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Assessing the economic and political environment in New Zealand

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June MPS - OCR to 3.25%; rate track more opaque

Despite anticipation of a new outline for the track of future Official Cash Rate increases over the next 18 months, Reserve Bank governor Graeme Wheeler produced a relatively bland Monetary Policy Statement, with very little variation in the forward track for key indicators.

As expected, the Official Cash Rate rises another 25 basis points to 3.25%, for a total 75 basis points rise since the current tightening cycle began at the March MPS, when the OCR moved from 2.5%.

At the March MPS, the RBNZ was explicit about expecting the OCR to rise to 4.5% over the next two years, but this month's MPS says only that "the speed and extent to which the OCR will need to rise will depend on future economic and financial data, and its implications for inflationary pressures."

The bank notes, without commentary, that forward swap rates indicate expectations of 15 basis points less tightening than previously expected over the year head. The assumed "neutral" OCR rate remains 4.5%.

The track for 90 day bill rates is slightly slower in the near term, but still eaching 5.3% in June 2017, in line with the March MPS. Quarterly GDP growth peaked in the March quarter and annual GDP will peak at 4% in the year to June. Sustainable annual output is still estimated to be around 2.75%.

The RBNZ notes "considerable momentum" in the economy, driven more by high immigration and construction than by export performance, which has peaked. While the terms of trade are expected to settle at historically high levels, underpinning domestic demand.

The TWI track is also roughly unchanged from March, although the bank anticipates a somewhat weaker currency in the near term, moving from a current high point of 80.0 to 77.7 by June 2015, and 74.6 at June 2017. Wheeler repeated the bank "does not believe the exchange rate is sustainable at current levels".

Some **key points** to note:

- the annual CPI now peaks at 2.1% in June 2015, compared with 1.9% at the last MPS, but moderates slightly through to the end of the forecast period, ending at 2.1% again June 2017.
- **the usual impact of OCR increases on mortgage rates is not occurring**. Bank funding costs have continued to fall. As a result, **2 and 3 year fixed rate mortgage rates are 15 basis points lower** now than they were at the beginning of the year, despite floating rates being 50 basis points higher. Despite LVR restrictions taking between 2.5 and 3.5 percentage points of heat out of house price inflation, the bank sways "**many high LVR borrowers presently face lower interest rates compared to the beginning of the year**".
- the **impact of increased housing construction** on the economic cycle will be "unusual" because of its expected longevity. Whereas construction activity generally follows the economic cycle, the bank says "over coming years construction is expected to remain elevated as a share of GDP, drawing on resources from other sources in which capacity pressures are moderating". Construction remains a key threat to inflation.
- **high net migration** remains an inflationary threat, although the extent to which it's driven by New Zealanders staying home rather than new arrivals means its **impact "may be more modest than in previous cycles"**. That said, the RBNZ sees upside risk for migration and includes a scenario in which the anticipated net 70,000 net inward migration over the next three years is raised to 113,000, with stronger pressure on house prices.
- **house price inflation is expected to moderate** as LVR's and higher interest rates have their impact. At present, Auckland house price inflation is running at 14.6%, Christchurch at 10.5%, and 4.3% elsewhere, for a national average of 8.5%.

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