27 September 2018

RBNZ Keeps Its Options Open on the OCR

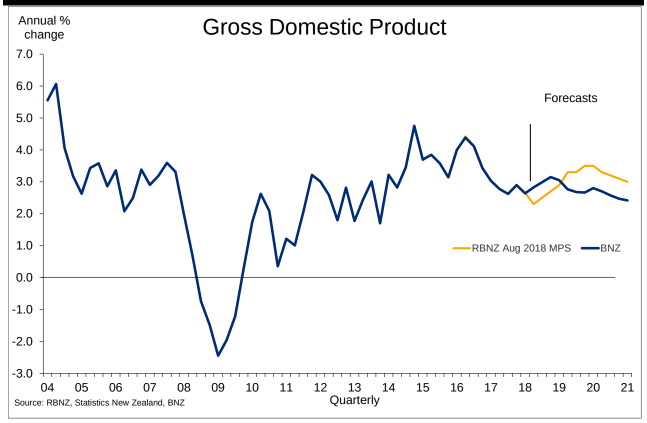
- RBNZ leaves OCR at 1.75% as widely expected
- While also keeping its up-or-down options open
- Markets yawn
- Bank still wary on GDP going forward
- But also alludes to inflation mid-point, not band
- Labour market data also key to OCR thoughts

The Reserve Bank kept its cash rate at a record low 1.75% this morning, while also repeating the key details from its previous commentary. In this, the Bank has retained its up-or-down language with respect to cash rate optionality, while reiterating a base case of it being unchanged right the way out to 2020. Practically, much still depends on where GDP growth, and CPI inflation, go over the coming year. However, also bear in mind the relevance of labour market data to OCR judgements.

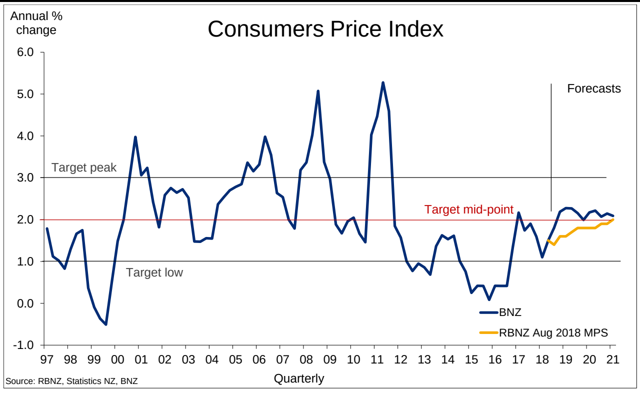
The Bank made clear today that "Our projection for the New Zealand economy, as detailed in the August Monetary Policy Statement, is little changed". Be that as it may, it is unclear to us whether this refers to the level of economic activity or the growth rate looking ahead. The distinction is important, given the economy, as at Q2 2018, was significantly stronger than the August MPS anticipated (and despite a big drag from gas and petroleum output that the Bank probably didn't have in its numbers, or at least not to the extent that transpired).

Of course, the Bank acknowledged today that Q2 GDP was stronger than it anticipated, but went on to say that "risks to the growth outlook remain". This is, to be fair, understandable in the context of weak business confidence alone (let alone some of the global tensions coming into play).

Unders And Overs



More Than Petrol



No, yesterday's ANZ business survey would not have changed this context for the Bank. The survey hardly improved, after adjusting for seasonal factors. So it remained consistent with an economy growing slower than most analysts, including those at the RBNZ, are forecasting. The Bank is probably right to feel a bit vulnerable with the strong GDP forecasts that it (presumably still) has, in other words. But whether this will undercut inflation or not, depends crucially on whether any slower growth in GDP reflects cooling demand or simply a diminishing capacity to supply.

The Bank is certainly set to be surprised by CPI inflation in our opinion, to the upside. Sure, the Bank also acknowledged today that "higher fuel prices are likely to boost inflation in the near term". But it also said it expected consumer price inflation to "gradually" rise to its 2% annual target.

This is interesting for two reasons. One that we believe annual CPI inflation will pick up more than gradually. The second point is that the Bank highlights 2% as the being the target rather than referencing the 1.0 to 3.0% band. Indeed, today's OCR commentary alluded to 2% being the target, three times.

This queries the perception that the new Governor might be, in some way, tolerant of inflation moving up into the top half of the 1.0 to 3.0% target band. Like Alan Bollard was, for a time.

So we should probably be wary of the Bank responding (albeit initially with rhetoric) should annual CPI inflation be looking like moving surely above this 2% mark. Thing is, we think it will.

An immediate test of this will be the Q3 CPI. This is due 16 October. We estimate a quarterly increase of 0.8% (subject to what September's food price index has to say on 11 October). This would bump annual inflation up to 1.8%. The August MPS forecast 1.4%.

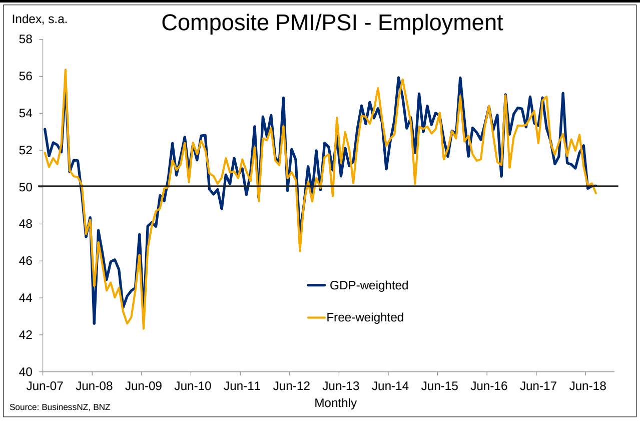
But we'll also be interested in the various core measures of inflation, as derived from the Q3 CPI. These have been creeping higher this year. Any more of a push in Q3 and they'll be even more closely huddled near the magical 2% per annum.

However, it's not just the CPI and GDP to keep in mind, when trying to figure out what the Reserve Bank will do with its policy interest rate. Bear a thought for the labour market data as well. We mention this with the Bank today once again inferring that the "maximum sustainable employment" part of its new dual mandate is essentially being met (even if the CPI part isn't, quite yet).

So what if the September quarter labour market data throws a wobbly? We say this with recent business surveys – including the PMI and PSI – telling of employment growth losing momentum. This could, in turn, raise the risk of the unemployment rate bumping up in Q3. While this is not our forecast, it is something to watch for.

If the labour market is the way weak business confidence is being transmitted into the economy (distinct from GDP), then the Bank might start to get a little nervous on this part of its mandate. With low imported inflation, the Bank certainly needs wage inflation to pick up in order to meet its 2% CPI inflation objective, on a sustained basis. A slackening labour market would undermine this.

Watch This Space



For the meantime, however, the market has largely taken the Bank's latest OCR commentary in its stride. There was little reaction, for sure. This left OCR pricing slim for a rate cut over the coming 12 months - perhaps an insurance thing, as there is a slight upward bent after that.

All up, we thought today's OCR missive was a balanced and well-considered one - arguably the best one so far from Adrian Orr, in terms of clarity. It gives a good template from which to work alternate views.

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

Statement by Reserve Bank Governor Adrian Orr:

The Official Cash Rate (OCR) remains at 1.75 percent.

We expect to keep the OCR at this level through 2019 and into 2020. The direction of our next OCR move could be up or down.

Employment is around its sustainable level and consumer price inflation remains below the 2 percent mid-point of our target, necessitating continued supportive monetary policy. Our outlook for the OCR assumes the pace of growth will pick up over the coming year, assisting inflation to return to the target mid-point.

Our projection for the New Zealand economy, as detailed in the August Monetary Policy Statement, is little changed. While GDP growth in the June quarter was stronger than we had anticipated, downside risks to the growth outlook remain.

Robust global economic growth and a lower New Zealand dollar exchange rate is expected to support demand for our exports. Global inflationary pressure is expected to rise, but remain modest. Trade tensions remain in some major economies, increasing the risk that ongoing increases in trade barriers could undermine global growth. Domestically, ongoing spending and investment, by both households and government, is expected to support growth.

There are welcome early signs of core inflation rising towards the mid-point of the target. Higher fuel prices are likely to boost inflation in the near term, but we will look through this volatility as appropriate. Consumer price inflation is expected to gradually rise to our 2 percent annual target as capacity pressures bite.

We will keep the OCR at an expansionary level for a considerable period to contribute to maximising sustainable employment, and maintaining low and stable inflation.

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