22 June 2017

RBNZ Pleasingly Skirts a Dovish Tilt

- RBNZ leaves OCR at record low 1.75%
- And chary to the net-negative news since May
- NZD and wholesale rates little changed
- August MPS risks looking a little dovish
- But we leave our Feb hike call for now
- As capacity constraints pressure core inflation

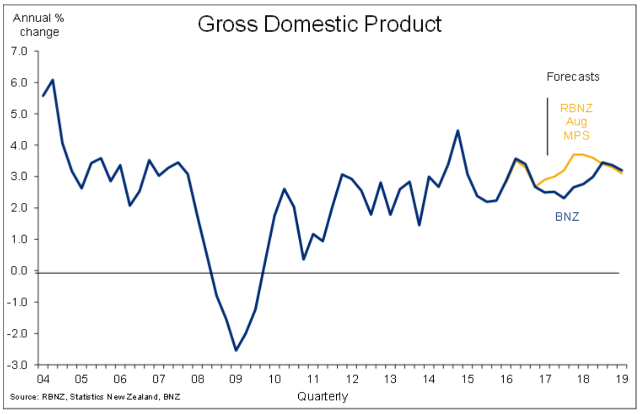
As widely expected, the Reserve Bank of New Zealand left its policy interest rate unchanged at this morning's OCR review, at a record low 1.75%. It also kept its language largely unchanged from last time. While we expected such a steady-as-she-goes approach, we did see a risk of the rhetoric tilting a fraction dovish, given the balance of news since the 11 May Monetary Policy Statement (MPS). But it didn't, which we were pleased to see.

Yes, the trade-weighted exchange rate (TWI) has drifted up almost 3% since the time of the May MPS. But the Bank talked about this in the context of the stronger terms of trade. Perhaps this is why the Bank refrained from its over-valuation language again this time. The fact is that New Zealand's commodity export income is turning to a significant tailwind, and for reasons well beyond the normalisation of dairy returns.

The TWI spiked about 0.5% in response to today's OCR review but by mid-morning had retraced most of that. But also bear in mind that at this time of year, 9:00am NZT is right on the New York market close, so interpreting moves around these time is muddied during this gap in liquidity.

We were also pleased to see that the Bank did not sound put off by the slow Q1 GDP. "Nevertheless, the growth outlook remains positive…" Recall that in May the Bank noted the under-shooting of GDP, which seemed to translate into a lessened output gap. We reckon the recent GDP outturns are not a good representation of underlying economic momentum and, if anything, might be telling us more about the degree of capacity constraint (and costs) bedeviling the economy that any sign of weak demand.

Too Much Too Soon?



Neither did the Reserve Bank sound concerned that the cooling the housing market was currently showing (albeit principally in Auckland) is going to morph into something worrisome. Indeed, a gradual dissipation of the housing imbalances should be welcomed in the first instance. However, it's a gorilla to watch, lest the psychology around the housing market turns nasty. This would have macro-economic implications, including for core inflation.

Unsurprisingly, the RBNZ today made first mention of the Budget, as it obviously came out after the May MPS. This, in the Bank's words, "should support the outlook for growth". While this is undeniable, we would have used slightly stronger language than that.

Interestingly, though, the Bank didn't mention the recent upticks to retail mortgage rates. This might have been because most of the increases, especially in fixed-term rates, occurred by the time of the May MPS. And while floating mortgage rates have kept creeping higher since, this might only encourage a bigger shift into short-term fixed rates, which are already the much bigger bucket of choice, where mortgage rates have been relatively steady.

The Reserve Bank will also be conscious that current retail interest rates are predicated on market expectations that the Bank will start hiking next year, albeit that the timing has drifted out to August (for the record, NZ wholesale interest rates were largely unmoved on this morning's OCR news).

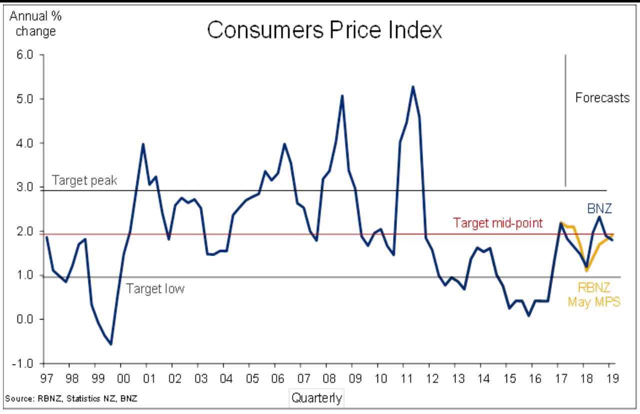
Nonetheless, any further moves in retail interest rates will be worth monitoring in the context of OCR expectations (and perceived pressure on bank funding).

In respect to global matters, granted, the Reserve Bank was still on about "major challenges remain (for global economic growth), with on-going surplus capacity and extensive political uncertainty." However, this was balanced, still, by recognition that "global growth has increased and become more broad-based."

Overall, then, we thought this was a fairly reasoned response by the RBNZ this morning to the marginal news, as it remains firmly anchored to its neutral stance.

In this sense, it's no reason to change our broad view on the OCR, which remains upwardly inclined. Our February hike call still risks being too soon. But there is no basis for shifting it out based on this morning's OCR decision and commentary.

Toned Down



It's also worth noting, from a market perspective, that today's Reserve Bank missive would have gone against the global sniff of central banks shifting to hawkish (less dovish) stances. We thought the global players were misguided in trying to overlay this onto the RBNZ. This is not because the NZ central bank isn't facing medium-term inflation risk – we think it is – but because of the way we thought the Bank will prefer to keep playing things for the meantime – from the cautious side.

Indeed, there remains the risk that by the time we get to the 10 August Monetary Policy Statement the Bank might yet sound a touch more dovish than it is already. In this vein, we suspect the Bank is assessing downside risk to its CPI track, partly because of the currency strength. But more directly by way of the 8% slump in local petrol prices over recent weeks, which carves about half a per cent off the CPI, all else equal. The Bank might also struggle to replicate the strength of its GDP growth forecasts, at the August MPS.

However, our fundamental view remains; that core inflation pressures and risks are building, which headline CPI and GDP results might not be very good at indicating for the next while. It's the medium term game we're still focused on.

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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. However, major challenges remain with on-going surplus capacity and extensive political uncertainty.

Headline inflation has increased over the past year in several countries, but moderated recently with the fall in energy prices. Core inflation and long-term bond yields remain low. Monetary policy is expected to remain stimulatory in the advanced economies, but less so going forward.

The trade-weighted exchange rate has increased by around 3 percent since May, partly in response to higher export prices. A lower New Zealand dollar would help rebalance the growth outlook towards the tradables sector.

GDP growth in the March quarter was lower than expected, with weaker export volumes and residential construction partially offset by stronger consumption. Nevertheless, the growth outlook remains positive, supported by accommodative monetary policy, strong population growth, and high terms of trade. Recent changes announced in Budget 2017 should support the outlook for growth.

House price inflation has moderated further, especially in Auckland. The slowdown 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 on-going 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. 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.

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

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