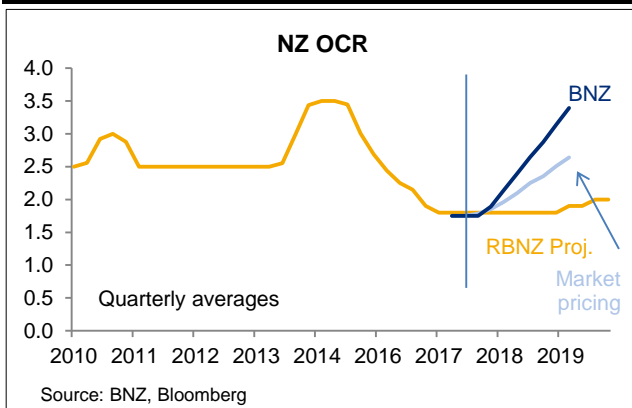
We have witnessed rising inflation, rising inflation expectations, falling unemployment, a weakening currency and a strengthening global economy. We had thought this would rattle the Reserve Bank. As it turns out, it all seemed to have counted for little as the Bank left its stance unchanged from both its February and March missives.

We are not at all surprised that the Reserve Bank left its cash rate at 1.75%; we are not at all surprised that it ruled out a rate increase in 2017; we are not at all surprised that it focused on the transitory nature of some of the price shocks that we have recently experienced. But we are perplexed that the overall stance of policy remains neutral and that there doesn't appear to be even the slightest nod to a tightening bias.

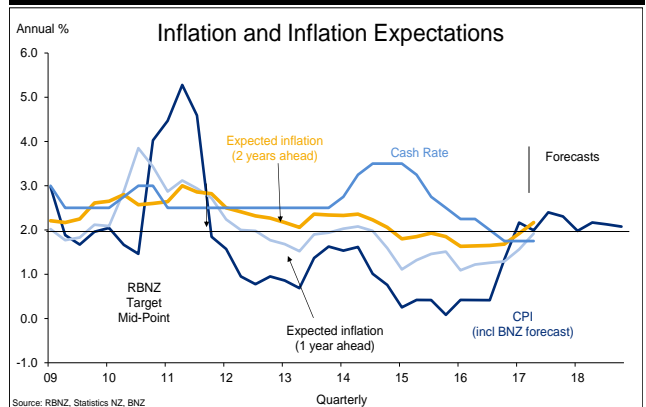
In the end, the Bank appears to have either written off the inflation that is evident as transitory and/or has accepted that the pressures that pervade are manageable and non-threatening. We do not think this is appropriate.

Clearly, we are not alone in our surprise as the NZD lost almost a cent against the USD and there has been a seven to eight basis rally in the front end of the curve. Yet despite this, the market still does not believe the RBNZ as it continues to price a rate hike in May when the Bank has

### Market Disbelieves RBNZ



### Rational For Current Rates Reduced



no sign of such until late 2019/early 2020. This, incidentally, was exactly the same view as the central bank held back in February.

We have recently moved our expectations of a first rate hike to February. Clearly this now looks premature. But we'll stick with this for the moment as we continue to believe that it is inappropriate to hold rates at current levels and that the Reserve Bank will eventually be forced into action.

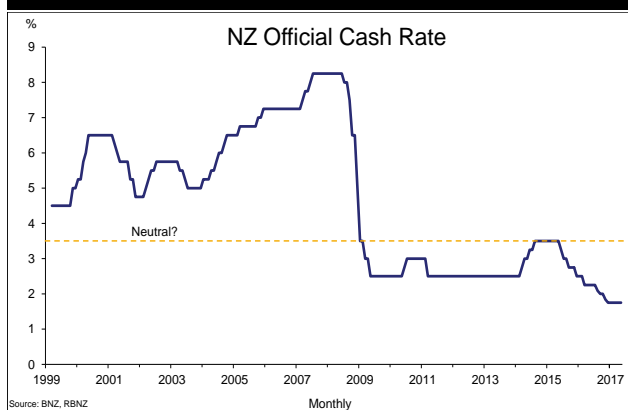
Given the apparently conservative nature of the Bank, we maintain our view that it will first move to a tightening bias, then publish a more aggressive rate track before finally pulling the trigger. We had thought this statement would be step one. It clearly wasn't. Accordingly, unless the RBNZ changes its spots, it now looks like February 2018 is the earliest possible time for a tightening.

Let's be clear on this, do we think that interest rates desperately need to be raised to contain inflation? Possibly not. We don't think lowering rates meaningfully raised inflation so nor will raising them push inflation markedly lower. For us it's all about normalization. With inflation (even by the RBNZ's forecasts) likely to settle at 2.0% over the medium term, the unemployment rate settling at around NAIRU levels, growth at around trend there is the opportunity to allow interest rates to drift back towards neutral. We're not sure where neutral is but we do strongly believe that it is higher than where it currently stands. This is all about creating longer term stability in the economy and providing the Bank with ammunition to fight any future downturn rather than any immediate inflationary threat.

Whatever the eventual truth of the matter, at the very least we simply cannot condone the Bank's implication that there remains an equal chance of an easing as a tightening in the current environment. Moreover, we repeat our previous view that the RBNZ mentioned falling inflation expectations and a deteriorating growth outlook as the primary reasons it cut interest rates. Where the world goes is still a moot point but the vast majority of commentators believe that the downside risks have at least moderated. What we can say, more conclusively, however, is that inflation expectations have certainly reversed their past declines (and more). Therefore the rationale for lowered rates is no longer there.

In the interests of the general well-being of the economy, we reiterate our opinion that the Reserve Bank risks being tardy in responding to the economic risks that pervade.

### Is This Degree of Stimulus Warranted?



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## The full text of today's RBNZ OCR Review – 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 increased and become more broad-based over recent months. However, major challenges remain with on-going surplus capacity and extensive political uncertainty.

Stronger global demand has helped to raise commodity prices over the past year, which has led to some increase in headline inflation across New Zealand's trading partners. However, the level of core inflation has generally remained low. Monetary policy is expected to remain stimulatory in the advanced economies, but less so going forward.

The trade-weighted exchange rate has fallen by around 5 percent since February, partly in response to global developments and reduced interest rate differentials. This is encouraging and, if sustained, will help to rebalance the growth outlook towards the tradables sector.

GDP growth in the second half of 2016 was weaker than expected. Nevertheless, the growth outlook remains positive, supported by on-going accommodative monetary policy, strong population growth, and high levels of household spending and construction activity.

House price inflation has moderated further, especially in Auckland. The slowing 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 continuing imbalance between supply and demand.

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 over the year ahead. 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.

Developments since the February Monetary Policy Statement on balance are considered to be neutral for the stance of monetary policy.

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

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