8 February 2018

RBNZ Maintains Tightening Bias

- Cash rate unchanged at 1.75%
- Inflation forecasts lowered
- But rate track still shows early 2020 tightening
- As RBNZ sees unemployment rate sub NAIRU
- And a softer NZD

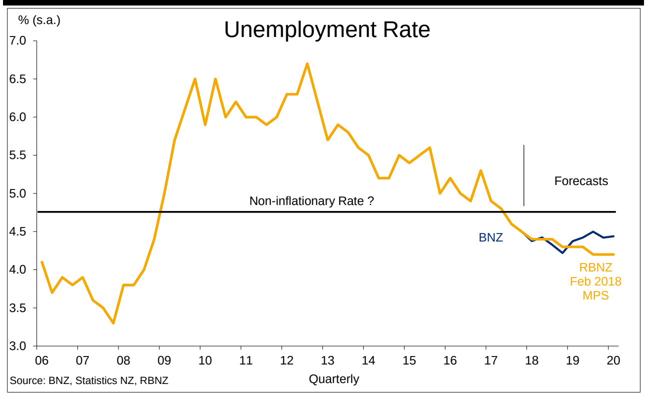
The RBNZ stuck to its core story with today's Monetary Policy Statement. Namely that it holds to a modest tightening bias but sees no need to move interest rates any time soon. Summarising this view is the Bank's published OCR track which is identical to that produced in November. The said track does not have a confirmed first rate increase until February 2020. This is backed up by a second increase in November 2020.

The upward track in interest rates is predicated on the idea that GDP growth will be sufficiently strong to ensure that current capacity pressures intensify further. However, the Bank again acknowledges that there "are substantial upside and downside risk to the projections" that may mean interest rate hikes are further postponed.

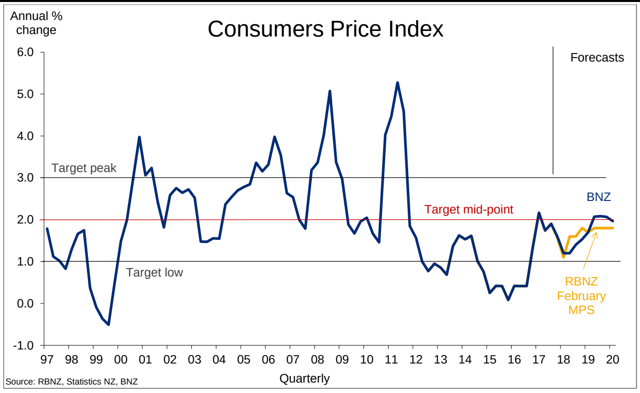
As expected, the Bank reduced its near term CPI inflation forecasts recognizing both the weaker-than-expected starting point and a stronger-than-anticipated NZD. Consequently, the Bank is not expecting annual CPI inflation to hit 2.0% until the September quarter of 2020.

The downward revision to the CPI forecasts will have some commentators questioning why the RBNZ did not print a lower interest rate track. We think the reason is obvious: the Bank is cognisant of the risks associated with rising global inflationary pressures and it is wary that a very tight labour market will eventually generate

Unemployment Rate Sub-NAIRU



Further Downside Risk To Inflation



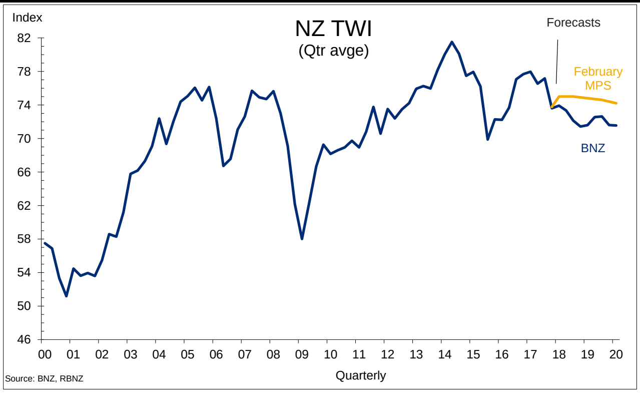
economy-wide inflation. The labour market concerns are highlighted by the Bank in its publication of the NAIRU being "in the vicinity of 4.7%". Right now the unemployment rate is 4.5% and the Bank has it forecast to drop further from current levels. Moreover, it believes it will stay at sub-NAIRU levels for the foreseeable future.

The key here, though, is the word "risk". Clearly there is limited sign of wage inflation at the moment but there must be a nagging concern at the Bank that it's just a matter of time.

We do think the RBNZ may have a communication issue on its hands over the next six months, as we believe that the CPI and GDP will end up lower than the Bank has forecast. This will have folk clamouring for rate cuts. We think that such weakness will be relatively transitory but will cause some grief nonetheless.

Interestingly, the NZD was sold off on the back of today's announcement. While the RBNZ's statement was exactly as we had anticipated, it appeared that offshore investors were looking for something a tad more hawkish. This has been reflected in recent economic polls which have shown offshore respondents expecting the RBNZ to raise interest rates more aggressively than domestic commentators. This seems to be the age-old issue that many beyond our shores sometimes place too much weight on the RBNZ having to follow the Fed. So, as expectations for Fed tightening have grown, expectations for the RBNZ moving more aggressively have followed suit. We reiterate that this will only be the case if (a) the NZD falls as a consequence of higher Fed rates; and (b) such a decline feeds into CPI inflation. Recently, there has been evidence of neither. That said, we note that when

Lower Currency Anticipated

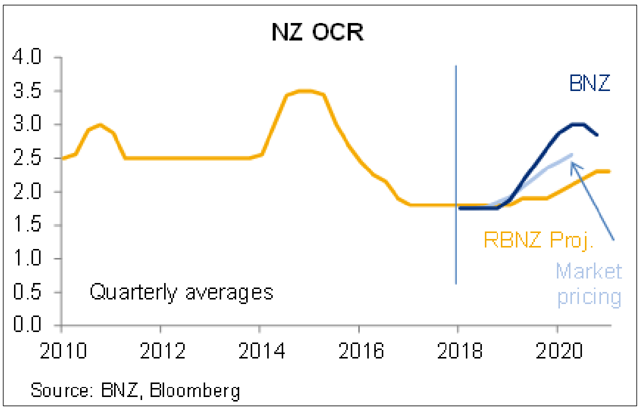


Governor Spencer mentioned in his "post-match" press conference that he was unconcerned at the level of the dollar it found some support.

With regard to the NZD, the RBNZ assumed a falling trend in the currency in this statement. This, however, does not really represent a change in view from the November statement. The end point (a TWI of 73.5) is identical in both sets of forecasts. All that has changed is the starting point, which reflects the recent jump in the NZD. Given today's drop in the currency the TWI is already where the RBNZ estimated it would fall to by the end of next year. Another 1.5% drop and it will be at the end point. Our own TWI estimates are more aggressively weaker than the Reserve Bank's assumptions.

Putting it all together, we see no need to change our view that the RBNZ starts raising interest rates in February 2019 and then it moves relatively aggressively. However, we equally concede that there are multiple risks around our hypothesis. In addition to economic developments, we will have a new RBNZ Governor for the next Monetary Policy Statement and, potentially, a very different Policy Targets Agreement. Whatever the case, though, barring a massive surprise, the chances of a rate hike at the RBNZ's meetings in March and May of this year are near zero.

We Still Foresee Earlier Tightening



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The full text of today's RBNZ OCR Review – Official Cash Rate unchanged at 1.75 percent

Statement by Reserve Bank Governor Grant Spencer

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 1.75 percent.

Global economic growth continues to improve. While global inflation remains subdued, there are some signs of emerging pressures. Commodity prices have increased, although agricultural prices are relatively soft. International bond yields have increased since November but remain relatively low. Equity markets have been strong, although volatility has increased recently. Monetary policy remains easy in the advanced economies but is gradually becoming less stimulatory.

The exchange rate has firmed since the November Statement, due in large part to a weak US dollar. We assume the trade weighted exchange rate will ease over the projection period.

GDP growth eased over the second half of 2017 but is expected to strengthen, driven by accommodative monetary policy, a high terms of trade, government spending and population growth. Labour market conditions continue to tighten. Compared to the November Statement, the growth profile is weaker in the near term but stronger in the medium term.

The Bank has revised its November estimates of the impact of government policies on economic activity based on Treasury's HYEFU. The net impact of these policies has been revised down in the near term. The Kiwibuild programme contributes to residential investment growth from 2019.

House price inflation has increased somewhat over the past few months but housing credit growth continues to moderate.

Annual CPI inflation in December was lower than expected at 1.6 percent, due to weakness in manufactured goods prices. While oil and food prices have recently increased, traded goods inflation is projected to remain subdued through the forecast period. Non-tradable inflation is moderate but expected to increase in line with increasing capacity pressures. Overall, CPI inflation is forecast to trend upwards towards the midpoint of the target range. Longer-term inflation expectations are well anchored at 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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