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Assessing the economic and political environment in New Zealand

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OCR stays at 3.5% for "some time"

As expected, the RBNZ has left the Official Cash Rate at 3.5% and will now spend "some time" assessing the impact of the 100 basis points increase so far this year. The Sept Monetary Policy Statement sees a lower inflation track, stronger output potential, and stabilising house prices, compared with the June MPS. It is signalling an ongoing pause of indefinite length in its track for the OCR. Its track for 90 day bills is now fully 50bps lower than at the June MPS, staying below 5% throughout the forecast period out to Sept 2017.

However, "at current levels interest rates are still providing support for demand growth", the bank says. "It is expected the OCR will need to increase towards a more neutral level for annual CPI inflation to settle around the 2% target mid-point and growth to continue at a sustainable pace."

However, having raised the OCR 100 bps this year, "it is prudent to spend some time assessing how the economy is responding to higher interest rates and the collection of other forces on it." No timeframe is given, although market pricing anticipates the next 25 basis point increase in the OCR in April next year.

"The profile of future OCR rises would take account of developments in the inflation outlook, including how interest rate increases were being transmitted through the economy."

The bank singles out "how the housing market and domestic demand are developing" for special attention, while noting that major global economies and Australia are moving only slowly to tighten monetary conditions, keeping global interest rates lower for longer.

Weak global growth and inflation among trading partners is expected to contain tradables inflation, even as the New Zealand dollar depreciates, although the kiwi will remain relatively strong and a "headwind".

Key points:

- **inflation:** weaker inflation expected through the first half of calendar 2015 pushes a 50bps drop in the RBNZ's forecast track for 90 day interest rates, now forecast to remain below 5% through the forecast period, settling at 4.8% in Sept 2017, compared with a 5.3% in the June MPS. Inflation expectations are "well-anchored". CPI inflation of 1.6% is forecast for the Sept 2015 year (1.9% in the June MPS);
- **house prices:** LVR lending restrictions and higher interest rates, combined with less demand pressure than expected from high net migration, has eased house price inflation to an annual rate of 6%. Until recently, high net migration reflected New Zealanders staying home rather than new arrivals, leading to less pressure on housing than usual. That may be starting to change, although the inward migration surge slackens;
- **GDP:** potential economic output has been revised up from 2.4% p.a. at the June MPS to 2.8% p.a. in today's release, reflecting increased business investment in new capacity and the expanding labour force, which continues to keep pressure off wages. The economy is expected to grow 3.6% in the year to March 2015, creating a potentially inflationary 1 percentage point output gap. The working population is estimated to have grown by 1.5% (50,000) owing to the migration surge, underpinning growth and demand;
- **NZ dollar:** the kiwi "has yet to adjust materially" to lower commodity prices and remains at "unjustified and unsustainable" levels - language that implies the RBNZ may intervene to push it lower. While it expects "a further significant depreciation", the recent fall in the terms of trade is expected to reverse this year. "The NZ dollar is assumed to remain relatively strong" and "will remain a significant headwind for export and import-competing businesses." The RBNZ now sees the TWI at 76.1 next Sept vs. 77.3 forecast in the June MPS and a level of around 79.5 at present;
- **Household finances:** Positive savings rates are expected to persist, despite subdued wage growth.

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