RESEARCH

ECONOMY WATCH

22 March 2018

Fed Hyperactive as RBNZ Hibernates

- NZ OCR kept at 1.75%
- RBNZ downplays short-term growth and inflation weakness
- But shows no signs of waking from its slumber
- Meanwhile, the Fed gets more aggressive
- Ultimately putting upward pressure on the RBNZ's future rate track

We had expected today's RBNZ OCR review to be singularly unexciting. We were right! There is nothing in today's very short missive from the Bank to suggest that it has changed from its February MPS view of the world in any meaningful way. And that view, remember, does not have a rate increase fully priced until Q1, 2020.

At the margin, we felt the Bank was giving a subtle signal that any talk of rate cuts should be smothered. Whenever the Bank noted issues of weakness it was quick to dispel their significance. For example:

- The RBNZ states that Q4 growth was weaker than expected but attributes this to "weather-effects on agricultural production" and then goes on to note that "growth is expected to strengthen";

- It reinforces this with "Labour market conditions are projected to tighten further";

- It acknowledges that "CPI is expected to weaken further" but reiterates its expectation that it will still then "trend upwards towards the midpoint of the target range".

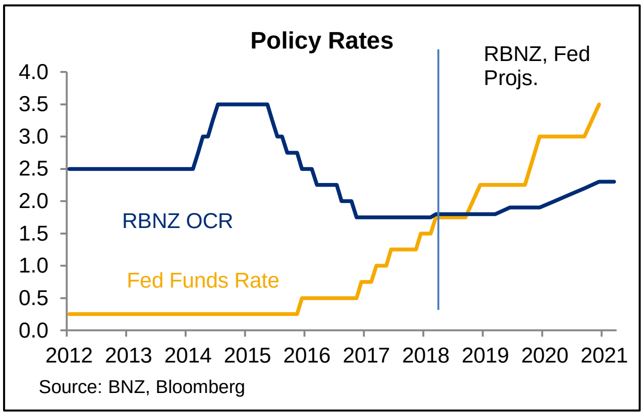
Not surprisingly, markets have not reacted to today's statement as there was nothing to react to.

The stance of the RBNZ stands out in stark comparison with the positioning of the United States' Federal Reserve, as evidenced in this morning's FOMC statement. While the RBNZ is happy to sit on its hands the Fed is all-go.

Today the Fed delivered a rate track that was even more aggressive than before. There's still another two rate hikes penned in for this year but now there are three hikes in 2019 (previously two) and two extra hikes in 2020 (previously one).

There are good reasons why the Fed is more aggressive than the RBNZ. Core inflation is closing in on the Fed's

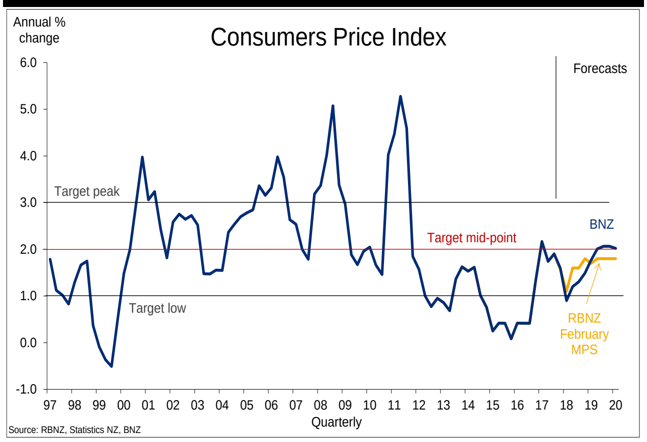
Fed Relatively Aggressive



target much more rapidly than core inflation in New Zealand is; the US economy is perceived to be closer to full capacity; and, importantly, its unemployment rate is threatening to fall well below that economy's NAIRU.

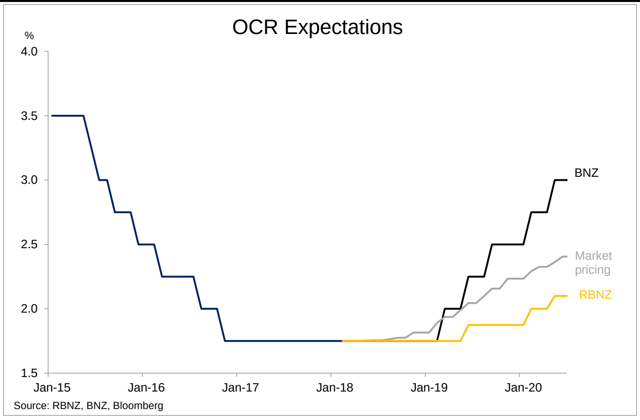
Be that as it may, we continue to struggle with the RBNZ's belief that rates here can stay as low, for as long, as it currently projects. If the Fed is right about the state of the US economy then this means that New Zealand will be facing into a more inflationary world. Moreover, we are reaching our own capacity constraints, particularly in the labour and housing markets. Additionally, one has to question how well the NZD would perform, and how NZ would fund itself in the event that the projected rates of the respective central banks come to fruition.

Inflation To Dip



This is one of the reasons we have taken a more aggressive stance on rates than the RBNZ has. We acknowledge, however, that the next set of inflation outcomes is likely to come in below the RBNZ's February MPS statement and that this will reinforce its view that the cash rate can stay here for longer than we have assumed. Accordingly, there is significant risk that we will need to postpone our forecast first rate increase from February 2019 to later in the year but we won't be rushing to do this as there is plenty of water to go under the bridge yet. Perhaps more importantly, we still believe that it would take a negative economic shock to generate the OCR track that the RBNZ currently projects.

RBNZ More Dovish Than Market



Source: RBNZ, BNZ, Bloomberg

While our rate forecasts are at the hawkish end of the spectrum, we equally note that market pricing also remains more aggressive than the RBNZ's expectations.

So now it's just wait and watch until the May MPS - an MPS that will be overseen by a new Governor, Adrian Orr, and a new Policy Targets Agreement, which will include some sort of employment maximization mandate alongside the current inflation objective. We don't expect these changes will have a material impact on the Bank's near-term stance but a changing of the guard will always bring with it new nuances that will need to be pondered.

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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.

The outlook for global growth continues to gradually improve. While global inflation remains subdued, there are some signs of emerging pressures. Commodity prices have continued to increase and agricultural prices are picking up. Equity markets have been strong, although volatility has increased. Monetary policy remains easy in the advanced economies but is gradually becoming less stimulatory.

GDP was weaker than expected in the fourth quarter, mainly due to weather effects on agricultural production. Growth is expected to strengthen, supported by accommodative monetary policy, a high terms of trade, government spending and population growth. Labour market conditions are projected to tighten further.

Residential construction continues to be hindered by capacity constraints. The Kiwibuild programme is expected to contribute to residential investment growth from 2019. House price inflation remains moderate with restrained credit growth and weak house sales.

CPI inflation is expected to weaken further in the near term due to softness in food and energy prices and adjustments to government charges. Tradables inflation is projected to remain subdued through the forecast period. Non-tradables inflation is moderate but is expected to increase in line with a rise in capacity pressure. Over the medium term, 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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